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Brexit: potential implications for structured finance

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Introduction

On 23 June 2016 the UK voted to leave the European Union. This vote is expected to result in ending the UK's existing relations with the EU and putting in place a new framework for its future relationship with the EU. This note considers some of the potential implications of the vote for structured finance transactions. For a wider discussion of the impact of the vote see also "FAQs on the impact of the UK's vote to leave the EU" and "If the UK votes to leave the EU – assessing the impact".

In light of statements from the UK Financial Conduct Authority and the Governor of the Bank of England on 24 June 2016, there are not expected to be any immediate legal changes as a result of the vote. The UK Financial Conduct Authority statement included the following paragraph:

"Much financial regulation currently applicable in the UK derives from EU legislation. This regulation will remain applicable until any changes are made, which will be a matter for Government and Parliament. Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect".

As at the date of this note, it is impossible to tell what kind of agreement will be reached between the EU and the UK. Until the terms of the UK's leaving the EU and of its new relationship with the EU are known, the precise effect of the vote on structured finance transactions will remain unclear.

Withdrawal – timing and terms

The process for a member state to withdraw is dealt with, in fairly short form, in Article 50 of the Treaty on European Union. To initiate the process of withdrawing from the EU, the UK must give formal notice to the European Council of its wish to withdraw. There is no set deadline by which the UK has to serve this notice, however, David Cameron has stated that any Article 50 withdrawal notice will not be served until after his successor as Prime Minister has been appointed. Under Article 50, a withdrawal agreement between the UK and the EU will need to be approved by the Council, acting by a qualified majority (i.e. 72%, or 20 out of 27, of the member states representing 65% of the total EU population). The European Parliament, acting by a simple majority, will also need to approve the deal.

The UK will remain a member of the EU, and (existing and new) EU rules will therefore continue to apply to it, until conclusion of the withdrawal agreement. However, if there is no agreement within two years after the formal notification, the Treaty rights and obligations will automatically cease to apply, meaning that the UK could leave the EU without an agreement having been concluded. This two year period can be extended – but only by the unanimous consent of all member states.

The withdrawal agreement will set out the arrangements needed for withdrawal, including the steps needed to undo the many legal, political and other obligations between the EU, its institutions and the UK, and the framework required for the UK's future relationship with the EU. Where rights and

obligations are being terminated, transitional arrangements may be required to avoid unnecessary disruption to existing arrangements.

Withdrawal – legal consequences

EU treaties, directives, directly effective decisions and regulations, and rulings of the European Court of Justice would cease to apply to the UK upon its withdrawal from the EU, unless their effect was specifically preserved by English law.

EU-derived law applies in the UK through a number of routes and the impact of withdrawal will differ depending on the type of law and, where relevant, how it has been implemented in the UK. There are two broad categories: (1) those which are directly effective such as regulations (such as the Prospectus Regulation, the Capital Requirements Regulation and the (new) Market Abuse Regulation); and (2) those, typically directives (such as the Prospectus Directive, the Capital Requirements Directive, the Directive on the reorganisation and winding-up of credit institutions, the Bank Recovery and Resolution Directive and the Solvency II Directive), which have had to be implemented within the UK by national legislation.

The former would cease to have effect at the point at which the UK withdraws/the Treaty obligations cease to have effect under Article 50.

In relation to the second category, many of the EU directives have been implemented in the UK by powers conferred on ministers under the European Communities Act 1972 (ECA 1972). In principle, if the ECA 1972 is repealed by the UK Parliament, any legislation made under it would also be deemed to be repealed, unless a specific saving provision is made.

However, not all EU laws have been implemented under the ECA 1972. Some have been implemented by Acts of Parliament or through other measures. The repeal of the ECA 1972 would not of itself affect these provisions and so, absent other steps being taken, they would stay in force.

Given the wide reach of EU-derived legislation and the complexities of unpicking it, it will be very difficult for the UK to determine fully what legislation it wants to keep/repeal/amend by the time it withdraws. In many areas there is no particular reason to suppose that there would be a policy desire to make significant changes to domestic law as a result of Brexit.

Therefore, it is likely that the UK government will need to pass some kind of continuity order or savings provision keeping all relevant legislation in place, so far as practicable, until it is specifically repealed or amended. However, this is still likely to raise a large number of technical and interpretive issues, particularly on questions such as transitional arrangements, replacement of references to EU institutions (such as the EBA and ESMA) and the scope of application of European Court of Justice decisions.

So, it will still be necessary to ensure that these laws function properly in the new situation. For example, the meaning of legislation or rules referring to the EU may need to be clarified and powers given to EU institutions would need to be replaced by alternative arrangements.

Certain areas for focus for structured finance

Certain areas for focus in the context of structured finance transactions are set out below. Each of these will require analysis in light of the terms of the UK's withdrawal.

> Risk Factors/disclosure: Prior to the EU referendum, risk factors relating to Brexit had already become increasingly common. Going forward, the scope and nature of risk factors or other Brexit-related prospectus disclosure may be expected not only to reflect the more generic risks arising from the current uncertainties around the terms of UK withdrawal from the EU but (where appropriate) also should reflect the specific nature of an issuer and its business and/or (where applicable) the underlying assets. Hence the importance of due diligence as discussed above. Consideration may also need to be given to the impact of any downgrade of the UK sovereign rating.

  Absent any specific concerns, we do not expect that the result of the vote would, of itself, trigger a requirement for an immediate supplement to a prospectus under Article 16 of the Prospectus Directive as a "significant new factor", in particular where a prospectus already includes risk factors or disclosure on Brexit and in light of

the current uncertainty as to the terms of the UK's withdrawal from the EU.

> Passporting of prospectuses: Institutional only and other Prospectus Directive-exempt private placements of securities in the EU should be unaffected. However, with respect to an issue of securities that would constitute a non-exempt public offer pursuant to the Prospectus Directive, a prospectus approved by the UK Listing Authority may, when the UK leaves the EU, cease to be recognised as passportable under the Prospectus Directive and as a result, the offer of any such security in the EU may necessitate either a second prospectus or approval of the offer from a competent authority in the EU.

> Risk retention: The current EU risk retention regime applies to certain types of EU regulated investor (e.g. banks, fund managers, insurers), but was written to allow those investors to invest in non-EU securitisations. So after the UK has left the EU, although UK securitisations sold to EU investors will still need to comply with this regime, in many cases that should be relatively straightforward. However, where the risk retainer is relying on the definition of sponsor, but is not a credit institution, that definition requires a sponsor to be an investment firm subject to MiFID and after the UK has left the EU, UK financial institutions will no longer be subject to MiFID. Although UK regulated entities investing in securitisations will no longer be subject to the EU risk retention regime, it is highly likely that the UK will (at least initially) adopt a similar regime when it leaves the EU.

> Consumer credit and mortgage regulation: A great deal of EU consumer credit legislation has come from existing UK legislation, so in many respects little may change after the UK leaves the EU. To the extent that there are provisions which are in the Consumer Credit Act because they are requirements of the Consumer Credit Directive, these could be removed or simplified. However, consumer protection is one of the UK Financial Conduct Authority's key objectives, so it is questionable whether such changes will be on the agenda. Similar considerations apply to the requirements of the Mortgage Credit Directive, the implementation of which has introduced new provisions to UK mortgage regulation, including additional disclosure obligations. Although, after a UK exit from the EU these could be removed or simplified, they have a consumer protection purpose, so it is by no means certain that this would be politically palatable.

> Insolvency: The Insolvency Regulation applies across the EU and determines matters such as where insolvency proceedings may be opened (there is a rebuttable presumption that it should be in the member state where the insolvent company has its centre of main interests (COMI)) and the recognition of insolvency proceedings in other member states. When the UK leaves the EU, the Insolvency Regulation will no longer apply in the UK. As a result, when considering whether or not to commence UK insolvency proceedings in respect of a company incorporated in the EU, the relevance of that company's COMI would fall away. In contrast, if an insolvent company's COMI were in the UK, main proceedings could not be commenced in an EU member state, where the Insolvency Regulation would still apply.

A UK insolvency process would no longer benefit from automatic recognition in an EU member state, so the UK insolvency office holder would need to apply for such recognition under the relevant local law. Similarly, an EU insolvency process would no longer benefit from automatic recognition in the UK, so the relevant EU insolvency office holder would need to apply for such recognition under the UK regulations implementing the UNCITRAL model law.

Certain classes of entity are expressly excluded from the ambit of the Insolvency Regulation, but are instead subject to insolvency regimes set out in specific EU directives - for example, the regime for credit institutions is set out in the Credit Institutions Reorganisation and Winding-Up Directive. After a UK withdrawal from the EU, the provisions of English law implementing this directive will continue to apply, but the mutual recognition of bank insolvency processes between the UK and EU members states will disappear.

> ECB eligibility: When the UK withdraws from the EU, debt securities issued by UK issuers may cease to be eligible as collateral with the ECB. Firstly, a number of the eligibility requirements for asset-backed securities (ABS) require an EEA connection (for example, the underlying assets must be originated in the EEA and sold to the SPV issuer by an EEA seller). In addition, the acquisition of the underlying assets by the ABS issuer must be governed by the law of an EU member state. As a result, it is unlikely that UK ABS will continue to be eligible collateral with the ECB after the UK withdraws from the EU. Furthermore, when the UK withdraws from the EU, non-ABS debt securities (including covered bonds) issued by UK issuers may also cease to be eligible as collateral with the ECB unless the UK joins the EEA or the ECB recognises the UK (as a member of the G10) as a jurisdiction in which its rights would be protected in an appropriate manner. Under current ECB eligibility criteria, any debt securities would also need to be listed on a regulated market within the meaning of the Prospectus Directive or another acceptable market (which may not include a listing in London) and satisfy the other eligibility criteria.

> UK regulated covered bonds: When the UK withdraws from the EU, the preferential regulatory treatment of UK Regulated Covered Bonds may cease. The current regulatory position of UK Regulated Covered Bonds restricts the availability of preferential treatment (including with respect to investment limits, regulatory capital and liquidity standards, as under the UCITS Directive, the Capital Requirements Regulation and the LCR Regulation) to covered bonds issued by a credit institution with its registered office in an EEA state. The continuation of such preferential treatment will ultimately depend on the nature of the future relationship between the UK and the remainder of the EU.

> Eligible liquid assets: The Capital Requirements Regulation and the LCR Regulation impose requirements on EU credit institutions to hold a certain amount of liquid assets. Only those securitisations which comply with a specific set of conditions can qualify as liquid assets for these purposes and a number of those conditions preclude securitisations where the underlying debtors are not located in the EU. As a result, after the UK leaves the EU, many securitisations of UK assets which currently qualify as liquid assets under this regime will cease to do so.

> STS securitisations: The proposed Securitisation Regulation includes conditions which, if satisfied, will accord a securitisation a beneficial regulatory treatment. Although the regulation is currently going through the EU legislative process, one version of the proposal includes a condition that the originator, original lender and sponsor must be in the EU in order for a securitisation to qualify. If the Securitisation Regulation is finalised with this (or a similarly restrictive) condition, a securitisation with underlying assets originated by a UK originator would not be compliant after the UK leaves the EU.

> Swaps: There may be an immediate impact of the vote to leave the EU on existing ISDA master agreements stemming from wider economic and financial issues (for example, margin calls may be triggered where collateral denominated in GBP has been posted under a CSA or other collateral agreement (where the base currency is non-GBP), due to a weakening of Sterling. The longer-term outlook will, of course, depend on the terms of the UK's exit from the EU and its future relationship with it. However, the impact on the creditworthiness of certain counterparties as a result of economic and financial issues may increase the risk of: (1) credit rating downgrade Additional Termination Events; (2) "credit related" Events of Default; and (3) Credit Events under credit derivatives.

> Force majeure: Whether the UK vote or the UK withdrawal from the EU would of itself trigger a market standard force majeure clause will need to be judged according to the individual circumstances of a debt securities' issuance. For a force majeure to be triggered, in the context of a market standard clause, this requires both a change (or prospective change) in financial, political or economic conditions or currency exchange rates, and for the change to be likely to prejudice materially the success of the offering and distribution of the debt securities or dealings

in the debt securities in the secondary market. For any subscription agreements signed after the announcement of the leave vote on 24 June 2016, there will need to be a new event that amounts to such a "change".

> Bail-in and contractual stay clauses: Article 55 of the EU Bank Recovery and Resolution Directive (BRRD) requires EU member states to ensure that EEA financial institutions incorporate contractual recognition of write-down and conversion language into most agreements creating (and in some cases modifying) non-EEA law governed liabilities. When the UK leaves the EU, the BRRD would be likely to continue to apply in the UK, at least initially, given how embedded it is in English law. However, as the UK would likely no longer be part of the EEA, an English law governed bond would constitute a non-EEA law governed liability for (non-UK) EU financial institutions. Such bail-in language may therefore need to be included in agreements with EU banks as a party thereto which are governed by English law. Similar considerations will apply in relation to contractual stay requirements. These are rules which require BRRD undertakings to include provisions limiting counterparty termination rights in certain non-EEA law contracts, including contracts for the purchase and sale of securities (such as subscription agreements).

> TARGET2: TARGET2 can be connected to by central banks of Eurozone countries and non-Eurozone countries for payments in euro. The UK's position in relation to TARGET2 is therefore unlikely to change, at least initially, when the UK leaves the EU.

> References to "the European Union" or "European Economic Area": Each reference to "the European Union" or "European Economic Area" in a document would require analysis as to how it should be interpreted after a UK withdrawal. The withdrawal arrangements would be likely to address general contractual interpretation of such references.

> Governing law clause: The English courts are obliged by two EU Regulations (Rome 1 and Rome 2, in relation to contractual and non-contractual obligations respectively) to give effect to the parties' choice of law (subject to limited exceptions). If this legislation (or any equivalent) does not continue under English law after UK withdrawal from the EU, the efficacy of the parties' choice of law would largely remain. The English courts would, under English common law, uphold the parties' choice in relation to contractual matters. Although the position in relation to non-contractual matters is largely untested, the English courts would also be likely to uphold the parties' choice. EU courts would continue to apply Rome 1 and Rome 2, and so would continue to recognise the parties' choice of English law.

> Jurisdiction clause: Subject to limited exceptions, EU legislation gives effect to a clause in favour of the English courts by conferring jurisdiction on those courts and requiring any non-chosen EU court to decline jurisdiction (if the clause is exclusive). This legislation is principally set out in EU Regulation No. 1215/2012, known as the Brussels 1 Recast. When the UK leaves the EU, if the withdrawal negotiations resulted in none of this legislation continuing to apply to the UK, the English courts would, under English common law, accept jurisdiction on the basis of the parties' choice. However, the treatment of the clause in relation to any non-chosen EU court declining jurisdiction in favour of the English courts, as a third-party non-EU state, would be more complex, potentially depending on the application of the Brussels 1 Recast, the Lugano Convention 2007 or national law and so resulting in greater inconsistency. This may be off-set by more freedom for the English courts to protect their jurisdiction, principally by way of anti-suit injunction.

> Judgments: Within the EU, enforcement of court judgments is facilitated by the Brussels 1 Recast. This will cease to apply as regards the UK, when the UK leaves the EU. Whether anything will remain in place between the UK and EU would be a matter for the UK's withdrawal negotiations. Assuming, however, a "worst-case" scenario where nothing is left to fill the gap, then the enforcement of an English court judgment by courts in the EU would become a matter for

national law, which will vary and local law advice would therefore be required. Foreign judgments from EU member states would be enforceable in England pursuant to English common law. This would be more cumbersome procedurally than under the current EU regime, but otherwise there would be little practical impact.

> Data transfer: European data protection law contains a restriction on the transfer of personal data to non-EEA countries that the EU considers do not provide an adequate level of protection. The UK might seek a finding that it provides adequate protection as part of the exit negotiations on the basis that it has already implemented EU law. However, if the UK does not obtain an adequacy finding, the transfer of personal data from the EU to the UK would be subject to additional restrictions once it leaves the EU. In the context of a structured finance transaction, this may affect, for example, the transfer of data about underlying obligors located in the EU to an issuer or servicer located in the UK.

> Tax: The UK's VAT legislation will (at least initially) remain, but the tie between this and the underlying EU law will cease. This means that aspects of the UK's VAT rules may be interpreted differently and the UK government will be free to amend (or repeal) the VAT rules as it wishes. Over time, the divergence could become significant. On leaving, the UK will also become a non-EU member state for the purposes of assessing whether the rules on intra-EU supplies apply.

Most UK tax policies are not driven by the EU; however, there are some areas where the UK has had to make changes to its tax rules to comply with EU law. The UK government could, if it wished, reinstate the aspects of previous rules which were amended or repealed to avoid non-compliance with EU law.

There are also a handful of EU Directives relating to direct tax. Whilst the significance of these in the UK is relatively limited, the UK leaving the EU could affect how payments between the UK and EU member states are taxed in the EU member states in question.

> Other issues: Other issues may also impact structured finance transactions and require consideration. For example, and crucially, UK banks and branches may no longer benefit from EU passporting rights to do business throughout the EU. Clearing euro-denominated amounts in London may require analysis. Pan-European initiatives, for example in relation to developing a private placement market, may face more challenges.

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