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Roadmap to securitisation in Luxembourg

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Why Luxembourg?

Luxembourg has for long been at the forefront of the trends and evolutions of the financial markets. It grew to become a well-established financial centre in Europe with worldwide recognition, known as one of the world's safest and business friendly environment. Issuers, investors and other actors benefit in Luxembourg from comprehensive and stable regulatory and tax frameworks, within the environment shaped by European Union directives and regulations.

Structured finance and securitisation in particular are no exemption to this mind-set. The innovative and pragmatic framework initiated over fifteen years ago by the Luxembourg law of 22 March 2004 on securitisation (as amended, the **Securitisation Law)** has ever since quickly adapted to address the evolutions of the business and legal practices surrounding securitisation transactions. The purpose of the Securitisation Law was from its inception to create a comprehensive, flexible, efficient and reliable legal and tax framework for securitisation transactions carried out through Luxembourg securitisation undertakings (*organismes de titrisation*) (hereafter, **Securitisation Undertakings**). The Securitisation Law allows for the securitisation of almost any kind of risks and assets. The number of Securitisation Undertakings incorporated in Luxembourg has been steadily growing since the entry into force of the Securitisation Law, now reaching over 1,350 Securitisation Undertakings, the majority of them being established as multi-compartments structures.

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Starting point: setting-up a Securitisation Undertaking

Company vs. Fund

A Securitisation Undertaking can be structured as a company or as a fund. When taking the form of a company, the Securitisation Undertaking can be established as a public limited liability company (*société anonyme*), a corporate partnership limited by shares (*société en commandite par actions*), a private limited liability company (*société à responsabilité limitée*) or a cooperative company organised as a public limited liability company (*société coopérative organisée comme une société anonyme*). The minimum share capital for a société anonyme is EUR 30,000 and for a *société à responsabilité limitée* EUR 12,000.

Alternatively, a Securitisation Undertaking can be set up as a securitisation fund. A securitisation fund is a sui generis type of funds created by the Securitisation Law. Unlike securitisation companies, securitisation funds do not have legal personality or their own assets. Rather, a securitisation fund consists of a pool of assets managed by a management company. The Securitisation Law allows securitisation funds to be structured in two ways: (i) as a co-ownership of assets (*co-propriété*) in which the investors have a right in rem over a portion of the relevant underlying securitised assets, or (ii) as a fiduciary property (in the sense of the Luxembourg law of 27 July 2003 on trust and fiduciary contracts). In the latter case, the management company will hold the securitised assets as fiduciary property (which will be segregated from its own assets). Whilst securitisation funds have been relatively seldom used in the past, there is a tendency to rely more and more on these structures in particular because of (i) their flexibility in terms of set up and (ii) the fact that they are exempted from the application of certain rules and regulations, notably from a tax perspective.

The articles of association of a Securitisation Undertaking or, as the case may be, the management regulations, must include a specific reference and submission to the Securitisation Law and specify whether the Securitisation Undertaking is set up as a regulated or unregulated vehicle. The constitutional documents of Securitisation Undertakings also customarily include limited recourse and non-petition provisions (specifically envisaged by the Securitisation Law and deviating from standard Luxembourg law provisions).

Definition of securitisation

"Securitisation" is defined in the Securitisation Law as the transaction by which "a securitisation undertaking (*organisme de titrisation*) acquires or assumes, directly or indirectly through another undertaking, risks relating to claims, other assets, or obligations assumed by third parties or inherent to all or part of the activities of third parties, and issues securities (*valeurs mobilières*), the value or yield of which depends on such risks". It is worth noting that this definition is much broader than the traditional understanding of securitisation, notably securitisation as it is understood in the relevant EU regulations, making the Luxembourg securitisation regime among the most flexible and efficient regimes worldwide.

The definition of securitisation in the sense of the Securitisation Law requires a few additional words on (i) the risks that can be assumed by a Securitisation Undertaking and (ii) the financing options for Securitisation Undertakings.

(i) Securitisable risks

A wide variety of risks can be securitised: risks relating to the holding of assets, whether movable or immovable, tangible or intangible, as well as risks resulting from the obligations assumed by third parties or relating to all or part of the activities of third parties. Securitisation transactions in Luxembourg traditionally include commercial loans, mortgage loans, car lease receivables, commercial receivables, consumer credits, non-performing loans, commodities, intellectual property rights, income from operating businesses, etc. – in theory, pretty much any kind of asset could be securitised.

The Commission of the Financial Sector (*Commission de Surveillance du Secteur Financier*) (the **CSSF**) has confirmed in its Frequently Asked Questions guidance on securitisation issued in 2013 (the **CSSF FAQ**) that a Securitisation Undertaking may originate loans in specific circumstances, and this operation will be regarded as a securitisation, provided that:

- the Securitisation Undertaking does not use funds collected from the public to engage in credit activities for its own account; and
- the issuance documentation of the securities (a) clearly defines the assets on which the service and the repayment of the loans granted by the Securitisation Undertaking will depend or (b) clearly describes (i) the borrowers and/or (ii) the criteria for the selection of the borrowers (the rationale aiming at allowing investors to gain adequate knowledge of the risks (including credit risk) and the return on their investments at the time of issuance of the securities).

The features of the loans granted by the Securitisation Undertaking will in any event need to be described in the issuance documentation.

The CSSF further accepts the securitisation of commodities provided that the acquisition of such commodities aims at providing financing to an entity and that the commodities constitute a collateral securing the repayment obligations of such entity.

Assets securitised by Securitisation Undertakings are often located outside of Luxembourg.

(ii) Financing of Securitisation Undertakings

The acquisition of the securitised risks by a Securitisation Undertaking must be financed through the issuance of securities (*valeurs mobilières*), the value or yield of which is linked to such risks. Whilst the Securitisation Law does not define "securities", the CSSF considers in its CSSF FAQ that (i) instruments that are considered as securities under their governing law (*lex contractus*) and (ii) instruments that constitute securities within the meaning of Directive 2014/65/EU on markets in financial instruments (the **MiFID II**) qualify as securities for the purpose of the Securitisation Law.

A Securitisation Undertaking may issue equity securities and debt securities in bearer, registered or dematerialised form. It can also issue securities whose value or yield is linked to specific compartments, assets or risks, or whose repayment is subject to the repayment of other instruments, certain claims or certain categories of shares.

A Securitisation Undertaking is allowed to temporarily rely on loans in order to pre-finance the acquisition of the risks to be securitised ahead of the actual issuance of the securities (warehousing). Borrowing can otherwise only be used on an ancillary basis, for instance in the form of liquidity facilities in case of lack of synchronisation between the cash flows relating to the securitised assets and the financial flows relating to the issued securities and/or credit lines temporarily necessary for the purpose of the securitisation. Investors' return can be leveraged through external loans provided that such borrowing remains ancillary and relatively limited with regard to the value of the issued securities. The relevant transaction documents must in any event properly disclose additional risks resulting from such leverage.

Acquisition of securitised assets

A Securitisation Undertaking may assume the securitised risks either by acquiring the assets directly (true sale) or by acquiring a "synthetic" exposure to the assets, notably through the use of derivative agreements.

The Securitisation Law shapes a protective and specific framework surrounding the acquisition of claims. It provides that the law governing the assigned claims governs the assignability of such claims, the relationship between the assignee and the debtor and the conditions under which the assignment will be effective against the debtor.

Such governing law will also determine the conditions for the valid discharge of the debtor's obligations. The Securitisation Law provides that the assignment of an existing claim to, or by, a Securitisation Undertaking becomes effective between the parties and against third parties as from the moment the assignment is agreed upon among the parties (unless agreed otherwise). It is also possible to assign future claims not yet in existence at the time of the entry into the securitisation transaction documents.
The assignment of claims to, or by, a Securitisation Undertaking entails by virtue of Luxembourg law the transfer of any underlying guarantees and security interests relating to such claims. The Securitisation Law further also provides that the law of the State of the assignor will be applicable in respect of the opposability of the assignment of claims towards third parties.

Passive management of securitised assets

Pursuant to the Securitisation Law and the CSSF FAQ, a Securitisation Undertaking must have a passive attitude when managing its assets. This essentially means that the Securitisation Undertaking should limit its activities to the administration of financial flows linked to the securitisation transaction and to the 'prudent-man' management of its assets. A Securitisation Undertaking can, as a rule, not generate by virtue of its activities additional risks or carry out activities that would result it being viewed as entrepreneur (typically activities which aim at creating additional wealth or promoting the commercial development of the Securitisation Undertaking would not be in line with the Securitisation Law).

The Securitisation Law also restricts the granting of security interests and guarantees by Securitisation Undertakings. A Securitisation Undertaking can only grant security interests over its assets in order to secure the obligations it has assumed for the securitisation or in favour of its investors. Security interests and guarantees created in violation of this restriction are legally and automatically void by virtue of the Securitisation Law.

Compartmentalisation

One of the main specificity of the Luxembourg securitisation framework and which is pretty unique in Europe lies in the fact that the estate of a Securitisation Undertaking can be segregated into different compartments, each representing a distinct part of the assets and liabilities of the Securitisation Undertaking. The Securitisation Law enables the segregation of the assets and liabilities of the Securitisation Undertaking among various compartments, whereby assets and liabilities become ring-fenced between each compartment. Compartments do not have distinct legal personality from the Securitisation Undertaking, meaning that towards third parties such compartments will always be represented by the Securitisation Undertaking acting on their account.

In this framework, the right of recourse of the investors and creditors are as a rule limited to the assets of the Securitisation Undertaking or the relevant compartment (only). Thus, where rights relate to a specific compartment or have arisen in connection with the creation, operation or liquidation of a specific compartment, the recourse of the relevant investors and creditors will then be limited to the assets of that specific compartment.

Compartments can be liquidated separately without affecting the status of the Securitisation Undertaking as a whole or any of its other compartments.
The creation of one or more compartments is entrusted with the management body of the Securitisation Undertaking, thereby ensuring a cheap and straightforward set up process.

Non-petition and limited recourse clauses

The Securitisation Law explicitly recognises the validity of non-petition and limited recourse clauses. Such clauses will typically be foreseen in the constitutional documents of the Securitisation Undertaking and in the contractual documentation with its investors and third parties. The effectiveness of such clauses contributes to the insolvency remoteness character of Securitisation Undertakings.

In order to improve their insolvency remoteness status, Luxembourg securitisation structures often also feature an orphan vehicle (typically a Dutch *stichting*) as sole shareholder of the Securitisation Undertaking company, thereby ensuring a clean segregation between the securitisation structure and the other parties involved (e.g. originators, sponsors, etc.).

Drive carefully: regulatory aspects

Supervision

The vast majority of Securitisation Undertakings are unregulated entities not subject to any prior authorisation or prudential supervision from the CSSF (there are currently 33 regulated Securitisation Undertakings in Luxembourg). A Securitisation Undertaking will need to be authorised by the CSSF when (i) issuing securities to the public, and (ii) on a continuous basis (cumulative criteria).

- **Continuous basis:** a Securitisation Undertaking will be deemed to issue securities on a continuous basis where it making more than three issues per year. For multi-compartments Securitisation Undertakings, this threshold is assessed at the level of the Securitisation Undertaking on a consolidated basis and not at the level of each compartment.
- **To the public:** the concept of public is not defined in the Securitisation Law, and differs from the concept of "offer to the public" pursuant to the Luxembourg law of 16 July 2019 on prospectuses for securities. The CSSF has provided guidance in this respect and considers that in certain circumstances, issues of securities will be considered not to be made to the public. This is the case for issues of securities exclusively addressed to professional clients (as defined in Annex II of MiFID II) which are not considered to be made to the public for the purpose of the Securitisation Law. Securities having a nominal value of at least EUR 125,000 each are also assumed to have not been issued to the public. The CSSF FAQ further indicates that a listing of securities issued by a Securitisation Undertaking will not automatically result in the securities being viewed as issued to the public. As a rule, private placements of securities should not constitute issues to the public. The characterisation of 'private placement' must be assessed on a case-by-case basis and, for example, the subscription of securities by an institutional investor or financial intermediary with a view to a subsequent placement of such securities to the public will qualify as an issue made to the public for the purpose of the Securitisation Law.

Securitisation Undertakings issuing securities to the public on a continuous basis need to be authorised and will be supervised by the CSSF. The application process entails the approval of the constitutional documents, shareholders and management of the Securitisation Undertaking by the CSSF. Whilst unregulated Securitisation Undertakings are not required to appoint a custodian bank, regulated Securitisation Undertakings have to entrust the custody of their liquid assets and securities with a credit institution established or having its registered office in Luxembourg. Regulated Securitisation Undertakings are required to comply with ongoing and periodic reporting and disclosure obligations towards the CSSF.

External audit

The annual accounts and financial statements of both regulated and unregulated Securitisation Undertakings need to be audited by one or more approved independent auditors (*réviseurs d'entreprises agréé*). For multi-compartments Securitisation Undertakings, each compartment will have to be separately detailed in the financial statements. Financial information relating to each compartment must be clearly identifiable and the approved independent auditor (*réviseur d'entreprises agréé*) must assess the proper drawing up of the annual accounts in light of the fair view principle both at the level of the Securitisation Undertaking as a whole and separately at the level of each compartment.

Reporting to Luxembourg Central Bank

Circular 2014/236 of the Luxembourg Central Bank on statistical data collection for securitisation vehicles requires qualifying Securitisation Undertakings to register with the Luxembourg Central Bank upon incorporation and to comply with the applicable ongoing and periodic reporting obligations towards the Luxembourg Central Bank (e.g. quarterly and monthly reports).

Securitisation Regulation

Regulation (EU) 2017/2402 of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation (the **Securitisation Regulation**) applies in respect of securities relating to securitisation transactions issued on or after 1 January 2019 and in respect of securitisation transactions closed prior to 1 January 2019 where new securities are issued on or after 1 January 2019.

The Securitisation Regulation essentially consolidates the legal framework governing European securitisations and lays down the rules for issuing simple, transparent and standardised (**STS**) securitisation transactions – principally aiming at establishing a more risk sensitive prudential framework for STSs. The Securitisation Regulation notably imposes new due diligence requirements for institutional investors and transparency requirements to give investors a better access to information on the underlying exposures. The Securitisation Regulation also reinstates risk retention requirements whereby either the originators, sponsors or lender will going forward be directly required to ensure compliance with the risk retention obligations.

Keep in mind: the definition of "securitisation" under the Securitisation Law is broader than the definition of "securitisation" in the Securitisation Regulation. As a result, a large number of securitisations carried out by Securitisation Undertakings will not fall into the scope of the Securitisation Regulation (notably unitranche securitisations and securitisations of non-credit risk related assets) whilst still being able to benefit from the favourable framework shaped by the Securitisation Law.

AIFMD

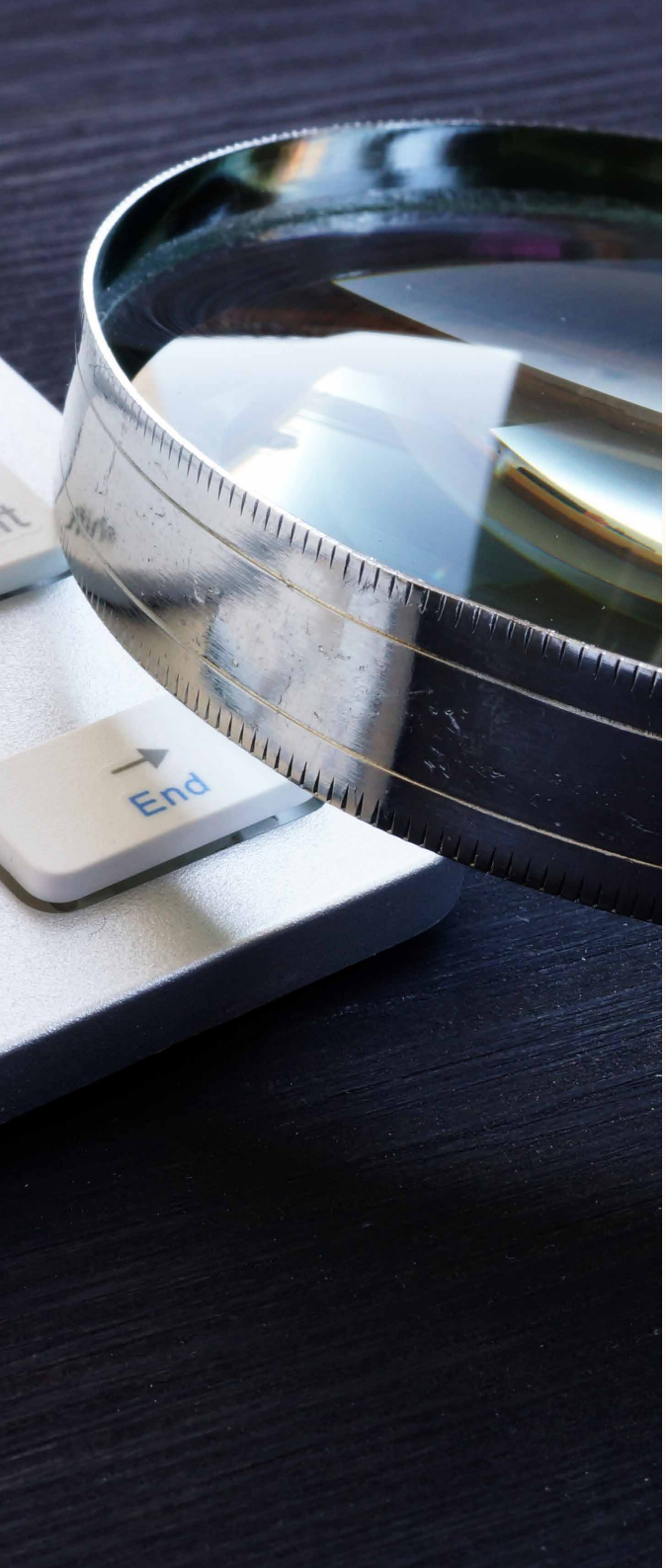
Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers (the **AIFMD**) and the Luxembourg law of 12 July 2013 on alternative investment fund managers (the **AIFM Law**) do not apply to securitisation special purpose entities (**SSPE**). An SSPE is defined in the AIFMD as an entity whose sole purpose is to carry on a securitisation or securitisations within the meaning of the European Central Bank's Regulation (EC) No. 24/2009 of 19 December 2008.

Securitisation Undertakings that do not meet the criteria to qualify as SSPE will need to assess on a case-by-case whether they could qualify as alternative investment fund and be subject to the AIFM Law.

Securitisation Undertakings issuing collateralised loan obligations (CLOs) are generally considered as being engaged in securitisation transactions and as a result, are not

subject to the AIFM Law. In contrast, entities which primarily act as a “first” lenders (i.e. originating new loans) are not considered as being engaged in securitisation transactions and will thus fall within the scope of the AIFM Law.

Pursuant to the CSSF FAQ, notwithstanding their potential qualification as SSPE (for the purpose of the AIFMD), Securitisation Undertakings which only issue debt instruments should not constitute alternative investment funds for the purpose of the AIFM Law. Similarly, it is the view of the CSSF that irrespective of the fact whether a Securitisation Undertaking qualifies as a SSPE for the purpose of the AIFMD, a Securitisation Undertaking that is not managed in accordance within a “defined investment policy” does not constitute an alternative investment fund.



Be efficient: tax aspects

Income tax

Securitisation Undertaking structured as a company

A Securitisation Undertaking company is subject to Luxembourg corporate income tax and municipal business tax on its income at a current overall rate of 24.94% (for a company located in Luxembourg City).

According to the Securitisation Law and subject to the ATAD 1 rules described below, all commitments (*engagements*) of a Securitisation Undertaking vis-à-vis investors and creditors are considered as deductible expenses for tax purposes, thereby ensuring that a Securitisation Undertaking company is close to tax neutral. The foregoing rule applies irrespective whether the investors hold equity or debt securities issued by the Securitisation Undertaking.

A Securitisation Undertaking company is as a rule exempt from net wealth tax pursuant to the Securitisation Law, save that in most cases they will nevertheless be required to pay an annual minimum tax of EUR 4,815.

Securitisation Undertaking companies are fully taxable Luxembourg-resident companies and consequently should be viewed as "liable to tax" in the sense of tax treaties and qualify as resident under such tax treaties.

Securitisation Undertaking structured as a fund

A Securitisation Undertaking structured as a fund is transparent for tax purposes; hence it will not be subject to income tax, municipal business tax or the minimum annual net wealth tax. A securitisation fund will neither be subject to the subscription tax which is normally due by investment funds. A securitisation fund will as a rule not qualify as a resident under tax treaties and should therefore generally not be entitled to applicable tax treaty benefits.

ATAD

As per 1 January 2019, most measures of the European Anti-Tax Avoidance Directive ((EU) 2016/1164 of 12 July 2016 – **ATAD 1**) have been implemented in Luxembourg (the **ATAD 1 Law)**.

The ATAD 1 Law introduces interest deduction limitation rules that may apply to Securitisation Undertakings which do not fall within the scope of the Securitisation Regulation. As a rule, a taxpayer's borrowing costs are generally deductible within the limits of its taxable interest revenues and other economically equivalent revenues. However, the ATAD 1 Law also makes it clear that excessive borrowing costs, i.e. borrowing costs that are in excess of interest revenues, are now subject to an interest limitation rule and shall be deductible in the tax period in which they are incurred only up to the highest of (i) 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA) or (ii) EUR 3 million. The recent entry into force of the ATAD 1 Law requires Securitisation Undertakings to carefully assess their structure to ensure that the drawbacks deriving from the interest deduction limitation rules are properly addressed. Exemptions to the restrictions shaped under the ATAD 1 Law applies, notably for securitisation special purpose entities within the meaning of the Securitisation Regulation and alternative investment funds. Securitisation Undertakings structured as a securitisation fund do not fall within the scope of the ATAD 1 Law.

Withholding tax

Payments of interest and dividends by a Securitisation Undertaking (whether a company or a fund) to its investors do not trigger withholding tax in Luxembourg.

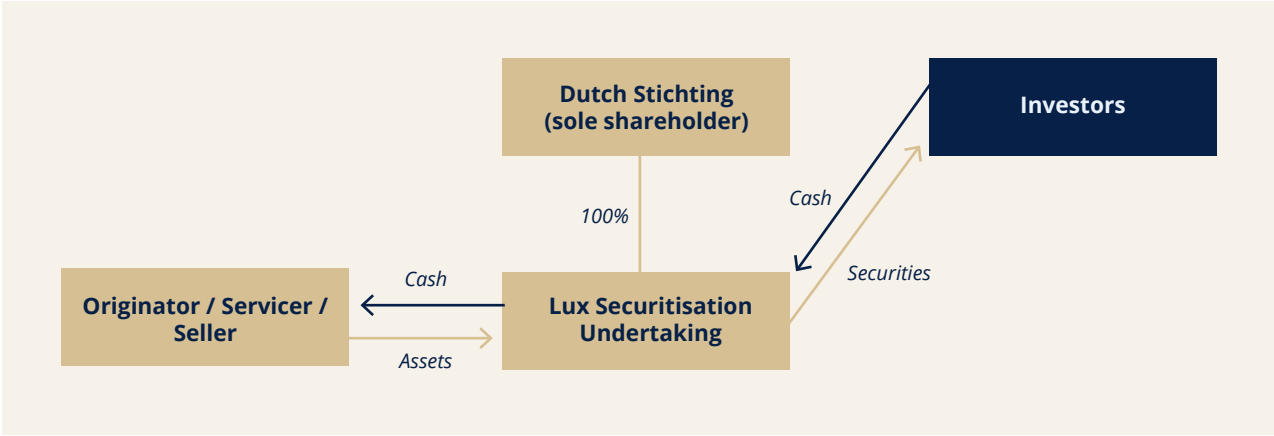
VAT

The management services provided to a Securitisation Undertaking benefit from a VAT exemption. This ensures that VAT leakage is therefore reduced to a minimum in Luxembourg securitisation structures. It is generally held that collateral management fees and investment advisory fees fall within this exemption, provided that they are specific and essential to the management of the Securitisation Undertaking.

Conclusion

Securitisation Undertakings subject to the Securitisation Law continue to benefit from one of the most flexible and favourable legal framework in the world. Despite the inflation of financial regulations witnessed over the last years, the Luxembourg securitisation environment shaped by the Securitisation Law continues to offer an extremely attractive and robust solution for asset-backed and refinancing structures.

Overview of a simplified securitisation scheme



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