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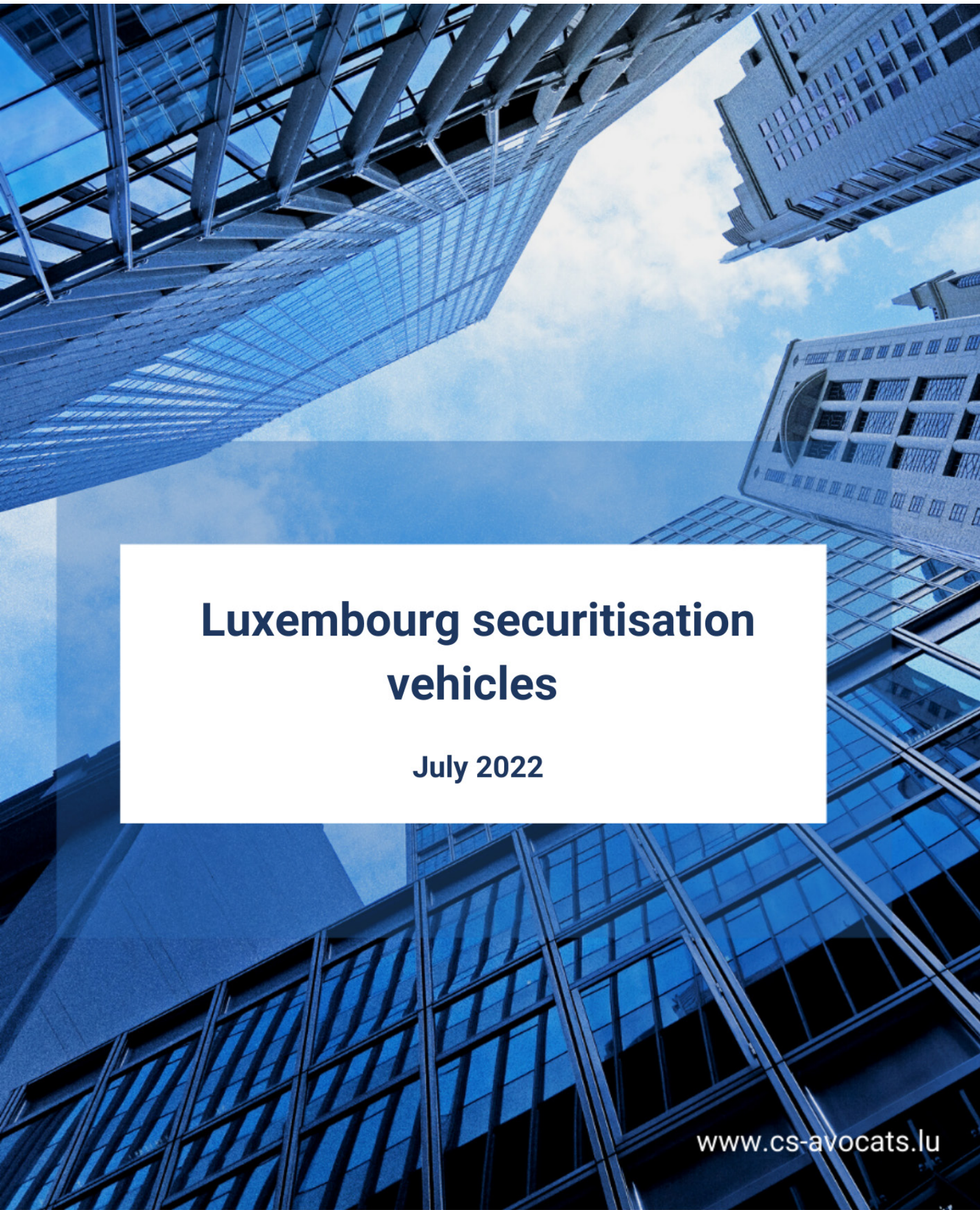

Luxembourg securitisation vehicles

July 2022

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INTRODUCTION

The Law of March 22, 2004, on securitisation (the "**Securitisation Law**") has been amended by legislation of February 25, 2022, intended to promote the flexibility of securitisation vehicles and to enhance the attractiveness of Luxembourg for securitisation. Here we will set out the main features of Luxembourg's securitisation regime and explain the flexibility and opportunities offered by the amended Securitisation Law.

WHAT IS SECURITISATION UNDER LUXEMBOURG LAW?

The Securitisation Law defines the process of securitisation as the acquisition or assumption, directly or through another undertaking, of risks associated with receivables, other assets or liabilities assumed by third parties or inherent in all or part of the activities carried out by third parties, and the issue of financial instruments or the use of any form of borrowing whose value or yield depends on those risks.

Securitisation vehicles (SVs) are entities that fully carry out the securitisation or those that participate in such a transaction by assuming all or part of the securitised risks by issuing financial instruments or taking out a loan or loans to finance it.

The Securitisation Law sets three conditions for a transaction to be qualified as securitisation:

- The SV must acquire assets or assume existing risks, directly or through another vehicle; and
- These risks are related to receivables, other assets or obligations assumed by third parties or inherent in all or part of the activities of third parties; and
- The SV issues financial instruments or takes out one or more loans whose value or yield depends on the risks.

The assets or the risks should be passively managed under a 'prudent man' approach, irrespective of whether management is delegated to a professional acting on behalf of the SV. It may include renegotiation of the repayment schedules or credit terms in the event of financial difficulties of a debtor.

However, the revised legislation authorises active management by the SV itself or a third party if the portfolio is composed of a basket of risks relating to debt securities, financial debt instruments or claims securitised through financial instruments not offered to the public.

The revised legislation thus makes collateralised loan obligations (CLOs, securities backed by a pool of debt, often backed by corporate loans with low credit ratings or loans taken out by private equity firms to conduct leveraged buyouts) and collateralised debt obligations (CDOs) more attractive to meet the needs of the promoters of securitisation

transactions.

The securitisation transaction may either be a true sale or synthetic, and it can be set up either as a long-term securitisation or as a short-term commercial paper programme. In a traditional true sale securitisation, one or several more or less homogeneous claims or assets are assigned to an ad hoc structure, the SV, which acquires them using the funds received through the issue of financial instruments or borrowing. One aim is to release the asset owner from the risks inherent to the assets by removing them from its balance sheet.

Only the risks linked to the assets are transferred in a synthetic securitisation, while the legal and beneficial ownership of the assets remains with the originator. For example, banks can use credit derivatives such as swaps to transfer only the credit risk of the asset pool while retaining ownership of the underlying assets.

WHAT IS THE RATIONALE OF THE SECURITISATION LAW?

The main purpose of the securitisation process is to transfer any risks related to an asset that the participants no longer wish to bear. Securitisation provides efficient access to capital markets, creates liquidity, diversifies funding sources and investor base, transfers the risk to third parties and lowers the capital requirement for banks and insurance companies. Borrowers obtain better credit terms, while investors can benefit from portfolio diversification. Luxembourg's implementation of the Securitisation Law is intended to maintain and deepen the competitiveness of its asset management market.

WHICH VEHICLES MAY BE USED?

The SV can be structured as a company or as a fund without legal personality managed by a management company. The securitisation company must adopt one of the following forms:

- Public limited liability company (*société anonyme* or S.A.).
- Private limited liability company (*société à responsabilité limitée* or S.àr.l.).
- Common limited partnership (*société en commandite simple* or SCS).
- Special limited partnership (*société en commandite spéciale* or SCSp).
- Partnership limited by shares (*société en commandite par actions* or SCA).
- Unlimited company (*société en nom collectif* or SENC).
- Simplified joint stock company (*société par actions simplifiées* or SAS).
- Co-operative company in the form of a public limited liability company (*société coopérative organisée comme une société anonyme* or SCSA).

The common limited partnership, special

limited partnership, unlimited company and simplified joint stock company are the four corporate forms added by the legislation to promote use of tax-efficient vehicles, including tax-transparent vehicles.

Securitisation funds can be structured either as a co-ownership of assets, in which case the investors in the securitisation fund will have a right to the underlying securitised assets, or as a fiduciary estate, where the management company holds the securitised assets as fiduciary property. The management company is a commercial company whose purpose is to manage securitisation funds or act as fiduciary of funds consisting of one or more fiduciary properties. All these forms allow tailored structuring of SVs.

WHAT TYPES OF ASSETS AND RISKS MAY AN SV ASSUME?

In Luxembourg, securitisation is available for all kinds of risks and assets in the broadest sense. All risks related to all movable or immovable property, or tangible or intangible assets, may be securitised. It also applies to risks associated with obligations assumed by third parties or inherent in all or part of third-party activities. Assets that may be securitised include the following:

- Receivables, loans, mortgages, future cash flow on sale of assets, current accounts.
- Bonds, shares, other financial instruments, derivatives, currencies.
- Real estate, aircraft, yachts, buildings, land, forests, commodities.
- Bank cards, car rentals, commercial, legal or political risks, catastrophe risks.
- Intellectual property, royalty income, future cash flow on activities, contractual rights.

HOW SHOULD THE SECURITISED RISKS BE ASSUMED?

There are many scenarios under which the acquisition or assumption of risks and the financing of SVs may take place. The assumption of risk by the SV may result from a transfer of assets, but also from other forms of risk transfer in which the SV hedges the risks.

Another possibility offered by the revised legislation is the indirect acquisition of the assets, using a fully or partially owned company to structure the acquisition of tangible assets such as real estate, aircraft, commodities (for which securitisation had previously been difficult), as long as the SV does not perform a commercial or entrepreneurial activity, which remains prohibited.

Securitisation can take several forms in Luxembourg. The securitisation may be structured as a true sale securitisation form or synthetic, or as a whole or partial business securitisation. A two-tier structure can be set up involving an assumption vehicle that takes

on all or part of the securitised risks, and an issuing vehicle, which finances the assumption of the risks or acquisition of the assets.

Moreover, securitisation can be long term, involving mortgage-backed securities, residential mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities or collateralised debt obligations. A short securitisation is a process with asset-backed commercial paper and a structured investment vehicle. Setting up note issuance facilities, where the notes are booked as debt securities by the SV and as loans by investors, is also possible.

ARE TRANCHING AND SUBORDINATION POSSIBLE FOR SVS?

The securitisation process may be carried out with compartmentalisation and tranching, for instance with senior, mezzanine, and junior tranches. The assets may be pooled, or the securitisation process may be used for only one asset or risk, for instance with a global note programme.

Subordination is permitted for SVs, with the revised legislation clarifying the subordination rules by creating a legal hierarchy between types of instruments. The financial instrument and credit agreement repayments are subordinated to the prior repayment of other securities, certain claims, or classes of shares. Junior financial instruments are subordinated to senior ones, but the SV is entitled to opt for a different ranking.

The legal hierarchy is as follows:

- Units of a securitisation fund are subordinated to other financial instruments issued and borrowing contracted by the fund.
- Shares, corporate units or partnership interests in a securitisation company are subordinated to other financial instruments issued and borrowing contracted by the company.
- Shares, corporate units or partnership interests in a securitisation company are subordinated to beneficiary shares issued by the company.
- Beneficiary shares issued by a securitisation company are subordinated to debt instruments issued and borrowing contracted by the company.
- Non-fixed income debt instruments issued by an SV are subordinated to fixed income debt instruments issued by the SV.

The law offers the possibility of consent to other subordination rules in the articles of association, management regulations and any contract concluded by the SV.

HOW IS THE SV FINANCED?

The revised legislation broadens the financing possibilities for SVs by replacing references to transferable securities with the term financial instruments and removing the limit relating to borrowing arrangements. The financial instruments that may be issued by the SV are defined to have the broadest possible meaning, thanks to a cross-reference to a list of instruments set out in Luxembourg's amended legislation of August 5, 2005, on financial collateral.

Borrowing is broadly defined as any form of debt creating a reimbursement obligation for the SV. It can be used either when the SV is structured, as an alternative to a direct investment in the equity tranche, as a liquidity facility, or to improve investors' yield. The value or yield of the financial instruments and the borrowing arrangements should be linked to the securitised assets or risks.

All types of debt security and trackers of specific assets or risks may also be used, as well as warrants, futures, options, and equity securities such as ordinary equity, preference shares or non-voting shares, tracker shares and beneficiary shares.

The shares and bonds issued by the SV may have different values. In such a case, the voting right attached to bonds and other debt securities is always proportional to the amount of the loan they represent, but it can be stipulated otherwise for shares.

The scope of collateral arrangements is broad. Granting of security interests and pledging of assets may be used to cover commitments relating to the transaction. This has been extended by the revised law to authorise SVs to grant security interests to third parties other than investors in the SV. For instance, the SV may grant a security interest over its underlying assets to a bank providing financing to an investor in the SV.

Whereas there is neither a restriction nor a definition of eligible investors, the law applicable to the financial instruments or loans may be applicable to the investors or creditors, according to their jurisdiction.

Based on the rules of conflict of law between lex contractus (law of the contract) for debt securities and lex societatis for equity securities under international private law, the financial instruments recognised as securities under applicable law or qualified as securities within the meaning of the EU's Markets in Financial Instruments Directive are deemed to be eligible financial instruments. For instance, the use of promissory notes (*Schuldscheindarlehen* governed by German law) is possible.

CAN SVS HAVE MULTIPLE COMPARTMENTS?

SVs are authorised to create one or more compartments, each corresponding to a distinct portion of the assets and liabilities and benefiting from independent management of these assets and liabilities.

The compartments are segregated with regard to third-party creditors of the SV, prohibiting third-party creditors whose claim relates to the creation, operation or liquidation of one compartment to take action affecting assets linked to another compartment.

The ability to create compartments must be set out in the articles of incorporation, the management rules, or the limited partnership agreement of the SV. The allocation of general expenses should be included in the articles of incorporation, and the financial statements and relating financial notes must be prepared with assets and liabilities for each compartment. The true and fair view principle is applied for both the company and the compartments.

The use of multiple compartments offers various advantages including high flexibility, ease and speed of creation, and complete segregation of assets and investors or creditors between compartments.

CAN AN SV BENEFIT FROM BANKRUPTCY REMOTENESS?

SVs may benefit from bankruptcy remoteness if it has been provided for in the articles of association, the management regulations or any contract concluded by the SV. The investors or creditors may waive their right to seize the assets of the SV and to initiate insolvency proceeding against it. They may also subordinate their right to payment to the prior payment of other investors or creditors.

The rights of investors and creditors are limited to the assets of the SV or the compartment to which they are attached. If the SV delegates the recovery of its claims to a third party that is subject to collective proceedings, sums recovered on behalf of the SV before the collective proceedings are protected; the SV has the right to recover them.

WHO MAY MANAGE AN SV?

The company law provisions corresponding to the structure of the management body and the daily management apply according to the legal form of the SV. It may be managed by a board of directors, a management board, one or more managers who may or may not be general partners, partners, a chairman or a director.
Management of the assets or risks may be entrusted to third parties, and notably the

active management of certain assets or risk can be transferred to a third-party asset manager. Most CLO securitisation structures are actively managed by CLO managers in order to maximise performance.

A registered or authorised alternative investment fund manager may be required to manage the SV if the conditions of the legislation of July 12, 2013, on alternative investment fund managers are met.

DOES THE AIFMD APPLY?

The AIFM legislation applies if the SV is deemed to be an alternative investment fund, specifically the law's ordinary investment and risk management rules. However, securitisation special purpose entities, as defined in the EU's Securitisation Regulation 2017/2402 of December 12, 2017, are excluded from the scope of the AIFM legislation.

A securitisation special purpose entity's sole purpose is to conduct one or more securitisations. Securitisation is also defined in the Securitisation Regulation, but the definition is not as broad as under Luxembourg's Securitisation Law. An SV not deemed to be a securitisation special purpose entity under the Securitisation Regulation may be considered an alternative investment fund that must be managed by an AIFM.

An SV is not considered as an AIF, irrespective of whether it qualifies as a securitisation special purpose entity, if it issues only debt instruments or it is not managed according to a defined investment policy, in which case the AIFM legislation does not apply and no AIFM is required.

IS AN SV REGULATED?

SVs may or may not be regulated. They are regulated by Luxembourg's Financial Sector Supervisory Authority (CSSF) if they issue financial instruments on a continuous basis to the public. These terms should be understood as follows:

- "Continuously" means more than three issues to the public per financial year by all compartments of the SV. To determine the number of annual issues of an SV under a programme, each series should in principle be regarded as a distinct issue unless the features of the various series indicate that the programme is a single issue.
- "To the public" means, according to the Securitisation Law, issues to non-professional clients as defined by the amended legislation of April 5, 1993, on the financial sector, in denominations of less than €100,000 and that are not distributed as private placements. The subscription of securities by an institutional investor or financial intermediary for a subsequent placement of the securities with the public constitutes a public offering, as is a wrapper aimed at the public for marketing purposes.

WHAT DOES SUPERVISION ENTAIL?

The constitutional documents of a supervised SV must be approved by the CSSF, a requirement that also applies to an existing SV seeking the regulator's authorisation. The SV must communicate to the CSSF the names of the securitisation project's arranger, its managers, and the beneficial owner(s). The human and material resources and the administrative and accounting organisation, including delegations, must be appropriate to ensure that the SV is able to perform its activity properly and in a professional manner.

"The members of the administrative, management and supervisory bodies of a securitisation company or a management company of an authorised securitisation undertaking, as well as its direct or indirect shareholders which are in a position to exercise a significant influence over the conduct of the business of such a company must be of sufficiently good repute and have the experience or means required for the performance of their duties."[1]

The presentation of all the guarantees of irreproachable business includes for instance, all the personal and professional characteristics which allow an individual to properly manage a professional supervised by the CSSF, such as the past and present professional activities.

If the directors' mandates are held exclusively by legal entities, the CSSF checks criteria regarding the capabilities and professional standing of directors that are legal entities and of individuals designated to represent directors that are entities.

"Any change in control of the securitisation company or the management company, any replacement of the management company, as well as any amendment to the management regulations or the articles of incorporation are subject to the prior approval of the CSSF."[2]

An authorised SV must provide the CSSF with a list of new issues of securities and a summary of its financial situation on a half-yearly basis within 30 days. Once they are finalised, the SV must provide the CSSF with a copy of final issue documents for any issue, financial reports, the annual reports and documents issued by the independent auditor, information on any change of service provider and substantive provisions of a contract, and on any change to fees and commission. The CSSF may require any other information or perform on-site inspections.

Supervised SVs must entrust their liquid assets and securities to a depositary established in or with its registered office in Luxembourg. The CSSF may request a periodical statement of the SV's assets and liabilities and its operating results. A minimum of three directors should be involved in the management. As the substance of administration of the regulated SV must be in Luxembourg, an administrative agent in the grand duchy is required. In most cases the SV

1 Art. 20 (2) of the Law of March 22, 2004, on securitization, as amended

2 Art. 20 (3) of the Law of March 22, 2004, on securitization, as amended

appoints a Luxembourg domiciliation agent, and all SVs, regulated or unregulated, should appoint an independent auditor approved by the CSSF. Their accounts should be approved once a year and then published.

Unregulated SVs are not required to apply to the CSSF, nor appoint a regulated administrator, manager or custodian, and there is no regulatory oversight of the SV's documentation or approval of its board members. Nor do they have to issue any form of private placement memorandum, prospectus or offering document, provided the issue of financial instruments falls within one of the exemptions under Luxembourg's Prospectus Law implementing the EU's Prospectus Directive.

WHAT DOCUMENTATIONS AND REPORTING REQUIREMENTS MUST AN SV COMPLY WITH?

SVs situated in Luxembourg have some reporting obligations including those set out in the European Central Bank's Regulation ECB/2013/40 of October 18, 2013, regarding statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions and the Luxembourg Central Bank's Circular 2014/236 of April 25, 2014, on statistical data collection for securitisation vehicles. In some cases, SVs should comply with European Market Infrastructure Regulation reporting obligations, such as when derivative contracts are used, and must register with Luxembourg's Trade and Companies Register. Regulated SVs or their management companies must comply with a much wider range of reporting obligations.

TO WHAT TAXATION IS AN SV SUBJECT?

No debt-equity ratio requirement: As above mentioned, SVs do not need to meet a debt-to-equity ratio obligation.

Withholding tax: Interest paid by an SV are not subject to any withholding tax (except under the application of EU law. and payments to shareholders such as dividends are not subject to any withholding tax. This is a significant advantage compared with a Luxembourg Soparfi, which is subject to a 15% withholding tax on dividends.

Deductibility of expenses and payments to investors in the Luxembourg SV: All expenses relating to the management of the SV are fully tax-deductible, and payments made to investors in the securitisation company (whether in the form of interest or dividends) are in principle deductible from the SV's taxable base. Interest charges are deductible subject to the EU's anti-tax avoidance directives, which sets limitations on the deductibility of interest. However, the ATAD regime includes various exemptions, notably for securitisation companies subject to the EU Regulation and autonomous entities.

The legal certainty offered by the Luxembourg

rules could be called into question by the EU authorities. Luxembourg received two letters of formal notice of May 14, 2020, from the European Commission, which in December 2021 sent a reasoned opinion. It called on Luxembourg to amend its legislation to correctly transpose the non-deductibility of interest payments rule set by the ATAD 1 directive. ATAD 2, which has been transposed into Luxembourg's income tax law, expands the scope of hybrid mismatch provisions under the first directive and implements reverse hybrid rules.

VAT exempt: The management services of SVs are exempt from value-added tax. However, these services should be reviewed since some VAT registration requirements may arise from the reverse charge mechanism.

Minimum net worth tax: SVs may be subject to a minimum annual net worth tax in Luxembourg.

Benefit from Luxembourg's double tax treaty network: As a resident of a contracting state and liable (or subject) to tax in that state, an SV can in principle benefit from Luxembourg's network of double taxation treaties.

Registration tax: Any agreement executed as part of a securitisation, or any related deed, is exempt from the registration formality unless it relates to real estate situated in Luxembourg, or aircraft or vessels recorded in a Luxembourg public register. For the registration of any agreement or deed relating to a securitisation, documents written in English are accepted without the need for translation into French or German.

HOW CAN WE ASSIST YOU?

Our finance team is experienced in structuring true sale and synthetic securitisations using Luxembourg securitisation companies and securitisation funds.

Our lawyers have the legal expertise and judgement required for complex securitisation transactions along with the sophisticated business perspective necessary in today's challenging environment. With the cross-border knowledge required across the various disciplines involved in a securitisation transaction, our lawyers advise on all aspects of securitisation including structuring, negotiating and documenting transactions, forming special purpose vehicles, obtaining ratings and establishing securitisation special purpose vehicles.

Our team advises on:

- Asset-backed securities.
- True sale and synthetic securitisations.
- Non-performing loans.
- Commercial real estate securitisation.
- Trade receivables securitisation.
- Esoteric asset and risks securitisation.
- Regulatory issues.

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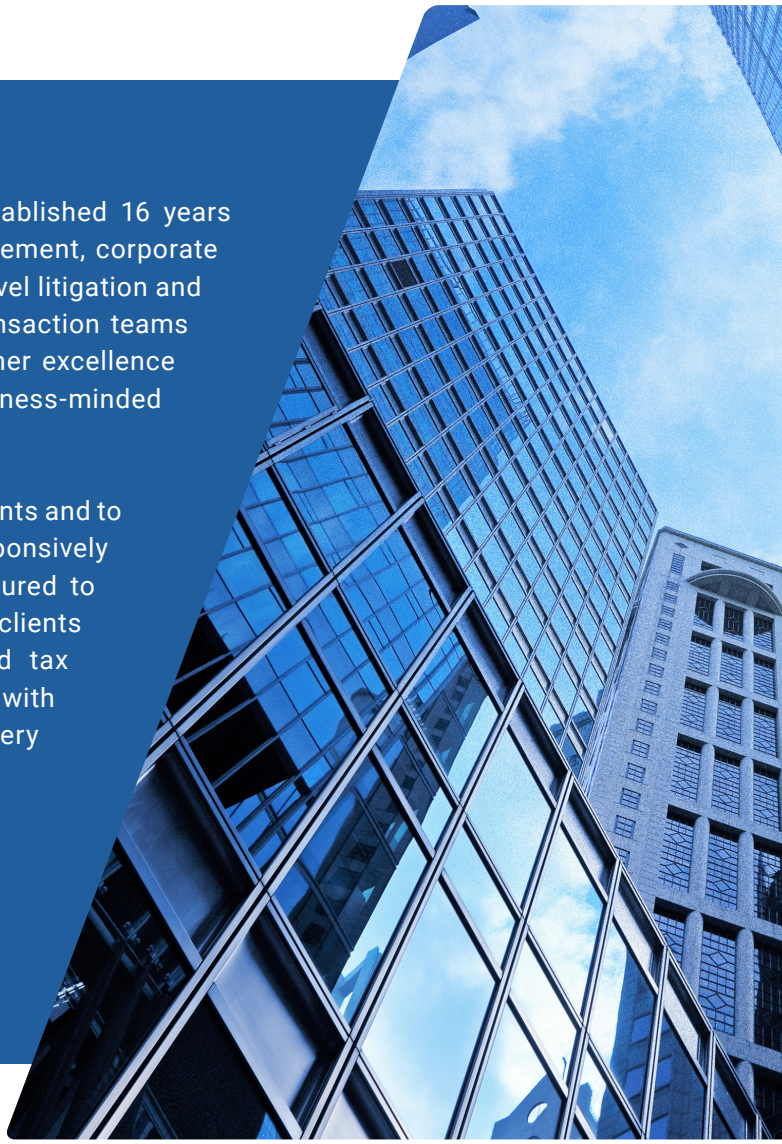
Chevalier & Sciales is a Luxembourg law firm established 16 years ago with specialist expertise in investment management, corporate transactions, banking and finance as well as high-level litigation and dispute resolutions. Our dynamic litigation and transaction teams have an international reputation for bringing together excellence and intellectual rigour with a practical and business-minded approach in serving our clients.

Our aim is to offer a one-stop shop service to our clients and to provide tailoired solutions to meet their needs, responsively and cost-effectively. Our practice areas are structured to ensure a comprehensive understanding of our clients business and markets. We work with recognised tax experts and other service providers to provide you with the assistances and services you require through every aspect of your transactions and business.

Chevalier & Sciales is recommended and listed in the area of investment funds, litigation and dispute resolution and banking and finance.



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