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 environments. 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 the evolution of the business and legal practices surrounding securitisation transactions. From its inception, the purpose of the Securitisation Law was to create a comprehensive, flexible, efficient and reliable legal and tax framework for securitisation transactions carried out through Luxembourg securitisation undertakings (*organismes de titrisation*) (hereinafter: **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, the majority of them established as multi-compartments structures.

The Securitisation Law underwent a major revision in March 2022 with a view to modernising the Luxembourg securitisation environment and making it even more attractive and flexible to financial market actors. Indeed, we expect this revised legal framework would be even more appealing to originators, sponsors and investors located in the US, UK, Germany, France, Spain, Italy and all other global main financial centers.

Key features of Luxembourg Securitisation Undertakings

- Possibility to create segregated compartments
- Wide variety of funding options
- Variety of vehicle structuring options
- Flexibility to securitise a wide range of assets
- Possibility to originate loans

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 is typically 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. With the recent changes introduced in the Securitisation Law, alternative tax transparent company structures are available, such as the general partnership (*société en nom collectif*), the common limited partnership (*société en commandite simple*) and the special limited partnership (*société en commandite spéciale*). It also became possible to structure the Securitisation Undertaking as a simplified limited company (*société par actions simplifiée*). It is expected that these new corporate forms will be widely used in the future.

A Securitisation Undertaking can also 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. A securitisation fund can be created with a minimum number of funds units whilst transactions are entirely financed through the issuance of financial instruments.

Securitisation Undertakings structured either as securitisation companies or as securitisation funds need to register with the Luxembourg trade and companies register.
The constitutional documents of a Securitisation Undertaking must include a specific reference and sspecify that the Securitisation Undertaking is subject to the Securitisation Law and specify whether the Securitisation Undertaking is set up as a regulated or unregulated vehicle. Customarily, the constitutional documents of Securitisation Undertakings also 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 financial instruments (*instruments financiers*) or contracts, in whole or in part, any form of loan, 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, placing 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) risks that can be assumed by a Securitisation Undertaking and (ii) 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, real estate, etc. – in theory, pretty much any kind of asset could be securitised. The Securitisation Law further explicitly confirms that tangible assets (such as commodities, aircrafts or ships) can be securitised, even if the securitisation is made indirectly through a dedicated SPV (look-through approach).

Assets securitised by Securitisation Undertakings are often located outside Luxembourg.

The Commission of the Financial Sector (*Commission de Surveillance du Secteur Financier*) (the **CSSF**) 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 financial instruments (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 financial instruments).

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

(ii) Financing of Securitisation Undertakings

The acquisition of the securitised risks by a Securitisation Undertaking must be financed through financial instruments (*instruments financiers*) or loans, the value or yield of which depends on such risks. The Securitisation Law defines financial instruments by reference to the Luxembourg law of 5 August 2005 on financial collateral arrangements, broadening substantially the financing options to a wide array of instruments (governed by Luxembourg law or foreign law), which can have equity or debt features.

A Securitisation Undertaking is allowed to be financed partially or entirely through loans, including promissory notes or loans, as long as the repayable amount depends on the securitised assets. This aims at aligning the Securitisation Law with 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**), which does not require financing solely in the form of securities, and opens Luxembourg securitisation structures to investors that are prevented for regulatory reasons to invest into securities.

The Securitisation Undertaking can also issue financial instruments or loans 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.

The Securitisation Law introduces a legal subordination for different types of securities that can be issued by a Securitisation Undertaking. Under the law, (i) shares and partnership interests will be subordinated to other financial instruments issued by the Securitisation Undertaking (or borrowings entered into by the Securitisation Undertaking), (ii) shares and partnership interests will be subordinated to beneficiary shares issued by the Securitisation Undertaking, (iii) beneficiary shares will be subordinated to debt financial instruments issued by the Securitisation Undertaking and (iv) variable floating rate financial instruments will be subordinated to fixed rate financial instruments issued by the Securitisation Undertaking. There is room for flexibility, though, as the set of subordination rules can be overridden in the constitutional documents or issuance documents.

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 puts up a protective and specific framework around 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 subject to 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. Under Luxembourg law, the assignment of claims to, or by, a Securitisation Undertaking entails the transfer of any underlying guarantees and security interests relating to such claims. The Securitisation Law 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.

Management of securitised assets

A key change recently introduced relates to the management of the securitised assets. Whilst the principle remains the passive management of the securitised assets by the Securitisation Undertaking – the guiding rule is that it role should be limited to the management of the financial flows of the securitisation transaction and the "prudentman" management of the securitised assets – active management (by the Securitisation Undertaking or a third party) is now allowed for Securitisation Undertakings in respect of risks linked to bonds, loans or other debt instruments (not for equity type of assets thus), to the extent the financial instruments are not issued to the public. This means that, going forward, the Luxembourg securitisation environment will also be suitable to hosting CDO/CLO structures (which imply an active management of the underlying debt/loans portfolios) which have historically been set up in other jurisdictions.

Granting of security interests and guarantees

The revisited Securitisation Law allows a Securitisation Undertaking to grant security interests over its assets to parties that are involved in a securitisation transaction but are not direct creditors of such Securitisation Undertaking. Multiple layers of security interests (so-called cascading pledges) are thus no longer required and there is a wide flexibility for actors to implement tailored security packages.

Compartmentalisation

One of the main special features of the Luxembourg securitisation framework – and one that is pretty unique in Europe – is 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 into various compartments, as a result of which assets and liabilities are ringfenced.

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 is 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 nor any of its other compartments.

The creation of one or more compartments is entrusted to the management body of the Securitisation Undertaking, thereby ensuring a cheap and straightforward set-up process.

The treatment and distribution of profits and losses of equity-financed compartments is addressed in the Securitisation Law, creating an optional regime to be included in the constitutional documents of the Securitisation Undertaking, and enabling the approval of specific financial statements per compartment or the distributions of profit on a compartment basis (without reference to the financial situation of the Securitisation Undertaking as a whole).

Non-petition and limited recourse clauses

The Securitisation Law explicitly recognises the validity of non-petition and limited recourse clauses. Such clauses are typically included 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.

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 and remote 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 fewer than 30 regulated Securitisation Undertakings in Luxembourg). A Securitisation Undertaking will need to be authorised by the CSSF if (i) more than three times per year (ii) it issues financial instruments to non-professional clients, (iii) the denomination of which instruments is less than EUR 100,000 per title and (iv) which instruments are not offered by way of private placement (cumulative criteria).

- **Three times 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 non-professional clients:** professional clients need to be understood in the sense of MiFID II.
- **Denomination:** the threshold for financial instruments has been reduced from EUR 125,000 to EUR 100,000 to match the EU Prospectus Regulation exemption.
- **Public offering:** how the financial instruments will be offered is also relevant. The concept of 'private placement' is not defined in the Securitisation Law and will likely need to be interpreted by reference to the concept of non-exempt offer of securities to the public captured by the EU Prospectus Regulation.

Securitisation Undertakings issuing financial instruments meeting the aforementioned criteria 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 must 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. Failure to apply for authorisation by the CSSF is subject to various sanctions.

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 (*réviseur d'entreprises agréé*). For multi-compartment 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

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 better access to information on the underlying exposures. The Securitisation Regulation also reinstates risk retention requirements pursuant to which either the originators, the sponsors or the lender will be directly required to ensure compliance with the risk retention obligations.

Keep in mind: the definition of "securitisation" in the Securitisation Law has a broader formulation 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 within 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 and rules offered 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 be considered an SSPE will need to assess on a case-by-case whether they could be considered an 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 "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 them being potentially considered to be SSPEs (for the purpose of the AIFMD), Securitisation Undertakings that only issue debt instruments do 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 is considered an 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 of whether the investors hold equity or debt securities issued by the Securitisation Undertaking.

As a rule, a Securitisation Undertaking company is 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 if the Securitisation Undertaking company's fixed financial assets, transferrable securities, inter-company receivables and cash exceed 90% of its total gross assets and EUR 350,000; a Securitisation Undertaking company will be required to pay an annual minimum tax ranging from EUR 535 to 32,100 depending on its total gross assets if either threshold is not met.

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 EU directives and qualify as resident under such tax treaties and EU directives.

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 corporate 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 payable by investment funds. A securitisation fund will as a rule not be considered a resident under tax treaties and EU directives and therefore tends not to be entitled to applicable tax treaty benefits and EU directives.

ATAD

With effect from 1 January 2019, most measures of the European Anti-Tax Avoidance Directive ((EU) 2016/1164 of 12 July 2016 – **ATAD 1**) were implemented in Luxembourg (the **ATAD 1 Law**).

The ATAD 1 Law introduces on interest deduction limitation rule that may apply to Securitisation Undertakings structured as companies. As a rule, a taxpayer's borrowing costs are generally deductible within the limits of its taxable interest revenues and other economically equivalent revenues. Excessive borrowing costs, i.e. borrowing costs that are in excess of interest revenues, are subject to an interest deduction limitation rule and will be deductible in the tax period in which they are incurred only up to the higher of (i) 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA) or (ii) EUR 3 million. ATAD 1 Law requires Securitisation Undertakings structured as companies to carefully assess their structure to ensure that the drawbacks deriving from the interest deduction limitation rule are properly addressed. Exemptions to the restrictions shaped under the ATAD 1 Law applies, notably for alternative investment funds. Securitisation Undertakings structured as securitisation funds 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 frameworks 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.

The recent updates to the Securitisation Law are expected to boost the Luxembourg securitisation environment and attract new types of structures to Luxembourg, contributing to its ever growing success.

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