29 May 2015

FINANCIAL MARKETS LAW COMMITTEE

Jonathan Faull
Director General, DG Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels
Belgium

Dear Mr Faull

"Building a Capital Markets Union"

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

On 18 February 2015, the European Commission published a Green Paper entitled "Building a Capital Markets Union" (the "Green Paper").[1] While it makes no comment as to matters of policy, the FMLC is supportive of the Capital Markets Union project and its objectives, which include diversifying the financing of the economy and improving access to financing for all businesses, especially SMEs.

One measure, which is identified in the Green Paper as an early priority, is the promotion and facilitation of high quality securitisation. This is initiated by a related Consultation Document entitled "An EU Framework for simple, transparent and standardised securitisation" (the "Securitisation Consultation Document").[2]

The FMLC has previously published various papers and letters highlighting issues of legal uncertainty which are of relevance to the Capital Markets Union project generally, as well as the Green Paper and Securitisation Consultation Document.[3] As a general response to question 32 of the Green Paper and to specific questions of the Securitisation Consultation Document and the Green Paper, the FMLC would like to draw to the attention of the European Commission FMLC papers and letters on four topics, in particular: (1) securitisation—risk retention; (2) securitisation—disclosure regimes; (3) collateral reuse; and (4) coordination in international financial regulation.

Securitisation—risk retention

In letters to the European Commission and European Banking Authority ("EBA") dated 7 December 2012, the FMLC outlined issues of uncertainty in the application of the European securitisation risk retention requirement—in particular as to the definitions of "originator", "original lender" and "sponsor"—to collateralised loan obligations ("CLOs").[4] The question at issue was whether parties to CLOs could safely rely on a flexible interpretation put forward by the Committee of European Banking Supervisors ("CEBS"), a predecessor body to the EBA.[5] Subsequently, the FMLC engaged with the EBA on this issue in the context of a consultation (EBA/CP/2013/4) on draft technical standards implementing Regulation EU/575/2013 on prudential requirements for credit institutions and investment firms (the "CRR").[6] In the course of finalising these technical standards (the "RTS"), the EBA rejected the flexible interpretation, thereby giving rise to discontinuity in the European regulatory approach to this issue.

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While it makes no comment as to matters of policy, the FMLC understands that the strict application of the securitisation risk retention requirement has had a detrimental effect on the European CLO market and has caused it to decline significantly—a decline which is also reflected in published statistics.[7] These are presumably unintended consequences of the legislation and the FMLC addresses the issue on that basis.

Question 3A of the Securitisation Consultation Document asks whether there are elements of the rules on risk retention which should be adjusted.[8] Acknowledging the conclusion reached by the EBA that CLOs should be subject to the risk retention regime,[9] in order to remedy the unintended consequences noted above, the regime needs to be adapted to fit CLOs better. The FMLC suggests that this could be achieved by codifying the flexible interpretation adopted by CEBS. If this is considered too great a departure from the current definition of "sponsor" in the CRR, another approach would be to amend that definition to remove the requirement for the relevant entity to be a credit institution or investment firm.

Securitisation—disclosure regimes

The FMLC has separately drafted a paper (the "Disclosure Paper"),[10] in response to the Securitisation Consultation Document, question 2.6 on standardisation, transparency and information disclosure. In the Disclosure Paper, the FMLC considers various transparency requirements applicable to securitisation transactions across jurisdictions, and in particular those that apply in the European Union, assessing the overlaps and inconsistencies between the different disclosure regimes and the possibility that a lack of standardisation may give rise to legal uncertainty in the legal framework of EU securitisation markets.[11] These issues and observations are also relevant to the Green Paper, which itself poses a number of questions about standardisation, transparency and information disclosure.[12]

The Disclosure Paper concludes by suggesting that the relevant legislation could usefully be rationalised and harmonised. Should the European Commission, having considered its priorities for Capital Markets Union, recommend standardising disclosure requirements, the FMLC would be delighted to assist in considering how to ensure those requirements are robust and preserve certainty in the legal framework of the wholesale financial markets.

Collateral reuse

The Green Paper notes the importance of, and increased demand for, collateral as a result of new regulatory requirements and a shift towards secured funding.[13]

It observes, however, that the fluidity of collateral throughout the EU is currently restricted, preventing markets from operating efficiently.[14] Question 27 of the Green Paper asks what measures could be taken to improve the cross-border flow of collateral.[15]

In a letter to the European Commission dated 10 February 2015, the FMLC raised issues of legal uncertainty in respect of the European Commission's Proposal for a Regulation on reporting and transparency of securities financing transactions (the "Proposed Regulation").[16] Article 15(1) of the Proposed Regulation introduces a transparency requirement applicable to securities financing transactions, whereby a receiving counterparty's entitlement to reuse collateral is subject to the conditions that the providing counterparty has (a) been informed of the risks of rehypothecation and (b) provided its consent to rehypothecation.[17]

In the letter, the FMLC notes, *inter alia*, that these conditions are illogical in the context of a title transfer financial collateral arrangement ("TTFCA"). As *owner*, the receiving counterparty has the right to reuse the collateral at its discretion, without any interference

from the providing counterparty which retains no interest in the collateral.[18] Accordingly, stipulating conditions for rehypothecation of the collateral is incongruous with the receiving counterparty being the owner and may risk introducing uncertainty into the legal framework for financial collateral arrangements.

As set out in the FMLC's letter, the Proposed Regulation is unclear as to the legal consequences of a breach of Article 15(1). In this regard, any uncertainty as to the validity or enforceability of a TTFCA would increase the risks for investors, banks and market infrastructure providers and could cause reluctance to lend. Further, measures which discourage collateral reuse will have the consequent effect of reducing the supply of collateral within the financial system, which is a concern that the Green Paper seeks to address. The FMLC therefore recommends that Article 15(1) is amended so that TTFCAs are outside its scope. (The Council and the Parliament have sought to address this legal uncertainty respectively in revised legislative texts; however, it has not been eradicated and remains a live issue.[19])

Coordination in international financial regulation

The Green Paper recognises that there are numerous barriers standing in the way of a Capital Markets Union, including legal barriers.[20] This is considered in more detail in the accompanying Staff Working Document which notes in particular a lack of harmonisation at the national level, "gold plating" by some Member States and a lack of convergence in the application of the regulatory frameworks created by the single rulebook.[21] The FMLC would add to this observation that these problems are exacerbated, for participants in cross-border markets, by a lack of harmonisation in the international implementation of G20 commitments. In this context the FMLC draws your attention to its recent discussion paper, "Coordination in the Reform of International Financial Regulation" which, in an annex, provides an overview of the areas in which overlaps and inconsistencies are causing greatest difficulty, many of which are pertinent to the issues raised in the Green Paper.[22]

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins

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FMLC Chief Executive

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1 Available at: http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf.

2 Available at: http://ec.europa.eu/finance/consultations/2015/securitisation/docs/consultation-document_en.pdf.

3 The FMLC's publications are available on its website: http://www.fmlc.org/publications.html.

4 http://www.fmlc.org/uploads/2/6/5/8/26584807/issue_168__letter_to_jonathan_faull_with_enclosure_2.pdf and http://www.fmlc.org/uploads/2/6/5/8/26584807/issue_168__letter_to_andrea_enria_with_enclosure_1.pdf.

5 The Guidelines, published in December 2010, can be found at: http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf

6 http://www.fmlc.org/uploads/2/6/5/8/26584807/168.pdf

[7] For example, see the table on page 13 of the Loans Syndications and Trading Association ("LSTA") 2013 publication entitled "Risk Retention and CLOs", available on the Federal Deposit Insurance Corporation website at https://www.fdic.gov/regulations/laws/federal/2013/2013-credit_risk_retention-staff_10-supp.pdf. The LSTA notes that "European CLO formation collapsed, due in large part to the risk retention rules".

[8] Page 8 of the Securitisation Consultation Document.

[9] See the EBA Report and opinion on Securitisation Risk Retention, Due Diligence and Disclosure dated 22 December 2014, pages 20 to 23 (the "EBA Report"). The EBA Report considers whether CLOs could be excluded from the risk retention requirement on the basis of the natural alignment provided by the structure of CLO managers' fees. It concludes, however, that they cannot, on the basis that the alignment provided by the management fees is not defined by law and is in substance different to the alignment created by retention of a net economic interest. The EBA Report also calls for a loophole in the definition of "originator" to be closed, however, this would not offer any assistance to the issues raised in this letter in respect of CLOs.

[10] "Issues of Legal Uncertainty in the Context of Securitisation Disclosure Regimes", May 2015, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_securitisation_disclosure_paper.pdf

[11] *Ibid.*

[12] *Ibid*, Section 4.1 "Standardisation as a mechanism to kick start markets", p. 15.

[13] See page 23 of the Green Paper.

[14] *Ibid.*

[15] *Ibid.*

[16] http://www.fmlc.org/uploads/2/6/5/8/26584807/letter_to_mr_jonathan_faull_on_the_proposed_regulation_on_securities_financing_transactions.pdf.

[17] The Council of the EU published a compromise proposal dated 14 November 2014, available at http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2015424%202014%20INIT, setting out its general approach to the Proposed Regulation (the "Council text"). This was followed by a report published by the European Parliament's Committee on Economic Affairs on 8 April 2015 available http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2015-0120+0+DOC+PDF+V0//EN. The report contains the European Parliament's suggested amendments to the Proposed Regulation (the "Parliament text"). Article 15(1) in both the Council text and the Parliament text differs from that set out in the Proposed Regulation. For example, where Article 15(1) of the Proposed Regulation applies to "rehypothecation", in both the Council text and the Parliament text, this is broadened to "reuse". On the basis that neither the Parliament text nor the Council text represents the final text, this letter (unless provided to the contrary) refers to Article 15(1) in its original form as set out in the Proposed Regulation.

[18] The collateral provider will only have a contractual claim against the collateral receiver for the delivery of financial instruments *equivalent* to the collateral: the collateral provider will not have a claim for redelivery of the actual collateral.

[19] The Council text states that the consent requirement is deemed to be fulfilled in the case of a TTFCA. The Parliament text goes further by providing that consent is not required in the case of a TTFCA. The receiving counterparty remains, however, subject to the requirement to inform the providing counterparty of the risks associated with a TTFCA. As such, the legal uncertainty remains: the disclosure requirement is at odds with the concept of ownership implicit in a TTFCA.

[20] Pages 3 and 4 of the Green Paper.

[21] Commission Staff Working Document entitled "Initial reflections on the obstacles to the development of deep and integrated EU capital markets", page 15 available at Initial Reflections on the Impediments to the Development of Deep and Integrated EU Capital Markets.

[22] http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_g20_discussion_paper.pdf. One of the areas identified is securitisation risk retention rules and the differences in implementation between the US and the EU. This is also picked up in the EBA Report – see pages 37 (a comparison table of the US and EU risk retention rules) and 39 to 41: "The EU regime and foreign legislation, if not harmonised, may drive a real wedge in the global securitisation markets and may further reduce EU issuers' ability to benefit from the global investor base and EU investors' ability to benefit from global securitisation investments".