

Managed Funds Association

The Voice of the Global Alternative Investment Industry

Washington, D.C. | New York | Brussels | London



30 October, 2023

Via email to: CP15_23@bankofengland.co.uk

Securitisation Policy team
Prudential Regulatory Authority
20 Moorgate
London
EC2R 6DA

Re: Consultation Paper CP15/23 – Securitisation: General Requirements

Dear Sir or Madam:

Managed Funds Association (“**MFA**”)¹ appreciates the opportunity to comment on Consultation Paper CP15/23 – Securitisation: General Requirements (the “**Consultation**”), published earlier by the Prudential Regulatory Authority (“**PRA**”).² We appreciate the efforts of the PRA to engage the manufacturers and investors of securitisations through this Consultation to facilitate the continued growth of the securitisation markets generally.

MFA represents over 170 alternative asset management firms, around half of whom have a presence in the UK and Europe.³ Our membership includes hedge funds, credit, and crossover funds that invest across a diverse group of investment strategies. We have a vital interest in ensuring that the UK remains a leading financial centre with a regulatory framework that promotes fair and efficient financial

¹ Managed Funds Association, based in Washington, D.C., New York, Brussels, and London, represents the global alternative asset management industry. MFA’s mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly \$2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

² PRA, CP15/23, Securitisation: General Requirements (27 July 2023), available at <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2023/cp1523-securitisation-general-requirements.pdf>.

³ The global alternative asset management industry, including hedge funds, credit funds, and crossover funds, has assets under management of \$4 trillion (Q4 2022). The industry serves thousands of public and private pension funds, charitable endowments, foundations, sovereign governments, and other global institutional investors by providing portfolio diversification and risk-adjusted returns to help meet their funding obligations and return targets.

markets, and which delivers the best possible outcomes for consumers, investors, and other market participants.

MFA supports the policy goals of securitisation generally, as securitisation is an important component of bank risk management practices. A bank that securitises loans no longer carry them on the bank's balance sheet, no longer has to reserve against those loans, and no longer needs to devote resources to administering and servicing those loans. The capital the bank previously maintained and spent servicing the loan portfolio is now freed for investment in development or expansion that benefits bank shareholders and the communities the bank serves. Investors in securitisations also benefit, as they now have access to a diversified asset class, often times at a higher yield than traditional fixed income investments, that also can serve as collateral against future investor borrowings.

Our comments centre around the collateral consequences of the EU/UK securitisation regime to investment managers, as purchasers of securities issued through a securitisation either as a direct investment or in the construction of a collateralized loan obligation (“CLO”). Artificial barriers and duplicative requirements of the securitisation rules have the potential to undercut the ability of banks to reduce risk – systemic and otherwise – from their balance sheets by making securitisation investments less attractive to investors. We ask that the PRA consider these knock-on effects as it evaluates the UK securitisation reforms and potential revisions.

A. Executive Summary

For the reasons set forth below, MFA recommends a shift in the approach of the UK regarding the appropriateness of imposing duplicative due diligence requirements on investment managers that are already subject to a range of initial and ongoing diligence requirements when considering a securitisation investment. We respectfully urge the PRA to consider the following key concerns, discussed in greater detail in subsequent sections of this letter:

- Investor Due Diligence
 - Investors such as asset management firms are currently subject to extensive due diligence requirements and managers, as purchasers of securitisation offerings, are fiduciaries to the funds they manage and as such have developed and use robust and evolving due diligence practices before investing.
 - Additional, duplicative due diligence requirements are not necessary and place UK-issued securitisations and UK-based managers at a competitive disadvantage with securitisations issued in other jurisdictions and non-UK managers.
- Cross-Border Issues
 - Both the securitisation markets and the private funds industry are global in nature, and as such it is important that the securitisation requirements in the UK reflect the fact that a manager investing in a securitisation vehicle in the EU on behalf of its clients may be domiciled in the EU, the UK, the US, or elsewhere, in addition to the securitisation offering originating from the US or elsewhere.

- The securitisation requirements in the UK should recognize the global, cross-border nature of securitisation offerings and permit a manager to invest in the securitisation if, as we discuss below, the offering is compliant with the requirements of the jurisdiction of the issuer.

B. Discussion

1. Duplicative Investor Due Diligence Requirements Create an Investment Disincentive for Managers

a. Policy Background

MFA's view is that alternative investment fund managers ("AIFMs") should not be subject to due diligence requirements under the UK's regulatory regime for securitisations that are duplicative and redundant to existing obligations.⁴ We have made similar comments to the FCA and FSB,⁵ and below we invite the PRA to consider the key policy drivers for making further changes to the proposed rules, as well as setting out our detailed response to the due diligence requirements.

MFA supports a definition of "institutional investor" that would remove AIFMs from the scope of the due diligence requirements. US-based AIFMs lawfully conducting business in the UK, for example, would not be "institutional investors" for purposes of the UK's securitisation rules and therefore would not be subject to additional due diligence requirements.⁶ While we would welcome this clarification, we note that non-US AIFMs are now at a greater competitive disadvantage to their US-based counterparts because of the duplicative and redundant due diligence requirements. We below recommend recognition of substantively equivalent jurisdictions to facilitate greater investment in securitisations globally.

In our view, it is not appropriate or proportionate for UK AIFMs to be subject to the same investor due diligence requirements as, for example, UK banks and insurance companies, because their business models, sources of capital and clients differ fundamentally. In each case, banks and insurance companies must consider the interests of their shareholders and, respectively, the interests of their depositors and policyholders. The same cannot be said of EU AIFMs.

Depositors and policyholders of UK banks and insurance companies, respectively, tend to be domiciled in the UK since banks and insurance companies, for example, cannot easily obtain customers from other countries. UK banks and insurance companies also tend to have large numbers of UK retail and other shareholders (even if the largest shareholders tend to be international asset managers). The failure of a UK bank or insurance company because of poor decision-making would have a significant

⁴ See Consultation, at §2.8.

⁵ Letter from Managed Funds Association to Financial Conduct Authority (14 Jun. 2023), avail. at www.managedfunds.org/wp-content/uploads/2023/06/MFA-Letter-to-FCA-UK-Securitisation-Regulation-6.14.2023.pdf; Letter from Managed Funds Association to Financial Stability Board (30 Oct. 2023), avail. at www.managedfunds.org.

⁶ UK-based managers, however, would be subject to duplicative and redundant due diligence requirements which, as we suggest below, should be revised to promote greater investment in global securitisations generally by recognizing jurisdictional equivalencies in securitisation regulations.

detrimental effect not only on shareholders, depositors, and policyholders in the UK from a financial and societal perspective, but also on business confidence in the UK generally.

UK AIFMs, on the other hand, typically form alternative investment funds (“AIFs”) in offshore jurisdictions and have a very different profile. First, the investor base in AIFs is typically institutional only, rather than retail, and investors in the AIF may be insurance companies, pensions, family offices, or endowments. Second, the AIF itself is more likely to be global in nature, rather than based in the UK. The impact of the failure of a UK AIFM, therefore, is that the institutional investors that invested in that AIF would lose the amounts invested in that AIF, but there would not be the kind of broad detrimental impact of the kind suffered by UK banks and insurance companies.

In consideration of these fundamental differences, there also should be a distinct approach for rulemaking with respect to AIFMs, namely, removing the investor due diligence requirements for AIFMs altogether and thus ensuring that UK AIFMs can compete with non-UK AIFMs.

We recognise that the application of due diligence requirements to institutional investors is principally a matter for member states to consider. Accordingly, we would encourage the PRA to engage in further conversation with member states to achieve a more proportionate outcome for UK AIFMs. As discussed further below, AIFMs are already subject to the risk management obligations. As a result, they are required to apply a high standard of scrutiny to all investment opportunities. MFA considers it disproportionate to impose additional regulatory burdens with respect to investments in securitisations, given the rigorous due diligence procedures currently required of AIFMs.

b. Risk-Retention Due Diligence

MFA would respectfully suggest that the risk retention due diligence requirement under existing rules has been particularly damaging to AIFMs. It has restricted investment opportunities to risk retention compliant securitisations, often with the result that AIFMs are unable to invest in securitisations whose sponsors or originators are established outside of the UK. This remains a key concern for MFA member firms.

We also note that this requirement has had the unintended consequence of encouraging non-UK AIFMs to resort to alternative fund structures to facilitate greater investment opportunities for their investors. For example, in order to invest in a US CLO, UK investment management firm might structure the business so that, instead of using a UK AIFM in its group, a non-UK AIFM is used instead, with such non-UK AIFM then delegating portfolio management discretion to the staff in the UK (assuming the UK AIFM has MiFID top-up permissions). Once again, this creates anti-competitive results for UK AIFMs and prevents them from maximising potential returns. Such a result also creates legal and compliance risk as the delegation must be documented and then managed on an ongoing basis.

Accordingly, we respectfully request that offshore AIFMs be excluded from the scope of the due diligence requirements. At a minimum, we encourage the PRA to consider removing AIFMs from the scope of the due diligence requirements to promote investments in the global securitisation market and allow AIFMs to diversify their portfolio risk.

c. Information Due Diligence

MFA welcomes a “principles-based” approach to rulemaking for institutional investors such as AIFMs.⁷ It is wholly appropriate to allow institutional investors to determine the scope and content of disclosures required for the purpose of their due diligence. We note that MFA members typically have found the reporting templates prescribed under the non-US due diligence requirements to be no more informative than information that they would otherwise have requested as part of their typical due diligence procedures when deciding whether to invest in a securitisation. Institutional investors should not be required to request reports in the form of prescribed templates (or anything “substantially the same” as these templates).

While we agree that AIFMs should receive information to enable them to independently assess the risks of investment opportunities, it is unnecessary (and we would potentially not useful) to prescribe the information that they need to obtain specifically with respect to investments in securitisations. Institutional investors typically do not rely on standardised due diligence templates to inform risk management decisions. In practice, AIFMs are already required to maintain due diligences procedures, which applies to all investment positions held by the relevant AIF (whether that be a securitisation position or otherwise).

In particular, we note the emphasis on risk management in existing rules.⁸ As discussed in greater detail below, AIFMs currently are required to maintain systems in order to identify, measure, manage and monitor the risks associated with the investment position of an AIF.⁹ This is aligned in principle with the requirement to assess the risks of holding the securitisation position. In addition, AIFMs must maintain documented due diligence processes on an ongoing basis,¹⁰ including appropriate stress testing procedures.¹¹

In our view, there is no added benefit in prescribing a list of due diligence requirements, or the details of monitoring procedures, for investments in securitisations when existing requirements already provide adequate coverage. Therefore, in the interest of proportionality, we would encourage a principles-based approach with respect to AIFMs by removing the due diligence requirements from the securitisation regulation and the related risk assessment and ongoing monitoring requirements.

d. AIFMs Are Already Subject to Due Diligence Requirements and as Such It Is Unnecessary to Subject Them to Additional, Duplicative Requirements in Securitisation Regulations

AIFMs are sophisticated buy-side firms, who have a fiduciary duty to their investors and operate in a highly regulated environment. The relationship between an AIFM and its AIF’s investors is subject to detailed disclosure and contractual requirements that underpin and govern the benefits and burdens

⁷ See Consultation, at §2.21.

⁸ FUND 3.7.5 R(1) and (2)

⁹ FUND 3.7.5 R(2)(b)

¹⁰ FUND 3.7.5 R

¹¹ See FUND 3.7.5 R (2)(a) and (b).

imposed on each party. Under global regulatory frameworks, they are subject to high standards of governance, compliance, and risk management.

In the EU and the UK, AIFMs are already subject to specific risk management and due diligence requirements in respect of their AIFs under Article 15 of the Alternative Investment Fund Managers Directive (“**AIFMD**”), which was implemented in the UK under Chapter 3.7 of the FCA FUND Sourcebook.

In particular, FUND 3.7.5 R provides:

- “1. (a) An AIFM must implement **adequate risk management systems** to identify, measure, manage and monitor all risks relevant to each AIF investment strategy and to which each AIF is, or may be, exposed.
- (b) In particular, an AIFM **must not solely or mechanistically rely on credit ratings** issued by credit rating agencies ... for assessing the creditworthiness of the AIF’s assets.
2. An AIFM must, at least:
 - (a) implement an appropriate, documented and regularly updated **due diligence process** when investing on behalf of the AIF, according to the investment strategy, objectives and risk profile of the AIF;
 - (b) **ensure that the risks** associated with each investment position of the AIF and their overall effect on the AIF’s portfolio **can be properly identified, measured, managed and monitored** on an ongoing basis, including through the use of appropriate stress testing procedures; and
 - (c) **ensure that the risk profile of the AIF corresponds to the size, portfolio structure and investment strategies and objectives of the AIF** as set out in the instrument constituting the fund, prospectus and offering documents.” (Emphasis added)

That is, UK and EU authorised AIFMs are already subject to strict due diligence and ongoing monitoring requirements. The Central Bank of Ireland imposes a similar due diligence requirement on AIFs organised in Ireland.¹² In addition, the requirement not to “solely or mechanistically rely on credit ratings” addresses indirectly the poor practices of the rating agencies and more directly of IKB and other banks that invested in securitisations on the basis of credit ratings without proper diligence.¹³ There is no need in our view to replicate such requirements specifically for securitisations, when AIFMs are able to make risk-based decisions, without separately mandated due diligence requirements, to invest other

¹² Central Bank of Ireland, [AIF Rulebook](https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/aifs/guidance/aif-rulebook-march-2018.pdf) (Mar. 2018), at §4.iii (available at <https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/aifs/guidance/aif-rulebook-march-2018.pdf>).

¹³ See note 15, *infra*.

assets that may have higher risk profiles, such as crypto-assets or complex derivatives.

Instead of improving risk management, the due diligence requirements under the UK Securitisation Regulation (EU) 2017/2402 (“**Sec Reg**”) have created an unnecessary barrier to investment, hindered global investment management strategies of many AIFMs and dampened the participation by AIFMs in the securitised markets generally. MFA of course recognises the importance of protecting investors, and AIFMs are well-equipped to understand the risks of their investment opportunities – robust risk management is core to AIFM business models generally – and investors demand no less through initial and ongoing due diligence of the AIFM. As noted above, AIFMs currently are required under the AIFMD/FUND 3.7 to have robust internal due diligence processes to help them make meticulous, well-informed investment decisions, regardless of the views of rating agencies, and regardless of their obligations under the Sec Reg. The due diligence requirements under the Sec Reg also create unnecessary limitations on AIFMs who otherwise do not face mandated investment limitations (this stands in contrast to UCITS management companies, and UCITS shares are sold widely to retail investors). In addition, investors in AIFs are typically experienced, large institutional investors, who are provided with detailed pre-contractual disclosures under the AIFMD and carry out extensive diligence on AIFs and their AIFMs before investing.

2. Securitisation Requirements Should Recognize the Functional Equivalence of the Jurisdiction of the Issuer

a. The Due Diligence Requirements Originated Principally Because of Bank Failure – Not AIFMs

It is important to recall the context behind due diligence requirements under the EU Securitisation Regulations that the Consultation is proposing to incorporate into UK rules. Investor due diligence requirements were introduced into the EU regulatory framework in response to the US subprime crisis in 2007-08, which was the primary catalyst for the Global Financial Crisis (“**GFC**”). That crisis was compounded by the prevalence of the “originate to distribute” model, which was commonly used by banks to shift sub-investment grade loans off balance sheets and shed the associated credit risk by effectively transferring the risk of these loans to investors in securitised products. The effect of the crisis was felt globally and securitisations were identified as a chief cause, albeit not the sole cause. As the European Commission (the “**Commission**”) observed at the time: “[T]he impact on EU banks was huge as they are exposed via securitisation to the risks that originate from the US.”¹⁴

High profile collapses in the banking sector raised concerns about the conduct of originators and investors in the securitisation market. A common theme was an overreliance on credit ratings of

¹⁴ Accompanying document to the Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, Impact Assessment COM(2008) 602 final, p. 17 (avail. at: https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2008/sec_2008_2532_en.pdf) (“**Securitisation Directive**”).

collateralised debt obligations.¹⁵ Many banks were publicly supported by their respective home governments (and thus their taxpayers) as a result.

It is critical to contrast the banks' public backstopping with the experience of AIFMs investing in securitisations during the period leading up to and following the GFC. Any losses sustained by AIFs did not affect retail investors or the wider financial system, as the losses were contained to the fund and experienced by the institutions and sophisticated investors who were fully apprised of the risks of investing. There was no taxpayer support required to protect the larger financial ecosystem from the activities of AIFMs, nor was any such support provided (or indeed available).

To address the issues faced by credit institutions, the Commission proposed amendments to the EU Capital Requirements Directive ("**CRD II**"). In the Impact Assessment accompanying the Commission proposal for CRD II,¹⁶ the Commission focused on the losses of EU banks and poor internal risk management more generally. The CRD II amendments mandated that no credit institution would be allowed to become "exposed" to a securitisation position unless the originator, sponsor or original lender retained, on an ongoing basis, a "material net economic interest" of at least 5 percent in the securitisation. Article 122a of CRD II also contained disclosure requirements for sponsor and originator institutions towards investors and obligations for sponsors and originators to ensure the application of the same sound and well-defined criteria for credit-granting with respect to exposures to be securitised and exposures to be kept in the institution's books.

The CRD II amendments (and the accompanying restrictions on resecuritisations in the subsequent EU Capital Requirements Directive (known as CRD III)) were then consolidated in 2019 for other EU financial institutions, including investment firms, insurance and reinsurance undertakings, occupational pension schemes, AIFMs and UCITS management companies, in the EU Sec Reg.

The approach taken in the EU and UK was different than that taken in the US under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd Frank**"). Like CRD II, Dodd-Frank included a 5 percent risk retention requirement and enhanced disclosure requirements; however, the requirement there was (and continues to be) for the originator/sponsor to retain the risk, rather than prohibiting the investor institution from investing unless the originator/sponsor retained the risk. MFA

¹⁵ One of the first banks to collapse was the German bank IKB Deutsche Industriebank AG, whose downfall was publicly linked to its asset-backed commercial paper (ABCP) conduit which invested heavily in subprime collateralised debt obligations (CDOs). IKB's failure was considered to be emblematic of wide-spread over-reliance on ratings agencies and a lack of due diligence practices deployed by banks. The rating agencies received their own share of criticism for lacklustre methodologies and a failure to appropriately consider risks associated with securitisations. In the Commission's view, had IKB conducted adequate due diligence on the CDOs that its conduit was holding, it would have looked beyond the AAA ratings of the CDOs and conducted its own examination of the quality of the underlying assets (which were often subprime asset-backed securities). As a result of the inadequate efforts of the rating agencies and what in hindsight were judged to be limited due diligence practices deployed by banks, retail depositors and shareholders suffered large losses globally, leading to a widespread lack of confidence in the banking sector.

¹⁶ See Securitisation Directive, at Art. 122a.

questions the merit of penalising the investor for the failure of the sponsor/originator from complying with the risk retention requirement. The effect is that US institutional investors in securitisations face far fewer impediments than EU/UK institutional investors in securitisations. It is thus no surprise that the US securitisation market has made a stronger, faster, and broader recovery from the GFC than the European securitisation market, and moreover that US companies have had greater access to capital and loans than UK or EU companies, and therefore have recovered more quickly in the wake of the GFC.

There are clear links to problems many areas of the broader EU and UK economies have in finding appropriate sources of finance to support their ongoing growth. For example, the Governor of the Bank of England amongst many other commentators identified “... The need to finance investment to support stronger potential growth, from its current weak level.”¹⁷ The Commission itself recently acknowledged that the US securitisation market grew “substantially” between 2015 and the end of 2021, whilst the EU market shrunk.¹⁸ Disparate regulatory burdens are not likely the sole cause for this divergence, but they cannot be wholly discounted as a contributing cause.

MFA recognises and appreciates the policy behind these initial measures in CRD II. Strong regulatory efforts in this area have had positive impacts on risk management and transparency of information in the banking sector, and MFA members have embraced their role as risk managers and the importance of the buy-side in a robust, thriving securitisation market. Wider regulatory reforms have effectively muted a culture of excessive risk-taking in the financial services sector – both for banks and non-prudentially regulated firms. If the FCA were to introduce greater proportionality into the regulatory framework by removing due diligence requirements under the UK Sec Reg and non-EU AIFMs, the regulatory infrastructure would be enhanced for the benefit of all market participants.

b. The Disparate Impact of Local Regulations Are Likely a Contributing Factor to the Uneven Recovery in the Securitisation Markets Globally

The securitisation markets in the US have recovered from the GFC more quickly and fully than in the UK and the EU. MFA would suggest that a principal reason is that the US requirements impose comparable risk retention requirements but rely on the existing due diligence requirements imposed on managers as fiduciaries to the funds they manage. The requirement to verify risk retention is a particularly difficult criteria for AIFMs to satisfy when investing in international markets. MFA members have found that US securitisations that are compliant with the risk retention requirements under the Sec Reg are in the minority, in spite of the fact that US originators/sponsors are required to retain an interest in transactions, but they are able to do so through different prescribed modalities, which can make it challenging for an AIFM to verify on a deal-by-deal basis.

¹⁷ Monetary and Financial Stability: Lessons from Recent Times, Speech by Andrew Bailey, Washington D.C. (12 Apr. 2023), available at <https://www.bankofengland.co.uk/speech/2023/april/andrew-bailey-remarks-at-the-institute-of-international-finance>.

¹⁸ Report from the Commission to the European Parliament and the Council on the functioning of the Securitisation Regulation COM(2022) 517 final, p. 5., available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2022:517:FIN>.

If, notwithstanding the arguments presented above, the PRA elects not to remove the risk retention due diligence requirements for AIFMs, then MFA would propose that – at a minimum – the reformed securitisation framework should allow AIFMs to invest in securitisations in foreign jurisdictions that have similar rules relating to risk retention and deliver similar outcomes as regards investor protection.

Similarly, MFA submits that if local law does not require risk retention for certain types of securitisations, the UK rules should recognise and give comity to the compliance with local, applicable non-UK rules. For example, in the US, sponsors of open-market CLOs are not required to retain an interest in the transaction. UK AIFMs, for example, should not be prevented from investing in such US open-market CLOs as a result. The regulatory focus should be on the nature of the securitisation and the laws which govern it, rather than the domicile of the fund which is investing. Such an approach would considerably enhance the competitiveness of non-US issuers, rather than applying additional and artificial barriers to the performance of UK AIFMs that will further hinder the long-awaited recovery of the UK securitisation market.

* * * * *

MFA recognises fully that balancing securitisation regulations against the competing needs of issuers, investors and their managers, and the markets more generally, is challenging. We look forward to working with the PRA to fine-tune the balance to allow the non-US securitisation markets to realise the same recoveries that the markets have experienced elsewhere.

MFA would be more than happy to elaborate on the points contained in this letter, should the PRA wish to engage in further conversation. If you have any questions regarding this letter, or if we can provide further information, please do not hesitate to contact the undersigned at JHan@managedfunds.org or Jeff Himstreet at JHimstreet@managedfunds.org.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President and Chief Counsel
Head of Global Regulatory Affairs
Managed Funds Association