

Financial Services  
Securitisation


# Securitisation in Luxembourg\*

A regulatory, accounting and tax practice guide

2007



\*connectedthinking

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# Preface

Since the publication of our first brochure “Structuring Securitisation Transactions in Luxembourg” in September 2004, the securitisation market in Europe generally, and in Luxembourg in particular, has developed tremendously. By the end of April 2007, there were at least 311 vehicles representing nearly 2,000 compartments in Luxembourg. And this growth is not likely to stop as market participants expect further growth in the coming years.

This revised edition of our brochure underlines the changes the securitisation market has undergone since 2004 and details some of the lessons learned namely in the fields of accounting and securitisation structures used.

In addition to presenting regulatory and fiscal provisions, we will provide a deeper understanding of the asset classes used (e.g. receivables, life insurance contracts, Mezzanine-Capital, repackaging deals, ...), compare single compartment and multiple-compartment structures and examine different business models using illustrative examples.

Another focus of this publication is on accounting issues. Particular aspects like disclosure of multiple-compartment vehicles, treatment of losses, and “technical gains” will be explained and commented on. In a separate appendix, we have attached an illustrative model of financial statements for a single and a multiple-compartment vehicle. With respect to taxation, recent VAT clarifications will be described.

In Part III of the brochure, special consideration will be paid to what is being done practically to combat Anti-Money-Laundering. Prospectus requirements resulting from the structure/distribution will be listed as well as the responsibilities of the Board of Directors of an SPV.

The remaining topics – IFRS and Basel II – relate more to the business needs of originators and investors. In this part, we will show how the structure chosen can impact on the originator’s and investor’s financial statements.

We hope that our choice of topics, and the experience we have brought to bear in discussing them, will provide you with a better understanding of the securitisation market and the practices used in Luxembourg.

Günter Simon

# 1 Part I: General Securitisation

## 1.1 Introduction

Today, securitisation is the funding and risk transfer method of choice for an increasing number of issuers and one of the largest growing contributor to the global capital markets.

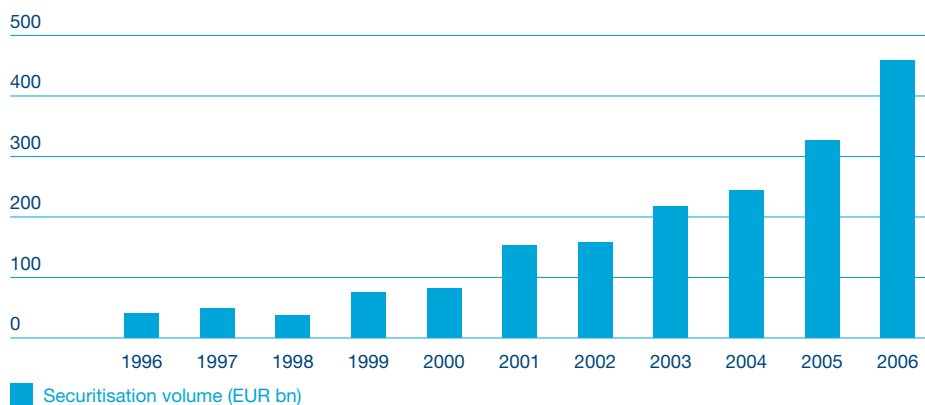
Although securitisation transactions as they are known today were made popular in the US, non-US transactions are taking a bigger share of the overall securitisation market. Securitisation may be of interest to any large corporate that owns suitable financial assets, whether a pool of debts or discrete revenue streams.

For the banking system, securitisation allows for lower solvability ratios and risks linked to financial sectors and regions; for companies and households, better financing conditions.

In most countries, the securitisation market historically started to develop through Mortgage-Backed Securities (MBS) and other types of financial receivables. As the securitisation market grew and became more sophisticated, the types of assets that were securitised were broadened into non-financial types of assets and future cash flows.

## 1.2 Market overview and trends

The European securitisation market grew by 40.4% in 2006 reaching a new high of EUR 458.9 billion, from EUR 327.0 billion in 2005. We have seen six years of growth in a row, a new record in the European securitisation market. The ongoing economic recovery and lower levels of credit defaults have raised investor confidence in the market. The RMBS<sup>1</sup>, CDO<sup>2</sup> and CMBS<sup>3</sup> sectors are the key growth drivers in the securitisation market in Europe.



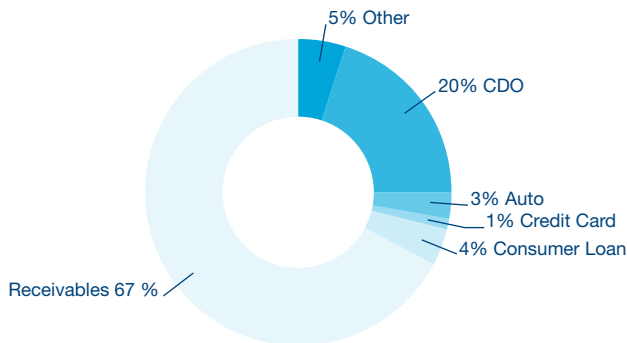
<sup>1</sup> Residential Mortgage-Backed Securities  
<sup>2</sup> Collateralised Debt Obligations  
<sup>3</sup> Commercial Mortgage-Backed Securities

Source: European Securitisation Forum (ESF)

As to the type of investors in securitisation bonds, at present there is a concentration of investment and insurance companies, as a certain level of expertise is required. However, as the market continues to develop, other types of investors will undoubtedly become more and more attracted by the favourable risk/return profiles: asset managers, federal/state/local governments, corporations as well as mutual and pension funds.

In terms of collateral, the European securitisation market looks as follows:

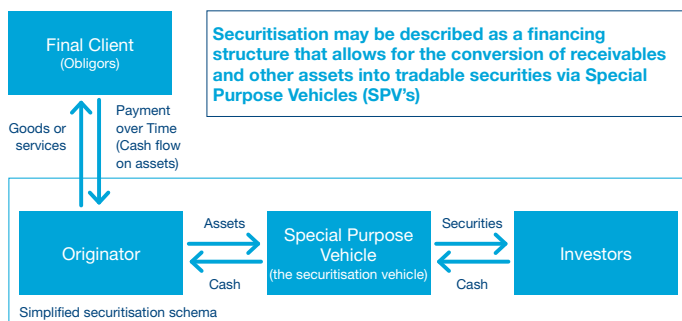
### European ABS issuance by collateral type – through Q4 2006



Source: ESF

### 1.3 What is “Securitisation”?

Securitisation is a type of structured financing in which a pool of financial assets is transferred from an originating company to a “Special Purpose Vehicle” (SPV). This SPV subsequently issues debt packages solely backed by the assets transferred, and payments derived, from those assets.



Historically, asset securitisation began with the structured financing of mortgage pools in the 1970s. Over the years, the transactions were structured more and more efficiently and loan originators replicated the process to other types of loans. Today, we recognise innumerable types of collateral as receivables (including mortgage-backed, train, property, rent) as well as different types of CDOs, Auto, Credit Card or Consumer Loans. Nonetheless, asset originators have proven extremely innovative at structuring cash flows and credit enhancements.

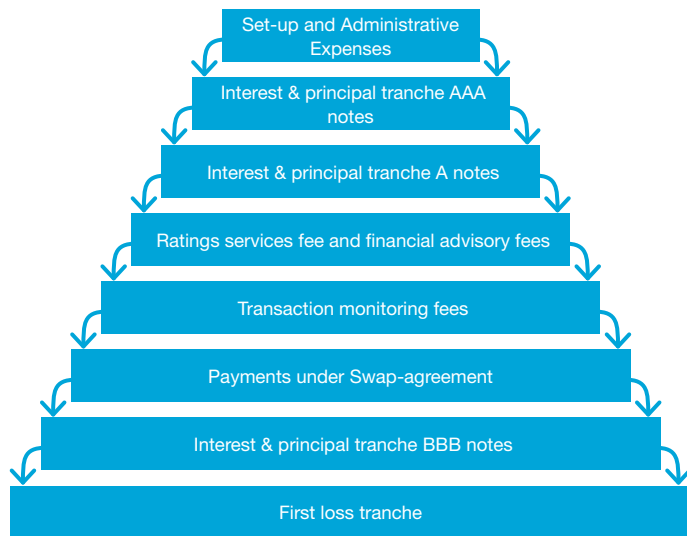
Due to the repackaging, new fungible financial assets, benefiting from a portfolio effect, are created. Acquisition, classification, collateralisation, composition, pooling and distribution are functions within this process. From an originator’s perspective, securitisation enables specific ownership risks to be transferred to parties more able to manage these risks, allows the capital market to be accessed with higher debt ratings than their general corporate rating, and provides other benefits described in more detail in section 1.5 below.

Structuring is one of the central elements of a securitisation transaction. Securitisation typically splits the credit risk into several tranches with varied risk profiles. This enables the issuer to attract a range of investors with different risk/reward appetites. A very common allocation of tranches is: 80% senior tranches with the remaining part split into junior/subordinated tranches. The most senior tranche is usually AAA or AA rated and is protected from credit losses by having priority on the cash flow from the assets.

The following tranches, often called subordinated, mezzanine or junior tranches, are rated lower and designed to absorb credit losses first. These tranches receive higher margins in order to compensate for the additional risk.

Furthermore, we have to consider first loss tranches (or so called first loss pieces). The most probable credit losses of a securitisation transaction are concentrated in this tranche. They are usually held by the originator and offer a high risk/return profile. The first loss tranche is usually capped at “expected” or “normal” rates of portfolio credit loss. Thus, all credit losses up to this point are effectively absorbed by this tranche. It typically receives portfolio cash flow after expenses (which include expected losses) in the form of excess spread.

This concept of structuring is called the “waterfall” payment sequence, so named because of its similarity to a champagne waterfall with tiers of glasses balanced one on top of another. The champagne waterfall can be transferred to securitisation as following:



The waterfall shows the order of the cash return on assets, which allows for the repayment and payment of interest on the notes issued as well as fees related to the transaction. The cash flow of the underlying portfolio is used to fill or refill the requirements of the top tranche (senior tranche). The surplus cash flow then goes to fill/refill the requirements of the second tranche (junior, mezzanine, subordinated) and so on. This process will last until the cash flow is exhausted. The bottom first loss tranche will receive the residual cash flow after all other prior claims have been satisfied. The residual cash flow thus represents a high rate of return if the underlying assets are performing well and vice versa.

## 1.4 Types of transactions

Different criteria can be used to distinguish between different types of securitisation transactions. The list is not exhaustive, but the following criteria should help to sort out the different kinds of transactions available and should facilitate understanding of its purpose.

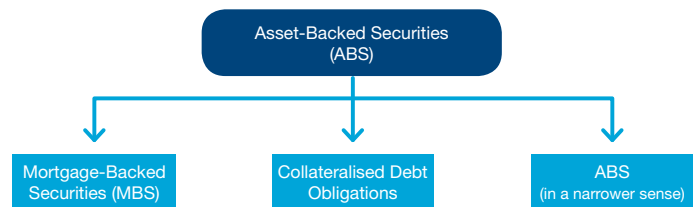
### Term securitisation vs. securitisation by Asset-Backed Commercial Paper (ABCP)

Term securitisations are long-term placements through the capital market. When the underlying portfolio

(assets or loans) are paid back the transaction is naturally closed. However, securitisations issued by ABCP also allow for short-term financing on a roll-over basis through the money market. These transactions are regularly set up for an unlimited period.

### Transactions by asset classes referring to the underlying risk

A trisection was established within the securitisation market to differentiate the following asset classes according to underlying risk: Mortgage-Backed Securities (MBS), Asset-Backed Securities (ABS) and Collateralised Debt Obligations (CDO).



MBS include all notes whose collateral for repayment consist of a mortgage loan or a pool of mortgage loans secured on real property. Investors receive payments of interest and principal that are derived from payments received on the underlying mortgage loan. Furthermore, we can differ between Residential-MBS (underlying mortgages of private persons) and Commercial-MBS (underlying mortgage loans secured by commercial properties).

CDOs are usually based on corporate risks – loans, assets or credit derivatives. Common types of transactions are Collateralised Loan Obligations (CLO) or Collateralised Bond Obligations (CBO). These transactions have to be classified into static or dynamic structures. In a static structure, the entire portfolio is fixed at the final closing date of the transaction. As a result, the assets are not actively changed irrespective of the performance of a single credit risk of the underlying portfolio. The number of the underlying assets will be changed only in case of defaults, but usually the default cannot be replaced. In dynamic or actively managed transactions, the responsible asset manager can replace one or more underlying credit risks. These risks can be traded actively and are not linked to any credit events.

ABS represents the residual part of the securitisation market, which is characterised by the heterogeneity of the underlying assets. The underlyings of ABS-transactions may vary from consumer loans, secured credit card receivables, trade receivables, student loans to the securitisation of life insurance policies.

### True sale vs. synthetic transactions

With regards to the transfer of rights of an asset, there are two forms of securitisation transactions:

#### True sale transactions

In a traditional true sale structure, the originator sells a pool of assets to a Special Purpose Vehicle by removing these from its balance sheet. The vehicle funds the purchase by issuing notes, which are rated by an agency. The rating of the notes reflects the fact that the SPV is isolated from any credit risk of the originator and the credit enhancement of the pool. Thus, the originator transfers both the legal and beneficial interest in the assets to the SPV. As a result, the investor of the SPV receives a legal and beneficial right to the underlying assets.

#### Synthetic transactions

In a synthetic securitisation, the originator buys protection through a series of credit derivatives instead of selling the asset pool to the SPV. Such transactions do not provide the originator with funding. They are typically undertaken to transfer credit risk and reduce regulatory capital requirements.

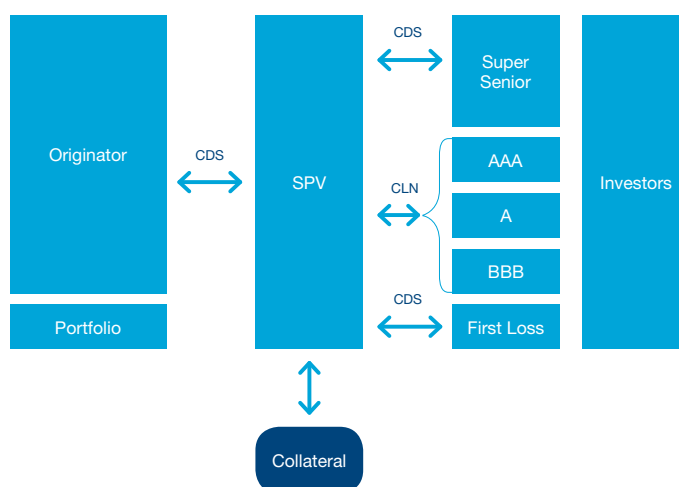
As a general rule, the owner of the assets (which we can refer to as the “Protection Buyer”) transfers the credit risk of a portfolio of assets (a “Reference Portfolio”) to another entity (the “Protection Seller”) or directly to the capital markets. Although the credit risk of the Reference Portfolio is transferred, actual ownership of the Reference Portfolio remains with the Protection Buyer.

The transfer of credit risk may be accomplished in a number of ways:

- The Protection Buyer might issue credit-linked notes to the Protection Seller or directly to investors. The terms of the notes would provide for a reduction of the Protection Buyer’s repayment obligation on the notes upon defaults or other credit events arising with respect to the Reference Portfolio;

- Alternatively, the Protection Buyer can enter into a credit default swap, total return swap or other credit derivative transaction with the Protection Seller. The Protection Seller agrees, in return for certain payments, that upon default or another credit event in respect of a Reference Portfolio, to pay an amount to the Protection Buyer. This is calculated by reference to the amount of payment defaults or on the diminution of market value of the defaulted Reference Portfolio.

The figure below shows a typical synthetic securitisation structure:



The credit risk is structured and transferred by credit derivatives. CDS are negotiated with the counterparties of the Super Senior Tranche and the First Loss Pieces. Credit Linked Notes (CLN) are more often used for tranches which are publically issued for a wide range of investors.

### 1.5 Benefits of securitisation

Below is a listing of the common benefits of securitisation, which may offer one or more of the benefits described below. However, securitisations are complex structured financings and it is critical that potential issuers understand the range of options and related implications to make informed decisions. While these benefits have varying degrees of importance for different originators, the common hallmark of securitisations is the desire for lower capital cost.

## Benefits for originators

Securitisation improves return on capital by converting an on-balance-sheet lending business into an off-balance-sheet fee income stream that is less capital intensive. Depending on the type of structure used, securitisation may have the following benefits:

- **Provide efficient access to capital markets:** transactions can be structured with AAA ratings on most of the debt, so pricing is not tied to the originator's credit rating. Thus, funding costs can be reduced by securitisation. For instance, a company rated BBB but with an AAA worthy cash flow would possibly be able to borrow at AAA rates. This is the main reason to securitise a cash flow and it can have tremendous impacts on borrowing costs.
- **Minimise issuer-specific limitations on ability to raise capital:** capital raised depends on the terms, credit quality, prepayment assumptions, and servicing of the assets and prevailing market conditions. Entities that are unable to borrow based on their individual credit quality, or who do so only at significant cost, may be able to complete securitisations. This applies as well to entities that are unable to raise equity.
- **Convert illiquid assets to cash:** assets that are not readily sellable may be combined to create a diversified collateral pool against which notes can be issued.
- **Diversify and target funding sources, investor base and transaction structures:** businesses can expand beyond existing bank lending and corporate debt markets to tap new markets and sets of investors. This is also able to lower the cost of other types of debt by reducing the volume issued, thereby allowing placement with marginal purchasers willing to pay a higher price. Especially for complex organisations, segmenting revenue streams or assets securing particular debt offerings enable issuers to market debt to investors based on their appetite for particular types of credit risk, while allowing these investors to minimise their exposure to unrelated issuer risk. Similarly, complex principal and interest payment structural features targeting the investment objectives of particular buyers can be incorporated into the debt. This segmentation of credit risk and structural features should minimise the overall cost of capital to the seller.
- **Raise capital to generate additional assets or apply to other more valuable uses:** for example, it allows lines of credit to be recycled quickly to generate additional assets as well as free long-term capital for related or broader uses. Capital raised can be used for any allowable purpose, such as retiring debt, repurchasing stock, purchasing additional assets, and completing capital projects.
- **Raise capital without prospectus-type disclosure:** allows sensitive information about business operations to be kept confidential, especially by issuing through a "conduit" or as a private placement.
- **Generate earnings:** when a true sale securitisation transaction takes place between the originator and the SPV, this sale has to take place at market value of the underlying assets. The transaction is reflected in the originators balance sheet, which will eventually boost earnings for the particular quarter or financial year by the amount of the sale.
- **Complete mergers and acquisitions as well as divestitures, more efficiently:** may assist in creating the most efficient combined structure and may serve as a source of capital for transactions. By segmenting and selling assets against which debt is issued, it may be possible to optimise the closing of business lines that no longer meet corporate objectives.
- **Transfer risk to third parties:** financial risk from defaults on loans or contractual obligations by customers can be partially transferred to investors and credit enhancers.

## Benefits for Investors

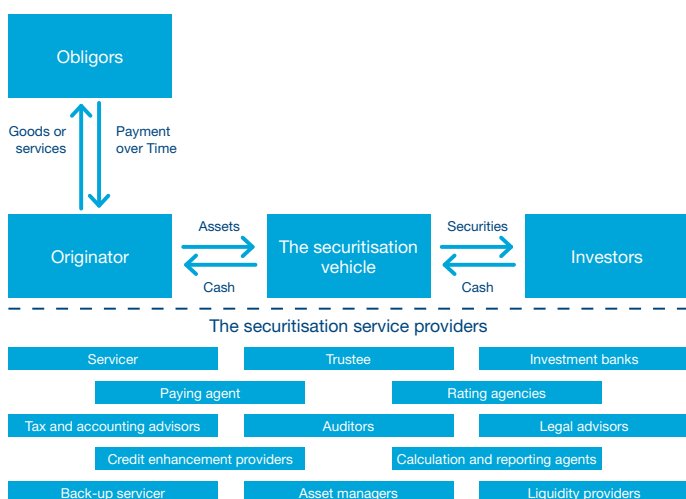
- **Broad possible combinations of yield and risk:** securitised assets offer a combination of attractive yields (compared with other instruments of similar quality), increasing secondary market liquidity, and generally, more protection by way of collateral coverages and/or guarantees by entities with high and stable credit ratings. They also offer flexibility because their payment streams and risk profiles can be structured to meet the particular requirements of investors. Most importantly, structural credit enhancements and diversified asset pools free investors of the need to obtain a detailed understanding of the underlying loans.
- **Higher returns:** opportunity to potentially earn a higher rate of return on investments in a specific pool of high quality credit-enhanced assets.

## Benefits for borrowers

- **Better credit terms:** borrowers benefit from the increasing availability of credit terms, which lenders may not have provided if they had kept the loans on their balance sheets. For example, lenders can extend fixed rate debt, which many consumers prefer over variable rate debt, without overexposing themselves to interest rate risk because of the existence of a market for Mortgage-Backed Securities. Credit card lenders can originate very large loan pools for a diverse customer base at lower rates. Nationwide competition among credit originators, coupled with a strong investor appetite for securities, has significantly expanded both the availability of credit, and the pool of cardholders over the past decade.

## 1.6 Securitisation players

This section describes the players involved in a securitisation transaction. In addition to directly involved parties, there are a number of other parties, generally defined as service providers, which are also involved in the securitisation process. Below you find an overview of the most relevant parties:



## Obligors/Borrowers

Obligors owe the originator a payment on the underlying loans/assets and are, therefore, ultimately responsible for the performance of the issued note. As obligors often are not informed about the sale of their loans, the originator, in many cases, maintains the customer relationship. From a credit risk perspective, securitisation groups obligors by letter or popular categories.

## Originator

The entity that assigns assets or risks in a securitisation transaction. Usually it is the party (lender) who originally underwrote and securitised the claims (loans). The obligations arising with respect to such loans are, therefore, originally owed to this entity before the transfer to the SPV takes place. Occasionally, the originator may be a third party who buys the pool with the intention to securitise it thereafter; in that case, the originator is also named as “sponsor”. Originators include captive financial companies of the major car manufacturers, other financial companies, commercial banks, building societies, computer companies, manufacturers, insurance companies and securities firms.

## Investors

Investors buy the notes that are issued by the SPV and are, therefore, entitled to receive the repayments and interests which are due to the underlying assets. Collaterals are the pecuniary claims from these assets and, therefore, just the cash flow. Investors do not participate directly in the cash flow generated by the assets. The largest purchasers of securitised assets are typically pension funds, insurance companies, fund managers and, to a lesser degree, commercial banks. The most compelling reason for investing in Asset-Backed Securities is their higher rate of return relative to other assets of comparable credit risk.

## Servicer

The entity that collects principal and interest payments from obligors and administers the portfolio after transaction closing. It is very common in securitisation transactions that the originators act as servicers though this is not always the case. For example, in most Non-Performing Loans (NPL) transactions, specialised servicers tend to carry out this role. Servicing includes customer service and payment processing for the obligors in the securitised pool and collection actions in accordance with the pooling and servicing agreement. Servicing can also include default management, collateral liquidation and the preparation of monthly reports. The servicer is typically compensated with a fixed servicing fee.

## Back-up servicer

In case the original servicer defaults, the back-up servicer replaces them. They take over all the responsibilities which were allocated to the servicer.

## Trustee

The trustee is a third party retained for a fee to administer the SPV in a securitisation transaction. Acting in a fiduciary capacity, the trustee is primarily concerned with preserving the rights of investors. The responsibilities of the trustee will vary from issue to issue and are delineated in a separate trust agreement. Generally, the trustee oversees the receipt and disbursement of cash flows as prescribed by the indenture or pooling and servicing agreement and monitors compliance with appropriate covenants by other parties to the agreement. If problems develop in the transaction (e.g. defaults), the trustee focuses particular attention on the obligations and performance of all parties associated with the note, particularly the servicer and the credit enhancer. Throughout the life of the transaction, the trustee receives periodic financial information from the originator/servicer delineating amounts collected, amounts charged off, collateral values, etc. The trustee is responsible for reviewing this information and ensuring that the underlying assets produce adequate cash flows to service the notes. The trustee is also responsible for declaring default or amortisation events.

## Investment banks

Investment banks mainly perform structuring, underwriting and marketing of the securitisation transaction.

## Tax and accounting advisers

Advise regarding the accounting and tax implications of the proposed structure of the transaction to the involved parties. Usually issuers try to choose a structure that will minimise the tax impact on the notes issued.

## Rating agencies

For successful securitisations, it is crucial to have the issued notes assessed by a rating agency. A wide range of investors like the majority of funds, pension funds or retail investors, requires a minimum rating of investment grade or higher. The rating process is dominated by the rating agencies: Standard & Poors, Moodys, Fitch or Dominion Bond Ratings Services. They have accumulated considerable expertise, data and modelling skills in assessing the expected losses of debt securities.

In general, rating agencies review the following factors:

- Quality of the pool of underlying assets in terms of repayment ability, maturity diversification, expected defaults and recovery rates;
- Abilities and strengths of the originator/servicer of the assets;
- Soundness of the transaction's overall structure, e.g. timing of cash flows (or mismatch) and impact of defaults;
- Analysis of legal risks in the structure, e.g. effectiveness of transfer of title to the assets;
- Ability of the asset manager to manage the portfolio;
- Quality of credit support, e.g. nature and levels of credit enhancements.

## Paying agent

The bank that has agreed to make payments on the notes issued to investors. Payments are usually made via a clearing system. In Europe, this role is often an entity affiliated with the trustee or the administrator.

## Legal advisers

As the legal structure and legal opinions are crucial to securitisation, considerable legal work goes into documentation. A typical transaction would involve numerous documents: sale and purchase agreements, offering documents etc.

## Credit enhancement providers

Credit enhancement is used to improve the credit rating of the issued note. Therefore, credit enhancement providers are third parties that agree to elevate the credit quality of another party or a pool of assets by making payments, usually up to a specified amount. This is done in the event that the other party defaults on its payment obligations or should the cash flow produced by the pool of assets be less than the amounts contractually required because of defaults by the underlying obligors.

## Calculation and reporting agents

Calculate the waterfall principal and interest payments due to note holders.

## Liquidity providers

Usually banks, which provide the SPV with cash to avoid any unsteadiness of the cash flows to the investors. It is a kind of bridge loan and short-term financing. It is not used for defaults within the underlying portfolio.

## Asset managers

Very common function in CDO/Structured Credit transactions. Asset managers are responsible for selecting underlying assets (e.g. corporates, banks, sovereigns), monitoring the portfolio and, if foreseen, replacing the assets.

## 1.7 Types of credit enhancements

There are many important things to consider when effectively structuring a securitisation transaction: the separation of credit risk between SPV and originator, avoidance of co-mingling of accounts between the originator and the SPV, no double taxation of the vehicle or withholding requirements for cross border transactions. Credit enhancements are also important in this respect. Defined as initiatives taken by the originator to enhance the creditworthiness of the issued notes to protect investors so that the pool of underlying assets is able to withstand fluctuations in the economy, credit enhancements protect investors from bearing all the credit risks in the pool of assets. Accordingly, mechanisms, both internal (techniques structured within the transaction), and external (insurance type policies purchased to protect investors in case of default), are typically built into the structure – a process that drives the ultimate ratings of the issued notes.

Most structures contain a combination of one or more of the enhancement techniques described below. The objective from an issuer's viewpoint, is to find the most practical and cost-effective credit protection method for the desired credit rating and pricing of the note. Most securities also contain performance-related features designed to protect investors (and credit enhancers) against portfolio deterioration. The originator will often negotiate with the rating agencies about the type and size of the internal and external credit enhancements.

Common types of each include:

### External credit enhancements

#### Third party/Parental guarantees

A policy provided by a third party or, in some cases, by the promoter of the securitisation transaction, that reimburses the SPV for losses up to a specified amount. Transactions can also include agreements to advance principal and interest or to buy back any defaulted loans. Third party guarantees are typically provided by AAA-rated financial guarantors or monoline insurance companies.

#### Letters Of Credit

With a Letter Of Credit (LOC), a financial institution – usually a bank – is paid a fee for providing a specified cash amount to reimburse the SPV for any cash shortfalls from the collateral – up to the required credit support amount. Letters Of Credit are becoming less common forms of credit enhancement, as much of their appeal was lost when the rating agencies downgraded the long-term debt of several LOC-provider banks in the fixed income sectors. Because notes enhanced with LOCs from these lenders faced possible downgrades as well, issuers began to utilise cash collateral accounts instead of LOCs in cases where external credit support was needed.

#### Surety bonds

Policy provided by a rated insurance company to protect principal and interest payments for certain investors. Typically provided on investment grade securities on condition that other forms of credit enhancement are employed as well. Securities paired with surety bonds have ratings that are the same as that of the surety bond's issuer.

### Internal credit enhancements

#### Over-collateralisation

Over-collateralisation is a commonly used form of credit enhancement. With this support structure, the face value of the underlying loan portfolio is larger than the notes it backs, thus the issued notes are over-collateralised. In this manner, even if some of the payments from the underlying loans are late or default, principal and interest payments on the issued notes can still be made.

## Subordination

A class of notes with rights that are subordinated to the rights of other classes of notes issued in connection with the same transaction. Subordination usually relates to the rights of note holders to receive promised debt service payments, particularly in situations where there is not sufficient cash flow to pay promised amounts to the holders of all note classes. However, it may also relate to the note holder's right to vote on issues concerning the operation of the transaction. Subordinated notes are repayable only after other classes of the notes with a higher ranking have been satisfied ("waterfall payment"). The payments of senior tranches are protected by subordinate tranches in case of loss.

## Excess spread

Net amount of interest payments of underlying assets after transaction administration expenses and bondholders' interest payments have been made. The excess could be used to cover losses and top-up reserve funds.

## Reserve funds

Funded accounts available for use by the SPV for one or more specified purposes. Some reserve accounts are also known as "spread accounts". Virtually all reserve accounts are at least partially funded at the start of the related transaction, but many are designed to be built up over time using the excess cash flow that is available after making payments to investors.

A credit enhancement can be illustrated by the following example.

As usual, a rating of AAA implies near certainty of timely payment of interest and principal on the issued debt. Although it is highly unlikely that an entire pool of residential mortgage loans will command such a rating, it is possible that a large portion of the portfolio will do so. The remaining portion of the portfolio is divided into different tranches through A and BBB to unrated first loss piece (which is typically held by the originator). Losses on the portfolio are allocated to the unrated position and then, usually, to the lower rated securities up to the senior AAA position.

## 1.8 Taxation in securitisation

The success of most products on the capital market largely depends on their taxation regime. For a securitisation transaction, tax neutrality is one of the key success factors in order to optimise investors' return and the originator's funding costs. Any tax levied on the securitisation vehicle or in relation to the securitisation itself would clearly increase the overall cost of the transaction, thus reducing its effectiveness. As a result, a securitisation transaction must be structured on a tax neutral basis in order to maximise its benefits. This means that all structural features of a securitisation transaction have to be clearly analysed from a tax perspective to ensure that none of the features lead to an additional tax burden, or accelerate tax liabilities that would have been incurred had the securitisation not taken place. In practice however, in many cases a securitisation transaction leads to some level of tax costs. In these circumstances, it is important that such costs are well known in advance and that there are no future uncertainties, so that a decision can be taken by the originator and/or investors on whether these costs are acceptable, considering the overall commercial benefits of the transaction.

Achieving a high degree of certainty in relation to the tax position of the issuer is also a pre-requisite in any securitisation transaction. In order to substantiate the rating assigned to the bonds, rating agencies will require a high degree of assurance that the issuer will not be subjected to any unexpected tax charges.

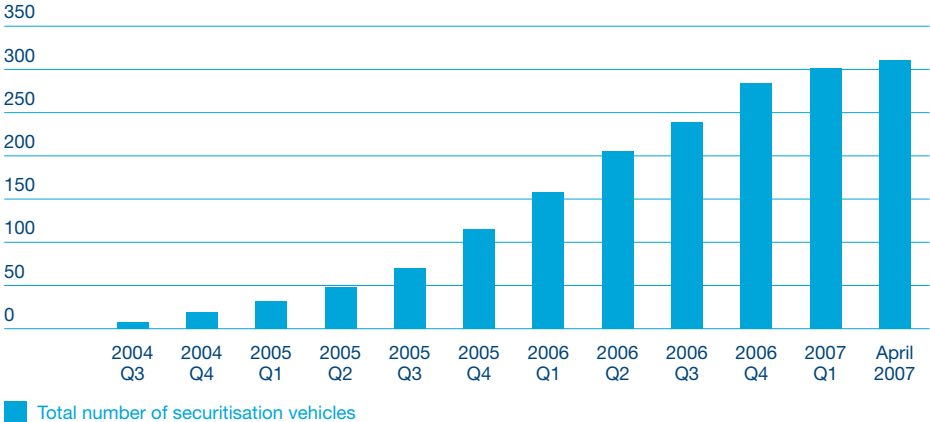
Generally, it is possible to structure securitisation transactions in order to achieve the required tax treatment. However, it is vital that relevant tax advice is provided at a very early stage to ensure that potential tax pitfalls are identified and properly addressed in the structure prior to the evaluation of external parties (e.g. rating agencies, legal and regulatory authorities, investors, etc). Furthermore, any option for advance tax clearances from tax authorities should be considered at an early stage in the process.

# 2 Part II: Luxembourg Securitisation Law – Key features and advantages

## 2.1 Luxembourg market overview

Since the introduction of the Luxembourg Law of March 22, 2004 on securitisation (“Securitisation Law”), the Luxembourg securitisation market has been developing very strongly. As detailed in the chart below, at least 311 securitisation vehicles were established in Luxembourg by the end of April 2007. But there are also other securitisation transactions on the market that are not using vehicles subject to the Securitisation Law. These structures are set up as commercial companies.

### Quarterly growth of vehicles



Source: Mémorial

Nearly all securitisation vehicles are set up in the form of securitisation companies; the small number of securitisation funds can be neglected. 58% of securitisation companies are incorporated as public limited companies (“S.A.”), 40% as private limited liability companies (“S.à r.l.”), and only 2% as partnerships limited by shares (“S.C.A.”). It needs to be pointed out that the total number of securitisation companies alone does not adequately illustrate the development of the market. Securitisation companies can consist of more than one compartment thereby structuring more than one securitisation transaction within a legal entity. We estimate that of the 311 vehicles created, nearly 2,000 compartments have been created.

The growth of vehicles shows that the goal of creating an attractive legal, regulatory, and tax framework for securitisation vehicles in Europe has been achieved. The main features of the law, the high degree of flexibility and certainty it provides to all originators, investors and creditors in Luxembourg and abroad, are summarised in the chapters below.

Currently, the main asset classes are loans, mortgages, life insurance policies, Mezzanine-Capital, lease receivables, trade receivables but also other securities in repackaging deals or structured investment products. Securitisation vehicles are also used within real estate or private equity structures or within hedge fund transactions.

Amongst the existing securitisation vehicles, as of April 30, 2007, 12 are regulated vehicles each incorporated as a public limited company. The total amount of assets securitised through regulated securitisation vehicles as at December 31, 2006 is about 14 billion Euro. In nearly all cases, the regulated securitisation companies created several compartments. Regulated securitisation companies use various models but three main structures can be summarised. Besides repacking transactions – which invest in securities and derivatives and issue notes whose yield depends on the performance of the securitised package – some regulated securitisation vehicles issue certificates as investment products for the retail business. Each certificate is usually represented by one compartment. Another structure is the securitisation of Small and Medium Enterprises (SMEs) financing products by using the capital market.

The outlook for the securitisation business in Luxembourg is very positive. It is expected that more investment product types of securitisation vehicles will be established and that securitisation transactions with assets from Russia, Eastern Europe and Germany will further develop the Luxembourg securitisation market.

## 2.2 Definition of securitisation

Compared to the common definition of securitisation as simply a financing process wherein an originator transfers one or more assets or risks to a securitisation vehicle (which, in turn, is financed by the issuance of notes backed by the assets or collaterals transferred and income generated by those assets) in exchange for cash, the definition of “securitisation” given by Luxembourg law is very broad. It encompasses all transactions wherein a securitisation vehicle acquires or assumes (directly or indirectly), any risk 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 transferable securities (shares, bonds or other securities), whose value or yield depends on such risks.

Within the meaning of the law, securitisation vehicles are entities, which carry out securitisation activities in full or which participate in securitisation transactions either by assuming all or parts of the securitised risk or by issuing securities for financing purposes. To qualify as a Luxembourg securitisation vehicle governed by the law, entities must specifically state in their articles of incorporation or management regulations (for securitisation funds) that they are subject to the provisions of the Securitisation Law.

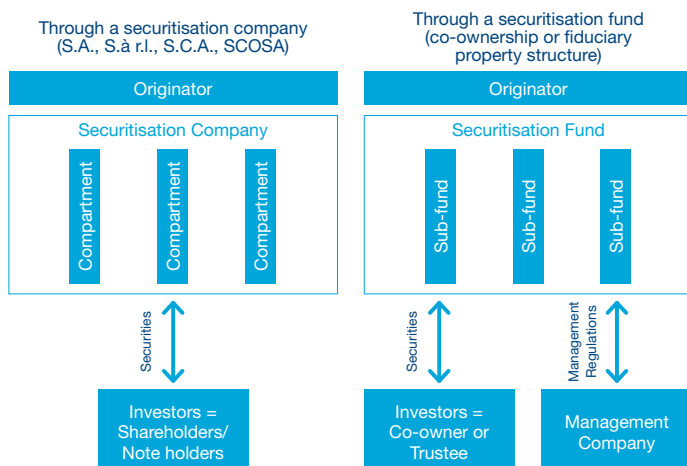
The law allows a wide range of assets such as trade receivables, mortgage loans, shares and, essentially, any tangible or intangible asset or activity with a reasonably ascertainable value or predictable future stream of revenue to be securitised. This has far-reaching implications. Securitisation transactions can be structured as all the types of transactions described in part I of this brochure. This means that transactions can be achieved by transferring the legal ownership of the assets (“True sale”) or by transferring credit risks linked to the assets (“synthetic”) set up either as a long-term-securitisation or as a short-term Commercial Paper Programme.

## 2.3 Regulatory

The regulatory aspects described in this section show two of the main characteristics of the law, which is the high degree of flexibility and the investor protection it provides.

### 2.3.1 Legal forms of securitisation vehicles

Modelled on the well-known investment fund regime in Luxembourg, the law introduced securitisation vehicles in the form of corporate entities as well as in the form of securitisation funds managed by a management company and governed by management regulations. The following schema provides a brief overview on the different forms Luxembourg securitisation vehicles can have.



Securitisation companies can take one of many legal forms such as a:

- “Société Anonyme” (“S.A.” equivalent to a public limited company); or
- “Société à Responsabilité Limitée” (“S.à r.l.” equivalent to a private limited liability company); or
- “Société en Commandite par Actions” (“S.C.A.”, partnership limited by shares); or
- “Société coopérative organisée comme une S.A.” (a cooperative company organised as a public limited company).

Should the securities be issued in a public offering, only a S.A. or a S.C.A. can be used, as a S.à r.l. cannot issue public instruments on the capital markets. One of the main advantages mentioned by many market participants is the possibility of creating several compartments within one legal entity. This concept is adapted from the well-appreciated umbrella-fund structure. To allow several compartments, the articles of incorporation of the securitisation company must simply authorise the Board of Directors to create separate compartments. This would allow each compartment to correspond to a distinct part of assets financed by distinct securities. The compartments allow for the separate management of a pool of assets and corresponding liabilities, so that the result of each pool is not influenced by the risks and liabilities of other compartments. Each compartment can be liquidated separately.

Securitisation companies are not subject to a specific minimum capital requirement. Consequently, the minimum share capital depends upon the legal form and ranges between EUR 12,500 for a S.à r.l. and EUR 31,000 for a S.A.. This minimum share capital refers to the whole legal entity and not to each single compartment.

A securitisation vehicle can also be organised in a pure contractual form as a **securitisation fund**. The fund does not have legal personality. It will, however, be entitled to issue units representing the rights of investors according to management regulations. In the absence of legal personality, the fund may be organised as a co-ownership or a trust. In both cases, the fund will be managed by a management company, which will be a commercial company with a legal personality. As for the securitisation company, the fund may be split into compartments, which may be liquidated separately. The characteristics of, and the rules applicable to each compartment may be determined by separate management regulations.

Securitisation funds are not subject to any minimum share capital requirements. Only the management company must meet the minimum capital requirement depending on the legal form chosen. Hence, the required capital ranges between EUR 12,500 for a S.à r.l. and EUR 31,000 for a S.A..

### 2.3.2 Regulation of securitisation vehicles

Regarding the authorisation and supervision of securitisation vehicles, the law differentiates between regulated and non-regulated entities. Regulated securitisation vehicles are authorised by the Luxembourg Supervisory Commission of the Financial Sector (the “CSSF”) to exercise their activities and also supervised by them which entails that the CSSF must in particular ascertain that they comply with the law and fulfill their obligations.

A securitisation vehicle is subject to CSSF supervision on a voluntary basis or mandatory if it issues securities to the public on a continuous basis. Since the law does not specifically define what “public” and “on a continuous basis” mean, the CSSF published the following criteria regarding the notion “public”:

- Subscription of securities by an institutional investor or financial intermediary for a subsequent placement of such securities with the public constitutes a placement with the public;
- Issues whose denominations do not exceed EUR 125,000. Those over this amount are assumed to not be placed with the public. The listing of an issue on a regulated market does not ipso facto entail that this issue will be placed with the public.

Note that issues to professional investors and private placements are not considered as issues to the public.

It should be noted that the definition of the term “public” in the area of securitisation is not in line with that of the Law of July 10, 2005 on prospectuses for securities, which defines the notion “offer to the public” and whose determining criteria is that of a proactive approach of solicitation and a specific offer adopted by the banker.

Regarding the notion “on a continuous basis”, the CSSF considers it to be fulfilled from the moment the securitisation undertaking has made at least four issues per year. However, a securitisation undertaking that makes at least four issues on an annual basis is not subject to the supervision of the CSSF if it issues denominations exceeding EUR 125,000. In the case of a multiple-compartment securitisation vehicle, the CSSF clarified that the number of issuances per year has to be determined on the level of the securitisation company and not on compartment level.

Authorisation by the CSSF means that the CSSF has to approve the articles of incorporation or management regulations of the securitisation vehicle and, if necessary, authorise the management company. To grant approval, the CSSF must be notified who the members of the administrative, management and supervisory bodies of the securitisation vehicle are. In the case of a management company of a regulated securitisation fund, the names of the shareholders who are in a position to exercise significant influence must also be mentioned. Securitisation companies and management companies of securitisation funds must have an adequate organisation and adequate resources to exercise their activities. The directors of the securitisation vehicle must be of good repute and have adequate experience. 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’s regulations or the articles of incorporation, are subject to the prior approval of the CSSF. After authorisation, the regulated securitisation vehicle will be entered into an official list by the CSSF. Such an entry is tantamount to authorisation and the securitisation vehicle shall be notified. This list and any amendments made thereto will be published by the CSSF.

The law has vested the CSSF with the authority to supervise securitisation vehicles on a continuous basis. It has wide investigative powers regarding all elements likely to influence the security of investors. To this end, the CSSF may request any information from the regulated entity. For the time being, the CSSF has not issued any specific circular that defines reporting requirements. Until more sophisticated standardised reporting is implemented, each regulated entity will receive a separate letter with reporting requirements. The reporting can be classified into three categories.

The following documents need to be submitted to the CSSF on an *ad hoc basis*:

- The final issue documents relating to each issue of securities;
- A copy of the financial statements drawn up by the securitisation vehicle for its investors and rating agencies, where applicable;
- A copy of the annual reports and documents issued by the external auditor resulting from its audit of annual accounts.

On a *half-yearly basis*, the CSSF requires that securitisation vehicles provide statements on new issues of securities, outstanding issues and issues that have been redeemed during the period under review. In connection with each issue, the nominal amount issued the nature of the securitisation transaction, the investor profile and, where applicable, the compartment concerned should be reported. In addition, the half-yearly report should include a brief statement of the financial situation of the securitisation vehicle and notably a breakdown (by compartment where applicable) of its assets and liabilities. At the financial year-end, a draft balance sheet and a profit and loss account are also to be added. The half-yearly reporting shall be submitted to the CSSF within 30 days. There are no special requirements regarding the format nor on the data support of the information to be submitted.

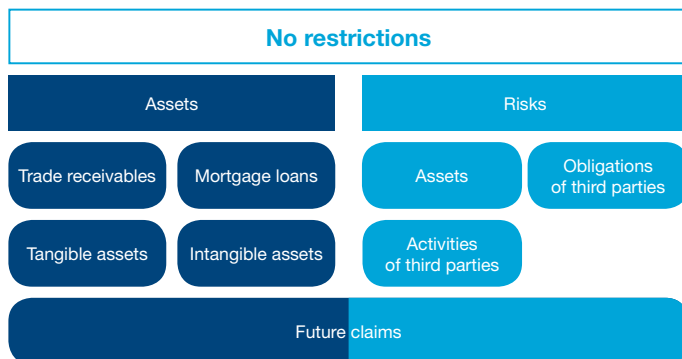
The third category of reporting is the *year-end reporting* which consists of the audited annual accounts and of the management letter issued by the auditor.

A further requirement for regulated securitisation vehicles is that their assets (securities and cash) need to be held in custody by a Luxembourg credit institution.

No regulatory requirements are provided for securitisation vehicles making a single securities issue or irregular issues or issuing securities in a private placement.

### 2.3.3 Asset classes

Another aspect of the law’s great flexibility is the wide range of asset classes that qualify for securitisations. The law does not limit securitised assets. Whilst in its early phases of development, the securitisation market essentially covered assets like loans and receivables of financial institutions – such as Mortgage-Backed loans, credit card receivables and student loans. Today, however, securitisation transactions cover tangible asset classes, such as railcars, diamonds and champagne or intangible assets, such as intellectual property.



Under Luxembourg law, risks may also be securitised. These risks relate to the holding of assets, whether movable or immovable, tangible or intangible. In addition, the risks can also result from the obligations assumed by third parties as well as relate to all or part of the activities of third parties. The securitisation vehicle can assume these risks by acquiring the assets, guaranteeing the obligations or by committing itself in any other way.

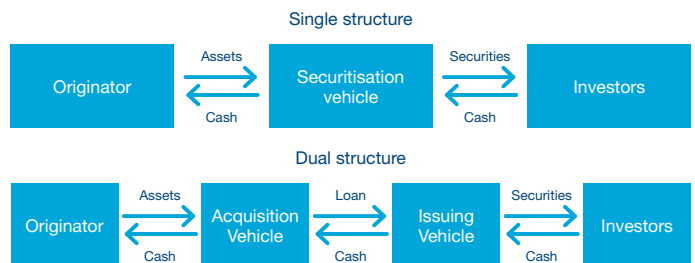
Regarding claims, it is also possible to assign existing claims to a securitisation vehicle but it is also possible to do this for future claims. These arise out of an existing or future agreement provided that they can be identified as being part of the assignment at the time they come into existence or at any other time agreed between the parties.

The main asset classes securitised through Luxembourg securitisation vehicles are securities, loans, mortgages, life insurance policies, Mezzanine-Capital, lease receivables, trade receivables and receivables in connection with real estate.

### 2.3.4 Forms of securitisation transactions

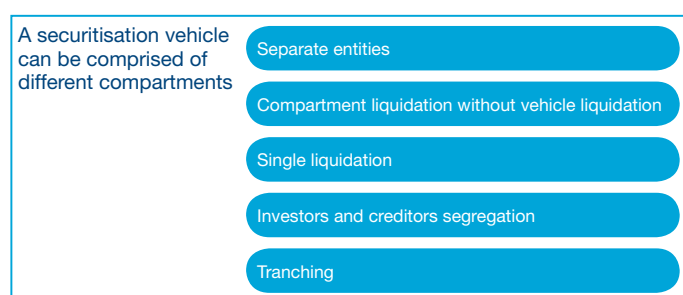
Securitisation transactions can be executed in the two forms described in Part I. Within the scope of a “True sale” transaction, the originator sells a pool of assets to a securitisation vehicle. Within the scope of a “Synthetic” transaction however, the originator buys credit risk protection through a series of credit derivatives.

As shown in the following schema, it is possible to structure securitisation transactions as single structures or as dual structures. In a single structure, one securitisation vehicle purchases the assets or the risks and issues the securities. In a dual structure on the other hand, two or more vehicles will be constituted. Some of them will act as “acquisition” vehicles, which purchase the assets or the risks. They are funded by loans provided by an “issuing” vehicle issuing notes to the market whose repayment is linked to the repayment of the loans granted to the acquisition vehicles. On the other hand, these loans are a mode of assuming a risk linked to underlying assets and whose repayments are linked to the cash flows resulting out of this underlying. In a dual structure, the acquisition vehicles can also be established in the country of the originator or in the country where the transferred assets are located.



### 2.3.5 Compartment segregation

The compartment segregation of the securitisation vehicle – a technique often applied to investment funds in Luxembourg – also characteristically illustrates the great flexibility securitisation transactions in Luxembourg provide. Such segregation has to be mentioned in the articles of incorporation of a securitisation company or in the management regulations of a securitisation fund.



Compartment segregation means that the assets and liabilities of the vehicle can be split into different compartments each of which are treated as separate entities making distinct transactions. The rights of investors and creditors are limited to the risks of a given compartment's assets. Each of the compartments can be liquidated separately without any negative impact on the vehicle's remaining compartments, i.e. without triggering the liquidation of other compartments. In case the securitisation vehicle is a corporate entity, all compartments can be liquidated without necessarily liquidating the whole vehicle.

In addition, the securitisation vehicle or one of its compartments can issue several tranches of securities corresponding to different collaterals and providing different values, yields and redemption terms. This can only be done however if provided for in the articles of incorporation, the management regulations or the issuance agreement. In case of a dual structure, where the acquisition vehicles are separated from the issuing vehicle, the value, yield and repayment terms of the transferable securities issued by the issuing vehicle may also be linked to the assets and liabilities of the acquisition vehicles.

### 2.3.6 Enhanced investor protection

One of the most important aspects of the Securitisation Law is the assurance of enhanced investor protection. The bankruptcy remoteness principle separates the securitised assets from any insolvency risks of the securitisation vehicle or of the originator, the service provider or collateral. The law allows for contractual provisions that are valid and enforceable and which aim to protect the securitisation vehicle from the individual interests of involved parties:

- **Subordination provision:** Investors and creditors may subordinate their rights to payment to the prior payment of other securities or debts by the securitisation vehicle.
- **Non recourse provision:** Investors and creditors may waive their rights to request enforcement. This means, for example, that if payment of interest is on default, the investor may agree to wait for payment and not recourse to legal action, as the situation is known or is temporary for example.
- **Non petition provision:** Investors and creditors may waive their rights to initiate a bankruptcy proceeding against the securitisation vehicle. This clause protects the vehicle against the actions of individual investors who would, for example, find an interest in a bankruptcy proceeding against the vehicle.

In addition, the law provides that the assets are exclusively available to satisfy the claims of the investors who funded them and of the creditor whose claims are in connection with their assets. Thus, compartment segregation prevents insolvency contamination.

### 2.3.7 Qualified service providers

The following two entities provide high investor protection as well as business opportunities for Luxembourg market players.

#### 2.3.7.1 The fiduciary representative

Fiduciary representatives are professionals of the financial sector who can be entrusted with safeguarding the interests of investors and certain creditors.

In their capacity as fiduciary representatives and in accordance with the legislation on trust and fiduciary agreements, the fiduciary representatives can accept, take, hold and exercise all sureties and guarantees on behalf of their clients and ensure that the securitisation vehicle manages the securitisation transactions properly. The extent of such rights and powers are laid down in a contractual document to be concluded with the investors and creditors, whose interests the fiduciary representatives must defend. If, and for as long as one or more fiduciary representatives have been appointed, all individual rights of represented investors and creditors are suspended.

Fiduciary representatives must be authorised by the Ministry of Finance. They must have their registered office in Luxembourg and they may not exercise any activity other than their principal activity except on an accessory and ancillary basis. The authorisation for exercising the activity of a fiduciary representative can only be granted to stock companies with a share capital and own funds of at least EUR 400,000.

For the time being, no fiduciary representative is registered in Luxembourg.

### 2.3.7.2 The custodian

In order to guarantee that assets in the form of cash or transferable securities held by a securitisation vehicle are kept under the best security conditions for the investor, the law requires regulated securitisation vehicles to deposit such assets with a Luxembourg credit institution.

## 2.4 Accounting

### 2.4.1 Basic principles

The Securitisation Law contains “most” of the necessary regulations. By “most” we mean that there is one noticeable exception: reference to other laws with respect to accounting principles. The accounting rules applicable to securitisation vehicles vary according to the legal forms they have. Securitisation vehicles established as securitisation companies must comply with the provisions of chapters II and IV of title II of the Law of December 19, 2002 on the trade and companies register and the accounting and the annual accounts of companies.

A securitisation company is obliged to prepare a management report if the size criteria of article 35 of the Law of December 19, 2002 is exceeded (non-small companies) or if it has its securities listed on an EU regulated market regardless of size. This management report must contain all material information relating to its financial situation, which could affect the rights of investors. The reference to commercial law also includes the application of the cost accounting principle.

On the other hand, a securitisation fund managed by a management company and governed by management regulations is subject to the accounting and tax regulations applicable to investment funds provided for by the Law of December 20, 2002 on investment funds. Hence, in general, the valuation of a securitisation fund is based on the mark-to-market principle.

Both forms of securitisation vehicles must be audited by an independent auditor. In the case of regulated securitisation vehicles, the independent auditor must be authorised by the CSSF.

### 2.4.2 Securitisation company accounting versus securitisation fund accounting

As mentioned before, the Securitisation Law allows securitisation vehicles to have two legal forms: a corporate entity as well as a securitisation fund.

Regarding the valuation principle of the assets of a securitisation vehicle, two references to different laws exist. Due to article 47 of the Securitisation Law, securitisation companies must comply with the provisions of the Law of December 19, 2002. A securitisation fund on the other hand, is subject to the accounting and tax provisions provided for by the Law of December 20, 2002 on investment funds.

As a consequence, due to the lower of cost or market principle, the assets of a securitisation company are valued at the lower of acquisition cost or the market value at year-end. A valuation above acquisition cost, based on higher market values, is in principle not feasible. On the contrary, the assets of a securitisation fund, are generally valued at their last known stock exchange price or at their probable realisation value unless otherwise stated in the management regulations of the securitisation fund. As a result, the securitisation fund could apply either mark-to-market valuation or, under certain conditions, cost accounting for the valuation of its assets.

The valuation of the assets at their acquisition cost and the necessary valuation of the notes issued on the liability side at their repayment amount, could lead to an unrealised loss. Therefore, applying the cost accounting principle for the annual accounts of a securitisation company – meaning that only profits realised can be included – can lead to accounting asymmetries.

Thus, the question arises why a securitisation company and a securitisation fund have to apply different valuation principles when both forms can be used for the same securitisation transaction. This unequal treatment does not appear appropriate as there is no difference regarding eligible assets. Consequently, and due to the fact that the annual accounts of a securitisation company should provide a true and fair view of the company's assets, liabilities, financial position and results, a securitisation company could also allow to disclose its assets at market value or probable realisation value. The regulations in article 26 (3) and (5) of the Law of December 19, 2002 could support this view. It is allowed, in exceptional cases, to deviate from existing regulations if a true and fair view can only be achieved through a symmetric presentation and valuation of the assets and the related issued liabilities. Any such derogation must be disclosed in the notes to the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and results. As a result, the application of mark-to-market valuation is allowed for a securitisation company as well.

From an economic perspective, a securitisation fund is more comparable to a securitisation company than to an investment fund. Since the reference to investment laws relates only to the accounting and tax provisions – and not to **disclosure** requirements – a securitisation fund could apply the same rules as a securitisation company. For the latter, detailed disclosure requirements are defined in the above-mentioned commercial law. Hence, the required disclosures for an investment fund – like the statement of change in net assets or an explicit disclosure of the portfolio – should not be demanded in the annual accounts of a securitisation fund, although it could be appropriate in some cases.

### 2.4.3 Multiple-compartment vehicles

One of Luxembourg's specialties adopted from the investment management industry is that a securitisation vehicle may be split into one or more separate compartments, each corresponding to a distinct part of its assets financed by distinct securities. As far as accounting is concerned, the CSSF confirmed that multiple-compartment securitisation companies should present their annual accounts as well as relating financial notes in such a form that the financial data for each compartment is clearly stated. It is possible however, to regroup the notes to the financial statements of several compartments. As a result, a securitisation vehicle with several compartments is seen as a combination of several companies under one legal entity. Regarding the financial disclosure of a multiple-compartment structure, it should be noted that the disclosure of only a combined balance sheet and a combined profit and loss account will not provide a true and fair view of the securitisation vehicles' activities and of its financial situation. Therefore, either separate balance sheets and profit and loss accounts for each compartment need to be disclosed in addition to the combined one, or a special note could be added in the notes to the financial statements describing the compartment structure including the assets and liabilities and the income and charges of each compartment. In the appendix to this brochure, we will present an illustrative example of the financial statements of a securitisation company including an example of how the disclosure requirements for a multiple-compartment structure can be achieved.

### 2.4.4 Treatment of losses

From the investors' perspective, the securitisation vehicle is bankruptcy remote. A bankruptcy remote structure provides reasonable certainty that the notes issued are collateralised by a pool of assets that have been legally isolated from the transferor in all possible circumstances, including insolvency. As a result, the assets in the securitisation vehicle should be beyond the reach of the transferor's liquidator.

On the other hand, the recovery of the notes issued is entirely dependent on the securitisation vehicle's asset pool generating sufficient cash flows as the investors usually have no recourse to the transferor, beyond its structural support, should asset cash flows be less than originally anticipated.

The ability of the asset pool to meet its obligations to the holders of the funding instruments is largely assessed on projected asset cash flows under various scenarios. These scenarios are, in principle, illustrated in the offering documents using key assumptions for prepayments and credit losses due to delinquencies and defaults. In some structures, cash flows from the pool may be used to acquire new assets from the originator or in the case of a CDO, from the secondary market until the end of a revolving period, at which stage collections are used to repay the funding instruments. To minimise the risk to investors investing in new assets, the assets must satisfy various eligibility criteria.

Investor risk is often further reduced by the structure. This is achieved most typically with a senior and subordinated structure of the notes issued by the securitisation vehicle. The notes are usually issued in a variety of tranches, each one having a different seniority as to payment from the cash flows of the pool of assets. When the cash flows from the asset pool are collected, they are used at first to meet the obligations of the most senior debt holders. Any residual cash flows after payment of the most senior class are then used to pay the less senior note holders. This process is known as the “waterfall” and has the effect of allocating cash flow shortfall to the most junior debt holders or investors.

Should losses resulting from the assets be significantly higher than anticipated and exceed the transferor’s interest, the note holders are exposed to credit losses. To provide a true and fair view, these losses shall be disclosed in the annual accounts. Therefore, a value adjustment will be made in respect of the assets, so that the assets are valued at the lower figure to be attributed to them at the balance sheet date. This value adjustment will lead to a loss in the profit and loss account. As described above, the loss will be absorbed by the holders of the notes issued. Consequently, the amount repayable will decrease. To reflect this in the annual accounts, a provision for value diminution shall be made in respect of the liabilities, so that the liabilities are disclosed at the lower figure to be attributed to them at the balance sheet date. This will lead to an unrealised gain in the profit and loss account and should be disclosed as an “equalisation provision”. As a result, the total net effect on the profit and loss account will be nil. To provide a better understanding, a description of the valuation method used to identify impairments or losses should be given in the notes to the annual accounts.

In addition, the waterfall structure and the consumption of the waterfall should be presented in the notes to the financial statements.

In the illustrative appendix to this brochure, note 9 provides an example of a possible disclosure schema.

#### **2.4.5 Technical gains**

As a securitisation vehicle usually distributes all cash flows it receives to the investors, it will usually neither disclose a profit nor a loss in the profit and loss accounts.

But in some cases, it may happen that the expected cash flows resulting from the assets are higher than the amount of the issued notes outstanding. If, for example, in the case of trade receivables, the actual default rate is lower than the expected one, the financial statements will show a profit for that financial year. Furthermore, a gain can result from valuation of the assets and liabilities and also from the application of the accrual principle. For example, the principle requires that interest income resulting from interest-bearing underlyings be accrued and not accounted for only at the time of the cash flows. As a result, all profit would lead to taxation in the respective financial year.

Due to the fact that all cash flows received by the securitisation vehicle will be distributed to investors or other parties involved – but not necessarily in the same period in which the profit takes place – a disclosure of profit does not provide a true and fair view of the financial situation of the securitisation vehicle.

As described above, there is no economic base for the profit in the respective financial year of the securitisation vehicle. Consequently, the profit could only be seen as a kind of technical profit.

To take into account the economical background of a securitisation transaction, the securitisation vehicle might book additional liability.

This will result in additional charges, which will equalise the profit resulting from the assets.

## 2.5 Tax neutrality

As mentioned in Part I, tax neutrality is one of the key success factors of securitisation transactions. Luxembourg law has been successful in achieving complete tax neutrality. The following schema shows the different tax types applicable to the two securitisation forms.



### 2.5.1 Tax specificities of securitisation companies

Securitisation vehicles organised as corporate entities are, as a rule, fully liable to **corporate income tax** and **municipal business tax** at an aggregate tax rate of maximum 29.63%. Therefore, they are in principle taxed on their net accounting profit (i.e. gross accounting profits minus expenses). According to the Securitisation Law however, the commitments of a securitisation company to remunerate investors for issued bonds or shares and other creditors qualify as interest on debt even if paid as return on equity. Hence, they are fully tax-deductible, so the tax impact should be very limited if not nil. However, it may be vital to secure the tax treaty benefits depending on the nature of the assets. Structuring the cash flows so as to leave a minimal taxable basis that can be effectively taxed, could play an essential role in this respect.

Securitisation companies are subject to a **capital duty** which is determined by the Grand Ducal Regulation dated April 29, 2005 at a fixed amount of EUR 1,250. This amount will cover any further capital increase as well as any conversion of the securitisation company into another corporate type including mergers, demergers or other reorganisations.

Furthermore, securitisation companies are not subject to **net worth tax** in Luxembourg.

Since securitisation companies are fully taxable resident companies, they benefit from Luxembourg's tax treaty network and from the EU Parent Subsidiary Directive. At present, the following 50 countries have signed tax treaties with Luxembourg:

- Austria
- Belgium
- Brazil
- Bulgaria
- Canada
- China (out of Hong Kong)
- Czech Republic
- Denmark
- Estonia (as from 1.1.2008)
- Finland
- France
- Germany
- Greece
- Hungary
- Iceland
- Indonesia
- Ireland
- Israel
- Italy
- Japan
- Latvia
- Lithuania
- Malta
- Malaysia
- Mauritius
- Mexico
- Mongolia
- Morocco
- Norway
- Poland
- Portugal
- Romania
- Russia
- Singapore
- Slovakia
- Slovenia
- South Africa
- South Korea
- Spain
- Sweden
- Switzerland
- Thailand
- Turkey
- The Netherlands
- Trinidad and Tobago
- Tunisia
- United Kingdom
- United States of America
- Uzbekistan
- Vietnam

### 2.5.2 Tax specificities of securitisation funds

Since securitisation funds are treated in the same way as investment funds in Luxembourg, they are exempt from corporate income tax and municipal business tax. Unlike most investment funds, securitisation funds benefit from a capital duty and subscription tax ("taxe d'abonnement") exemption.

The management company of the fund is subject to a capital duty of maximum EUR 1,250.

### 2.5.3 Common features

The shareholders of the securitisation company or the unit holders of the securitisation fund are treated like bondholders. Dividend distributions and payments on fund units made by a securitisation vehicle are exempt from withholding tax. Interest payments are exempt from withholding tax but subject to the European Savings Directive.

The management of securitisation vehicles is exempt from VAT. Therefore, the exemption applies to the services rendered by management companies of funds and third parties performing management services for securitisation vehicles.

The liquidation of securitisation vehicles, whatever their nature, is tax exempt. The registration of securitisation vehicles' deeds is exempt from registration formality rules, unless they relate to real estate situated in Luxembourg, or aircrafts and vessels recorded in a Luxembourg public register. In case of voluntary registration of deed, a fixed registration duty of EUR 12 applies.

## 2.5.4 VAT

### 2.5.4.1 VAT status of securitisation vehicles

The Luxembourg VAT administration issued on December 29, 2006 a Circular regarding VAT rules applicable to investment funds and similar vehicles including securitisation vehicles (Circular n°723). The aim of this Circular was to clarify the Luxembourg VAT authorities' interpretation of notably, the European Court of Justice Case n°C-8/03 "BBL" (21/10/2004) concerning the VAT status of undertakings for collective investments set up as investment companies.

In its Circular, the VAT administration took a common approach for all investment funds and similar vehicles including securitisation vehicles listed under article 44.1.d. of the Luxembourg VAT law (see point 2.5.4.2.). These vehicles are considered as VAT taxable persons performing management services of special investment funds exempt from VAT pursuant to article 44.1.d. VAT. This position by the Luxembourg VAT administration is different from the ones taken in the past and has significant consequences.

The change implies that such vehicles are unable to recover VAT suffered on costs and can no longer apply for the "full VAT registration regime" but only for the "simplified VAT registration regime" when paying Luxembourg VAT on goods and services received from abroad pursuant to the reverse charge mechanism. The Circular also specifies that "umbrella-funds" should be regarded as a single taxable person.

This position has the advantage of lowering the administrative obligations of investment funds. On the other hand, even if a lot of services acquired by securitisation vehicles could be VAT exempt (see 2.5.4.2), the denial of VAT recovery could constitute a drawback when it comes to professional fees.

It should be emphasised that the position of the administration can be debated, especially in the case of securitisation vehicles. Moreover, it should be noted that, before the issuance of this Circular, the VAT administration accepted the registration of some securitisation vehicles under the full VAT registration scheme and thus, full or partial VAT recovery was possible. A careful analysis of the activities performed by each securitisation vehicle should thus be made on a case-by-case basis.

### 2.5.4.2 VAT exemption of services rendered to securitisation vehicles

Article 44.1.d) of the Luxembourg VAT law (implementing article 13.B.d.6) of the pre-recast 6<sup>th</sup> EU VAT Directive/article 135 of the recast 6<sup>th</sup> EU VAT Directive) foresees that management services of special investment funds are exempt from VAT. The law lists the eligible funds or vehicles but not the eligible services. The vehicles affected by the Securitisation Law are listed under article 44.1.d) and could thus receive VAT exempt services from their service providers.

As mentioned above, article 44.1.d) does not provide a list or define the services that could benefit from exemption. However, in practice the exemption has always been applied in a very broad manner. Although the concept of management is not defined, it is usually accepted that the services falling within the scope of this exemption are those mainly dealing with the day-to-day management of special investment funds. Provided some conditions are met, this exemption may also apply to transactions supplied to special investment funds, which would not have been exempt if they were supplied to individuals or to other undertakings. This means that administrative services, portfolio management services and the services of depositary banks could benefit from exemption.

Regarding depositary services, the recent Abbey National case (C169-04) ruled by the European Court of Justice on May 4, 2006 should be taken into account. The Court decided that custody services are not management services because the custodian's role is not to manage the fund but to control and supervise it.

Based on the Circular, the "control and supervision" services performed by depositary banks are, as from April 1, 2007, liable to VAT at the rate of 12%. Other services performed by depositary banks such as transactions services are not impacted by this case however.

## 2.6 Summary and examples

As described above, the Luxembourg Securitisation Law offers an attractive regulatory framework for setting up workable securitisation structures in Luxembourg at reasonable costs. The strong development of the securitisation market in the past years confirms this. The key features, which make the law attractive practically are summarised as follows:

- Vast flexibility in entity establishment from a cost and structural point of view;
- Legal certainty;
- Broad bankruptcy remoteness mechanisms;
- Qualified service providers;
- Tax neutrality.

Such vast flexibility is also the result of having studied the different securitisation transactions effected on the Luxembourg market since the establishment of the Securitisation Law. The end of part II that presents the Luxembourg Securitisation Law will provide some typical examples of Luxembourg securitisation vehicles.

### Life insurance securitisation

American senior life settlements have come about because some insured individuals no longer want, need or are able to afford their coverage. Instead of selling the policy back to the originating insurance company at less than market value, or allowing the policy to lapse and forfeit the value, life settlements permit another exit option to the benefit of the policy owner.

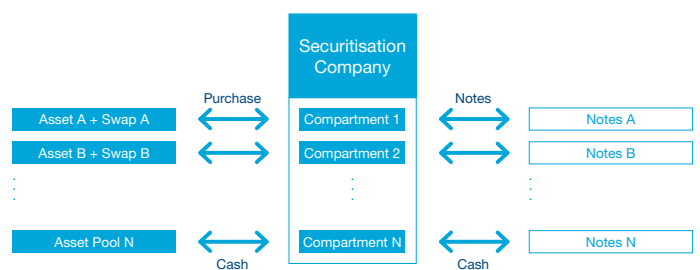
Therefore, Luxembourg securitisation vehicles issue bonds collateralised by an underlying portfolio of life settlement policies. The proceeds of issuance are partly used for purchasing the policies and partly to pay ongoing premiums.

Upon maturity of the purchased policies, all proceeds are put to the benefit of the securitisation vehicle. These proceeds will be used to repay the issued bonds together with interest accruals. The following schema shows a typical set up example:



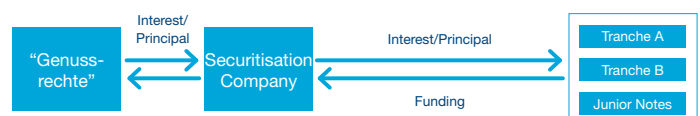
### Securitisation for issuance of certificates for the retail business

Another typical Luxembourg securitisation structure which uses the possibility of creating several independent compartments under one legal entity is a multiple-compartment vehicle issuing certificates whose performance depends on various underlyings, like the interest rate development, growth of a special market or an industry sector etc. To structure such certificates, each compartment purchases a collateral with an excellent rating, like a mortgage or a government bond which generally generates plain vanilla interest payments. Then, for each compartment, the company enters into an OTC Swap Agreement to swap the interest derived from the collateral against the performance payment of the underlying of the notes issued. The following schema shows the typical structure:



### Securitisation of Mezzanine-Capital

The last successful example presented is the securitisation of Mezzanine-Capital. In this case, several small and medium sized entities have raised capital by issuing Profit Participation Agreements (“Genussrechte”) purchased by the Luxembourg securitisation vehicle. To finance the purchase, the securitisation company issued notes with limited recourse to the related Profit Participation Agreements. The notes issued are split into senior and junior tranches while payments are made out of the available funds arising from interest and principle payments of the collaterals. The following schema illustrates the structure:



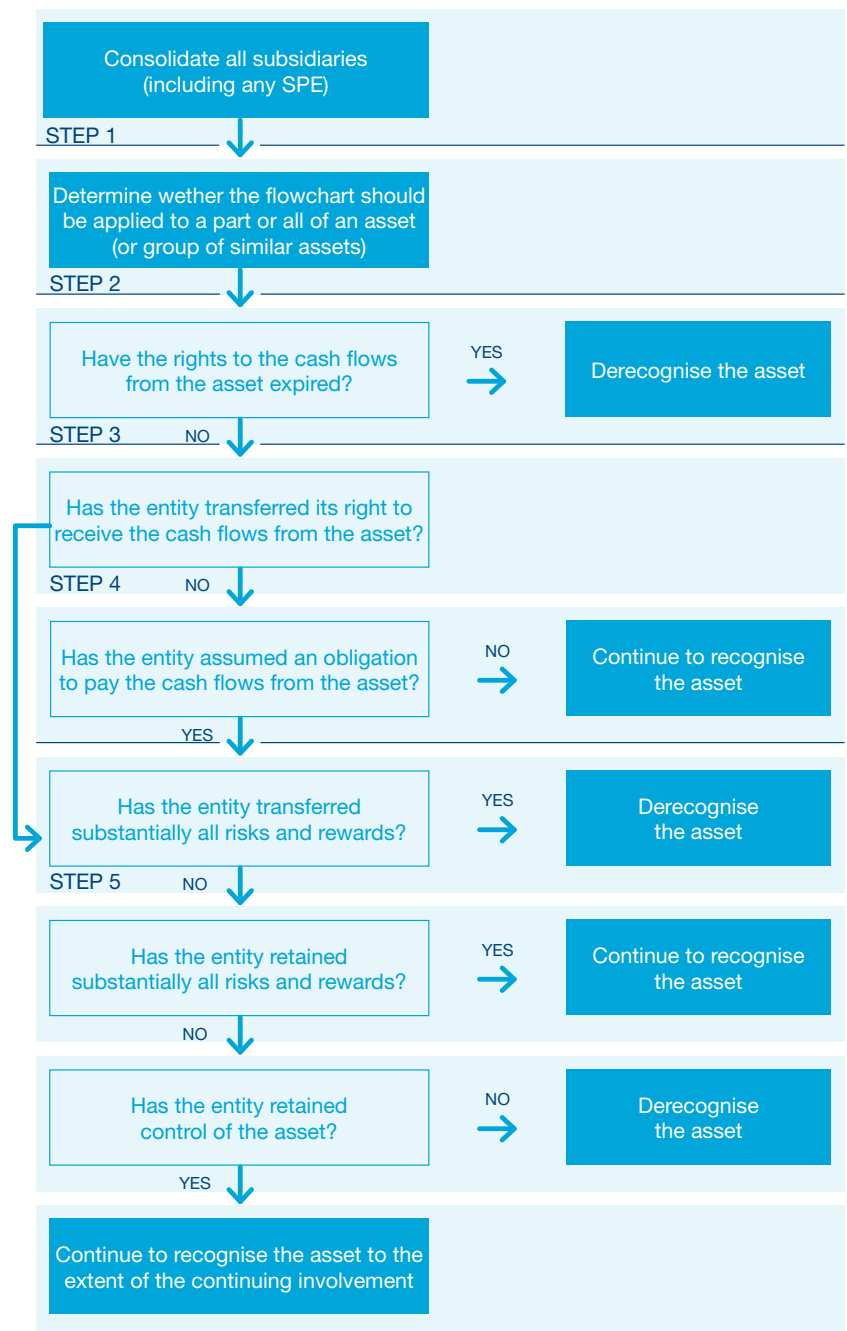
# 3 Special issues

## 3.1 IFRS – Accounting and consolidation issues for the originator and the SPV

### 3.1.1 Introduction

Questions have been arising concerning the accounting treatment of ABS-transactions not least because of the implementation of the International Financial Reporting Standards (IFRS) in the European Union. One of the major issues for the originator of these transactions is consolidation and the recognition or derecognition of securitised assets. Even for investors, there might be consolidation issues under IFRS. But at first, we will deal with the accounting and consolidation issues (especially derecognition rules) for the originator and the SPV.

The rules to derecognise financial instruments are defined in IAS 39 “Financial Instruments: Recognition and Measurement”. The rules of derecognition are summarised in the following chart:



One of the most important features of these derecognition rules is that the derecognition test for financial assets must be applied on a consolidated level. Therefore, the first step in determining if the securitised assets will be derecognised from the balance sheet is to determine the scope of consolidation.

### 3.1.2 Step 1: Consolidation of the SPV

The consolidation criteria under IFRS are defined in IAS 27 “Consolidated and Separate Financial Statements” and SIC 12 “Consolidation – Special Purpose Entities”. In accordance to IAS 27.12, consolidated financial statements shall include all subsidiaries of the parent company. Therefore, in a first step, it must be determined if the SPV in a securitisation transaction is seen as a subsidiary.

A subsidiary is an entity that is controlled by another entity. Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

IAS 27.13 stipulates: “Control is presumed to exist when the parent owns, directly or indirectly, through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:

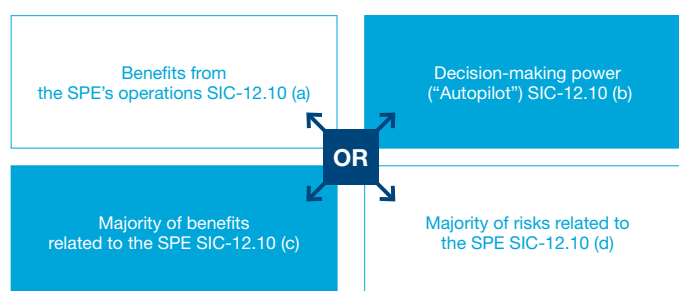
- Power over more than half of the voting rights by virtue of an agreement with other investors;
- Power to govern the financial and operating policies of the entity under a statute or an agreement;
- Power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- Power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.”

In many securitisations, none of the above criteria would be fulfilled, as the SPV will usually be legally separated from the originator and the agreements will fulfill none of the above-mentioned criteria for control.

In addition to IAS 27, SIC 12 provides additional guidance on consolidation requirements of SPVs. Whereas IAS 27 focuses more on the legal relationship between entities, SIC 12 clarifies that an SPV shall be consolidated when the substance of the relationship between an entity and the SPV indicates that the SPV is controlled by that entity. Examples that may indicate that an entity controls an SPV include:

- In substance, the activities of the SPV are being conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the SPV’s operation;
- In substance, the enterprise has the decision-making power to obtain the majority of the benefits of the activities of the SPV or, by setting up an “autopilot” mechanism, the enterprise has delegated these decision-making powers;
- In substance, the enterprise has rights to obtain the majority of the benefits of the SPV and therefore may be exposed to risks incident to the activities of the SPV; or
- In substance, the enterprise retains the majority of the residual or ownership risks related to the SPV or its assets in order to obtain benefits from its activities.

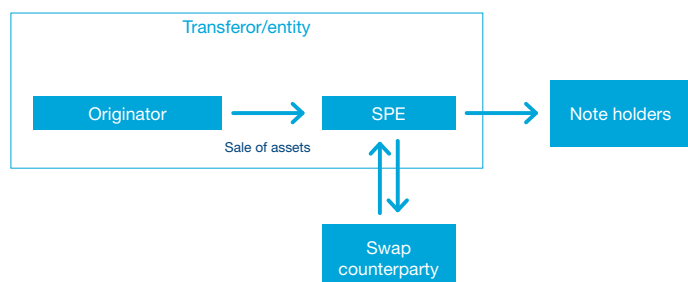
Figure 1: Consolidation criteria for an SPV



Therefore, when considering the consolidated accounts of an originator who has securitised assets, the consolidation requirements have to be examined by considering both IAS 27 and SIC 12.

As described before, the derecognition principles have to be applied on a consolidated level. This means that usually in securitisation, the next steps in derecognition are applied on “group” level consisting of the Transferor and the SPV (in the following “the entity”).

Figure 2: Derecognition on group level



### 3.1.3 Step 2: Determination if derecognition principles should be applied to a part or all of an asset

The next step is to identify the assets (or part of assets) which should be tested for derecognition.

The tests may be applied to any of the following:

- An entire asset (e.g., an unconditional sale of a financial asset);
- A fully proportionate share of the cash flows from an asset (e.g., a sale of 10 percent of all principal and interest cash flows);
- Specifically identified cash flows from an asset (e.g., a sale of an interest-only strip), or;
- A fully proportionate share of specifically identified cash flows from an asset (e.g., a sale of a 10% interest-only strip).

### 3.1.4 Step 3: Have the rights to cash flows from the asset expired?

If the contractual rights to the cash flows from a financial asset (or part of the asset) have expired or been forfeited, the financial asset should be derecognised.

This is the case when a debtor discharges its obligation by paying the holder of the financial asset or when the debtor's obligations to the holder have ceased (e.g., when the rights under an option expire).

### 3.1.5 Step 4: Has the asset been transferred?

A transaction qualifies as a transfer if the entity transfers the contractual rights to receive the cash flows to a third party or where it retains the contractual rights but assumes a contractual obligation to pass on these cash flows to another (pass through arrangements).

### Test 1: Has the entity transferred its rights to receive the cash flows from the asset?

Some transactions clearly involve the transfer of rights to another party. For example, an entity that has sold a financial asset (e.g., a legal sale of a bond) has transferred its rights to receive the cash flows from the asset. The transfer then has to be assessed in Step 5 to determine whether it meets the derecognition criteria.

### Test 2: Has the entity assumed an obligation to pay the cash flows from the asset?

An entity that retains its contractual rights to receive cash flows from a financial asset may still assume a contractual obligation to pass on the cash flows to one or more entities (pass through arrangements).

This situation may arise especially in securitisations; as the SPV issues beneficial interests in the underlying financial assets that it owns to investors whilst continuing to service those financial assets (i.e. custody of the underlying asset remains with the transferor).

Additional requirements have to be fulfilled to conclude that a pass-through arrangement meets the criteria for a transfer.

If the following conditions are met, the entity has to perform the derecognition tests in Step 5 in order to determine whether it meets the derecognition criteria:

- The entity has no obligation to pay cash flows to the transferee unless it collects equivalent cash flows from the transferred asset;
- The entity is prohibited from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pass through cash flows;
- The entity is obliged to remit any cash flows without material delay and subject to certain investment restrictions.

If the conditions are not met, the financial assets remain on the balance sheet.

### 3.1.6 Step 5: Perform derecognition tests

#### Test 1: Has the entity transferred substantially all risks and rewards?

If the entity transfers substantially all the risks and rewards of ownership of the asset (e.g., an unconditional sale of a financial asset), the entity derecognises the asset.

The transfer of risks and rewards is evaluated on the entity's exposure before and after the transfer to the variability in amount and timing of the cash flows that are likely to occur in practice. In most cases, it will be clear whether the entity has transferred substantially all the risks and rewards without the need for a calculation. If substantially all the risks and rewards have been transferred, the asset is derecognised.

If the entity has not transferred substantially all risks and rewards, Test 2 has to be carried out.

#### Test 2: Has the entity retained substantially all risks and rewards?

If the entity retains substantially all the risks and rewards of ownership of the asset, the entity continues to recognise the asset.

If the transferor's exposure has not changed substantially as a result of the transfer, it has retained substantially all risks and rewards of ownership and should not derecognise the asset.

For example, this would be the case where a sale of a financial asset is accompanied by a total return swap that transfers the full exposure back to the transferor.

If the entity has not retained substantially all the risks and rewards, Test 3 has to be carried out.

#### Test 3: Has the entity retained control of the asset?

If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the asset, the entity has to determine whether it has retained control of the asset.

Control is based on the transferee's practical ability to sell the asset. The transferee has this ability if it can sell the asset in its entirety, unilaterally to an unrelated third party without needing to impose further restrictions on the transfer.

The key issue is what the transferee is able to do in practice and not what contractual rights the transferee has. A transferee has the practical ability to sell the asset if it is traded on an active market because the transferee could purchase the asset on the market if it needs to return the asset to the transferor.

If an asset subject to a call option can be readily obtained by the transferee on the market, the transferor has lost control although they have retained some of the risks and rewards in relation to the asset.

On the other hand, the contractual right to dispose of an asset is of little practical use if there is no market for the asset.

If the entity has lost control, the asset is derecognised.

If the entity has retained control, it continues to recognise the asset to the extent of its continuing involvement.

### 3.1.7 Consequences of derecognition or failed derecognition

#### Derecognition of a financial asset – gain recognition

On derecognition of a financial asset in its entirety, the difference between the carrying amount and the consideration received (including any cumulative gain or loss that had been recognised directly in equity) is included in the income statement.

If only a part of a financial asset is derecognised, the previous carrying amount of the financial asset is allocated between the part that continues to be recognised and the part that is derecognised based on relative fair values at the date of transfer. The difference between the carrying amount allocated to the part derecognised (including any cumulative gain or loss relating to the part derecognised that has previously been recognised in equity) and the consideration received is included in the gain or loss on derecognition.

#### Failed derecognition of a financial asset – substantially all risks and rewards of ownership retained

A transaction is accounted for as a collateralised borrowing if the transfer does not satisfy the conditions for derecognition. The entity recognises a financial liability for the consideration received for the transferred asset.

If the transferee has the right to sell or repledge the collateral, the asset is presented separately in the balance sheet (e.g., as loaned assets, pledge securities, or repurchase receivables).

### Failed derecognition – not substantially all risks and rewards of ownership retained (continuing involvement)

If the asset is not derecognised because the entity has neither transferred nor retained substantially all the risks and rewards of ownership and control has not passed to the transferee, the entity continues to recognise the asset to the extent of its continuing exposure to the asset. Consequently, to that extent, a liability must also be recognised. Revised IAS 39 contains detailed guidance on how to account for a range of different scenarios. Essentially, the principle is that the combined presentation of the asset and liability should result in the recognition of the entity's net exposure to the asset on the balance sheet either at fair value – if the asset was previously held at fair value – or at amortised cost, if the asset was accounted for on that basis.

How the changes in liability are treated should be consistent with how the changes in the asset are treated. Consequently, when the asset subject to the transfer is classified as available-for-sale, gains and losses for both the asset and the liability will be taken to equity.

### 3.1.8 Conclusion

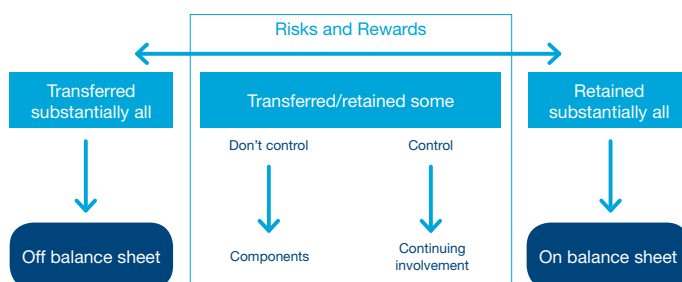
The following difficulties often hamper securitisations to achieve derecognition.

- Since the SPV is likely to be consolidated under SIC-12, the right to cash flows will not be transferred from the reporting group. Therefore, the transfer will have to meet the criteria for pass through cash flows set out in Test 2 of Step 4. Few securitisations are structured in such a way so as to pass these tests.
- Even if the structure does meet the transfer requirements, it is unlikely that substantially all the risks and rewards have been passed to the transferee. Full derecognition will thus not be achieved by that route.
- Assuming that the transferor does not retain substantially all the risks (as may often be the case), the control test will always fail since the SPV will not be able to sell the asset.

Consequently, the entity will need to recognise the assets to the extent of its continuing involvement.

The chart below summarises the four possible accounting options in connections with derecognition under IAS 39.

Figure 3: Accounting options



## 3.2 IFRS – Accounting and consolidation issues for the investor

### 3.2.1 Introduction

In addition to the consolidation and accounting issues for the originator and the SPV, note holders are equally confronted by consolidation issues stemming from the consolidation criteria of IAS 27 and SIC 12. In certain circumstances, note holders might have to consolidate the notes instead of recognising and measuring them as financial instruments in accordance with IAS 39. As SIC 12 defines an SPV rather broadly as an entity that may be created to accomplish a narrow and well-defined objective, unincorporated entities, as well as compartments, may be considered as SPVs in terms of SIC 12.

### 3.2.2 Consolidation of the SPV or the compartment

As described above, the obligation for consolidation depends on whether the investor controls the SPV or the respective compartment. Whether the investor controls the SPV or the compartment must thus also be looked at from their perspective.

SIC 12 is applied on a compartment if the compartment is considered as a separate SPV. This means that each compartment is strictly separated from each of the others.

Furthermore, for multiple-compartment securitisation vehicles, situations might exist where some of the criteria for SPV consolidation are met by the originator and some others by the investor. In this situation, the application of the control concept requires that the relevant factors of each case be examined.

If the SPV issued different tranches within the same compartment, the analysis of risks and rewards must take into account the several risk situations on the respective tranche. So if one investor holds 100% of the first loss tranche, it is probable that the majority of risks and rewards related to the assets are linked to this investor. Nevertheless, the question of risk and reward allocation can only be answered after a detailed analysis.

### **3.2.3 Accounting of the notes by the investor (no consolidation)**

If no consolidation is needed, the accounting treatment and the disclosure of the notes issued by the SPV follow IAS 39 rules.

In accordance with IAS 39, the investor first has to classify the notes into one of the four categories of financial instruments. After classification, it must be considered if the notes include embedded derivatives. In accordance with IAS 39.11, embedded derivatives shall be separated if:

- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and;
- The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised as profit or loss.

Especially in the case of synthetic securitisations, the securitised credit risk is represented by credit default swaps (CDSs) instead of receivables or bonds owned by the SPV. Assuming that the credit default swaps are derivatives in accordance to IAS 39, these CDSs must be separated from the notes:

IAS 39 AG 30(h): “Credit derivatives that are embedded in a host debt instrument and allow one party (the “beneficiary”) to transfer the credit risk of a particular reference asset, which it may not own, to another party (the “guarantor”) are not closely related

to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it”.

In addition to the consolidation issue and equally applicable in the case of stand alone accounts, the individual structure of a securitisation has to be analysed in detail to make sure that all IFRS requirements are met.

## **3.3 Basel II**

### **Introduction**

Basel II is the name widely used for the new capital adequacy framework to be implemented worldwide by bank supervisory authorities. This framework has been transformed to an EU Directive, the Capital Adequacy Directive (CAD). Luxembourg has implemented this directive by issuing the circular CSSF 2006/273. In the following section the term “Basel II” is further used for this regulatory framework.

The Basel II framework is structured in three “Pillars”. The first “Pillar”, Minimum Capital Requirements, deals with the methodology for calculating the capital adequacy. Given that the approach in Basel II is based on the economic substance of transactions rather than its legal form, the chapters encompassing Pillar I contain a number of quantitative aspects backed by qualitative analysis. Pillar II, Supervisory Review Process, is mainly qualitative and provides a significant level of discretion to supervisory authorities when evaluating the application of the Basel II framework. Pillar III, Market Discipline, aims to enhance the degree of transparency of a bank’s public reporting. It requires that the bank discloses of both quantitative and qualitative aspects of the methods it uses to manage its capital requirements.

### **Basel II and securitisation**

The capital treatment of securitisation transactions has been one of the most difficult areas to determine in the new framework. A number of publications solely related to the theme were issued by the Basel Committee, where the final publication contains chapters exclusively dedicated to securitisation. This securitisation framework has been adopted by the European Commission issuing the new CAD and by the CSSF, the competent authority for the implementation of the revised capital standards in Luxembourg.

## Overview of the Basel II framework related to securitisation

### Pillar I – Minimum capital requirements for securitisation positions

This part is the most important with regards to the capital treatment for securitisation transactions as it details all quantitative aspects as well as the key qualitative aspects (i.e. operational requirements) to be taken into account when calculating the capital requirements of securitisation transactions.

There are two cornerstones in relation to the regulatory approach described in this part. These are:

#### a) The “economic substance approach”

As previously described, the overall Basel II approach is based on economic substance rather than the legal form. Therefore, the analysis of securitisation transactions follows the same principle.

It is important to re-emphasise, however, that although Basel II established the “economic substance” approach, it seems, at least implicitly, to only consider risk transfer and funding as drivers of a securitisation transaction and does not take into account other drivers of the transaction and their impact on the originator’s activities. The framework however provides a certain amount of flexibility to supervisory authorities to take such elements into account.

#### b) A broad focus on “securitisation exposures”

During the initial stages of development of Basel II, focus was placed on the role played by banks. However, there is now a significant shift on the focus towards the risk arising from different exposures.

The practical evaluation of securitisation exposures is broader than credit risk exposures, and it includes the evaluation of structural elements (such as early amortisation and clean up calls for instance) as well as commercial aspects such as implicit support. This is in line with the “economic substance approach”.

The framework also divides securitisation transactions into two groups: the “traditional securitisation” and the “synthetic securitisation”.

A traditional securitisation transaction is defined to be a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures. Junior securitisation tranches are established to absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of liquidation.

For a synthetic securitisation structure the difference is based on the fact that credit risk from the underlying exposures is transferred, in whole or in part, through the use of funded (e.g. credit-linked notes) or unfunded (e.g. credit default swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio.

For both of these groups, the framework defines certain eligibility criteria in order to assess the materiality and the risk transfer of the transaction.

Another important definition is that of “originating banks” which, generally, is the bank originating directly or indirectly underlying exposures included in the securitisation. According to this definition, the originator can also act as a “sponsoring bank” in Asset-Backed Commercial Paper (ABCP) transactions. Normally, in such transactions, a bank does not tend to originate the assets but rather provides a guarantee (normally at secondary credit enhancement level) for the whole ABCP program.

### Operational requirements

There are detailed operational requirements that an originating bank has to comply with in order to be able to calculate its capital requirements. The operational requirements are divided into requirements for traditional securitisations and synthetic securitisations, those related to clean-up calls, those for the use of credit assessments and those for inferred ratings. In essence, the first three requirements aim to ensure that exposures are transferred and that there are no mechanisms that allow these exposures to be returned to the originating bank, whereas the last two aim to ensure that a rating can be relied upon.

From a “principle” point of view, the operational requirements are clear. However, the number of terms used, is not clearly defined; it can be highly subjective.

### Treatment of capital exposures

The treatment of capital exposures for a bank is defined based on the exposure rather than the role played by the banks. There is one aspect that distinguishes between originator and investor: It is related to exposures mapped to the credit quality category 4 for the standardised approach (as detailed below) according to which investors can apply a risk weight of 350% rather than a capital deduction.

Banks are required to hold capital against all of their securitisation exposures, including those arising from:

- The provision of credit risk mitigants to a securitisation transaction;
- Investments in ABS;
- Retention of a subordinated tranche;
- Extension of a liquidity facility;
- Granting of a credit enhancement and provision of implicit support to a securitisation; and
- Repurchased securitisation exposures.

In summary, a bank can calculate the capital requirements arising from securitisation exposures based upon two approaches: (a) the standardised approach; and (b) the Internal Ratings Based (IRB) approach. It is compulsory to use the same approach selected by the bank for the treatment of the underlying portfolio of assets. In other words, if for instance, for a Mortgage-Backed Securities transaction, the bank has selected the standardised approach for its mortgage portfolio held in the bank’s books, this approach is to be used for any Mortgage-Backed Securities transaction carried out by the bank. In certain instances, it may be the case that a securitisation transaction contains more than one type of underlying portfolio. In this case, Basel II is clear that the approach to be used is that of the dominant portfolio.

#### a) The standardised approach

The standardised approach consists of calculating a risk weighted asset amount of the exposure based upon an existing table in the framework. In summary, for exposures mapped into credit quality class 4 and better, there are different risk weights applicable which vary between 20% and 350%.

Exposures with an assessed credit quality below class 4 are subject to a full capital deduction. The mapping of the external ratings of the eligible rating agencies to credit quality classes provided by the CAD is part of the responsibility of the national supervisory authority, i.e. for Luxembourg, the CSSF.

### Standardised approach for exposures with external rating

Risk weight in dependence of the external rating of the securitisation exposure					
Exposures with short-term rating:					
Credit Quality	1	2	3	Others	
Risk weight	20%	50%	100%	1250%	
Exposures with short-term rating:					
Credit Quality	1	2	3	4	5 and worse
Risk weight	20%	50%	100%	350%	1250%

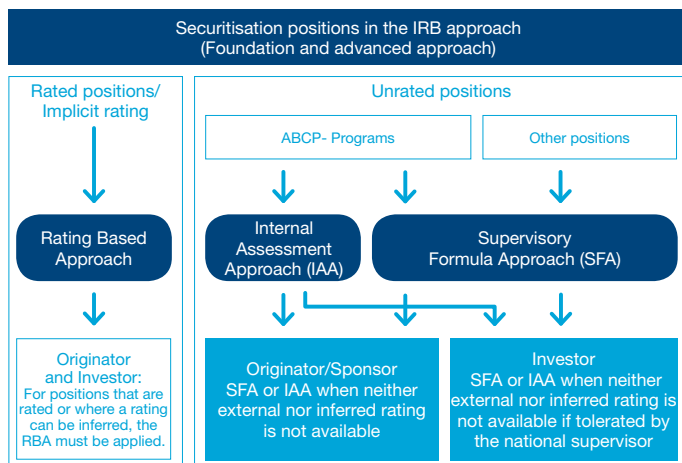
When the exposure is an asset, it is easily quantifiable as it is, in general, the book value recorded. However, a more complex analysis needs to be carried out for other types of exposures, like second loss positions, liquidity facilities, cash advance facilities, or early amortisation provisions, which are converted into “assets” through the application of Credit Conversion Factors (CCFs).

#### b) The IRB approach

The IRB approach is subdivided into two potential calculations:

(a) the Ratings-Based Approach and (b) the Supervisory Formula or the Internal Assessment Approach. The maximum capital requirement of securitisation exposures under the IRB approach is limited to the capital requirement that would have been calculated if the underlying exposures had not been securitised.

There is a hierarchy in applying these approaches: The Ratings-Based Approach (RBA) must be applied for all rated exposures that are either rated or in which a rating can be inferred. For all other exposures, the Supervisory Formula (SF) or Internal Assessment Approach (IAA) is to be applied.



The RBA approach is relatively similar to the standardised approach with the exception that the tables included in the framework are more sophisticated and the risk weight will depend not only on the ratings but also on the granularity of the underlying pool and the seniority of the position. In summary, this means that securitisation exposures backed by retail pools can be considered to generally attract less capital than those backed by big ticket transactions.

The Supervisory Formula is a complex methodology for non-rated exposures, which is clearly defined in the framework. There are certain simplifications possible depending on the underlying portfolio of assets. It is based upon five inputs necessary to be supplied by the originator:

- The IRB capital charged given that the underlying exposures had not been securitised;
- The tranche’s credit enhancement level;
- The thickness of the tranche;
- The pool’s effective number of exposures, and;
- The pool’s exposure weighted average loss given default.

Given the complexity of the Supervisory Formula, it is expected that a number of banks will adopt full capital deduction for their non-rated exposures rather than apply the formula and obtain all the data necessary for its calculation. Also, it is unlikely that an originating bank will share with an investing bank certain of the above input data. Therefore, an investing bank will most likely deduct its exposure from the capital base.

The Internal Assessment Approach is limited to exposures arising from ABCP programmes and it is subjected to a number of operational requirements. By using this approach, a bank has to map its internal assessments of exposures provided to ABCP programmes to equivalent external ratings of an eligible External Credit Assessment Institution (ECAI).

### Pillar II – Supervisory review process for securitisation

These parts define Pillar II of the capital framework and can be substantially considered a complement to the operational requirements already defined in Pillar I. In summary, these parts provide the necessary support for supervisory authorities to modify, or refine, the calculation of capital requirements in order to take into account the specifics of each securitisation transaction, and any factors which have not been directly dealt with by the existing framework.

### Pillar III – Disclosure requirements for securitisation

As securitisation exposures form part of the risks weighted assets banks have to disclose certain information regarding:

- The bank’s objectives in relation to securitisation activity, including the extent of the credit risk transfer away from the bank to other entities;
- The roles played by the bank in the securitisation process;
- The regulatory capital approaches used by the bank;
- A description of the bank’s accounting policies;
- Names of the ECAs used for securitisations;
- The total outstanding exposures securitised by the bank and subject to the securitisation framework;
- Amount of impaired/past due assets securitised;
- Losses recognised by the bank;
- Aggregate amount of securitisation exposures retained or purchased and the associated IRB and Standardised Approach capital charges for these exposures;
- Summary of current year’s securitisation activity.

## Conclusion

With the new Basel II framework and the implementation of the new rules related to securitisation the supervisory authorities for the first time offer a comprehensive body of rules and regulations which take into account the different types of structures and the roles played by respective banks. These rules are intended to take into account differing degrees of information about the transactions as well as the experience a bank has in using securitisation transactions. Furthermore, the rules are flexible enough to cover special characteristics of these transactions and credit activities in conjunction with securitisation transactions.

However, because of the various possibilities regarding the structuring of the transactions, it is not expected that the rules cover each of them in detail. Upcoming questions are to be discussed with the banks as well as with the national supervisory authority.

### 3.4 Anti-Money Laundering regulations

Regulators are facing growing pressure to provide Anti-Money Laundering (AML) and Anti-Terrorist Financing (ATF) frameworks as the risk of suddenly being involved, directly or indirectly, in money laundering or terrorist financing, is on the rise. Regulatory and reputation risks have now become major concerns for a rising number of company Board members.

In recent years, regulations combating money laundering and the financing of terrorism – as well as preventing the financial sector to be used for such purposes – have been enlarged. This is seen with the Laws of August 11, 1998, August 12, 2003 and November 12, 2004 as well as by the circular CSSF 05/211 which integrates in a consistent manner and within a single circular all the guidelines and instructions concerning professional obligations in order to make the existing regulations more comprehensible. All financial sector professionals are covered by this legislation, as well as, for example, insurance companies, notaries, auditing companies, casinos, attorneys-at-law, estate agents, tax and financial advisors and persons selling high value goods.

However, looking more closely at the scope of the AML/ATF regulations, you will notice that they do not mention Luxembourg securitisation vehicles. This is because according to article 2 (1) No. 7 of the Anti-Money Laundering Law of November 12, 2004, the two last bullet points of article 13 (2) of the Law of April 5, 1993 relating to the financial sector in Luxembourg are excluded from its scope. Consequently, securitisation vehicles are not subject to AML regulations and hence, are not obliged to identify beneficial owners.

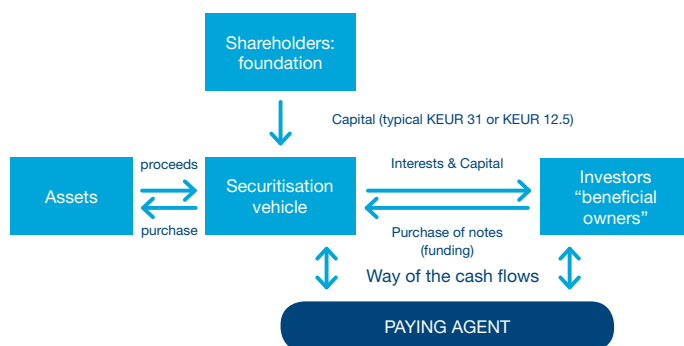
However, many service providers of securitisation vehicles, like domiciliation agents, paying agents, auditors etc., must comply with AML regulations and identify beneficial owners of the securitisation vehicles as well as analyse business connections and investigate the sources of funds. For example, due to the Law of May 31, 1999, companies who have their registered offices at third party addresses, need to conclude a domiciliation contract with a domiciliation agent. The circular CSSF 01/29 provides a minimal amount of information on such domiciliation contracts. Accordingly, the domiciliation agent is responsible for identifying the Board of Directors, the shareholders and the ultimate beneficial owners as well as monitoring the transactions and checking the names of the persons identified against the blacklists.

#### Who are the beneficial owners of a typical securitisation vehicle?

Usually, securitisation vehicles are only capitalised with the required minimum capital, which is typically brought in by foundations, like charitable trusts or Dutch “Stichtings”. It is obvious that these entities are not the beneficial owners of the assets or of the cash flows of the securitisation vehicle.

The beneficial owners of a securitisation transaction are mostly the investors who provide the funds to purchase assets for which they received securities, whose interest and capital payments are achieved out of the cash flows of the purchased assets, and who bear the risks and rewards of the transaction. The “Paying Agent” is usually responsible for the transfer of the received cash flows to the investors. In many transactions, a custodian transmits the cash flows resulting from the assets to the securitisation vehicle. These service providers are typically credit institutions, which are subject to supervision by a financial supervisory authority or equivalent identification obligations as the ones mentioned in the Luxembourg AML regulations, if they are located in FATF equivalent countries.

The following schema shows the cash flows of a typical securitisation transaction:



### 3.5 Prospectus directive/Listing in Luxembourg

#### 3.5.1 When is a prospectus required?

Once a securitisation transaction has been structured, questions regarding the distribution of the notes issued could come up. Whether a prospectus will need to be published will depend on the distribution structure used, (i.e. who the potential investors are, whether they are institutional or retail, in which countries the notes should be sold in, in only one or throughout Europe, is a listing on a regulated market demanded or not).

The requirements governing the publication of a prospectus are set up in the EU Prospectus Directive 2003/71/EC and transposed into Luxembourg legislation by the Law of July 10, 2005 on the prospectus of securities. The directive was adopted to respond to the following main objectives:

- Harmonising the necessary disclosure requirements to obtain a single EU passport. Thus, a prospectus approved by the Authority of one Member State is valid within other Member States;
- Setting out the conditions to be met by issuers when making information available;
- Specifying minimum disclosure requirements for different products;
- Ensuring that interested parties have access to prospectuses.

The Prospectus Law identifies three different prospectus regimes for issuers making a “public offer of securities” and/or a “listing of securities”. Before having a deeper look at the regimes, the meaning of “Public offering” should be defined. Under the Prospectus Law, essentially any offer of securities within the scope of the law to more than one person will constitute a public offer and, consequently, require the publication of a prospectus. Due to article 5 (2), the obligation to publish a prospectus does not have to be met for the following distribution forms:

- Offers to qualified investors only and/or;
- Offers to less than 100 individuals or legal entities per EU or EEA Member State other than qualified investors, and/or;
- Offers to investors who subscribe at least EUR 50,000 per investor, and/or;
- Offers where each security has a nominal value of at least EUR 50,000 and/or;
- Offers where the total amount issued is less than EUR 100,000.

For ease of reference, such offers will be referred to hereafter as “private placements”. Placements of securities through a financial intermediary require the publication of a prospectus if none of the above-mentioned criteria are respected. In connection with private placements, there are no further requirements described in the Prospectus Law. Concerning the information required to be made available to potential investors within private placements, the law only states that all material information should be provided to them. However, it does not determine what information qualifies as “material”. Because of the liability attached to a prospectus, the private placement memorandum should include any material information necessary for investors to make an informed assessment of the securities offered.

Contrary to private placements, any person intending to make a public offer of securities in Luxembourg must notify the CSSF in advance and must publish a prospectus (or, as the case may be, a simplified prospectus), which must be approved by the CSSF. As mentioned above, the Prospectus Law distinguishes three regimes.

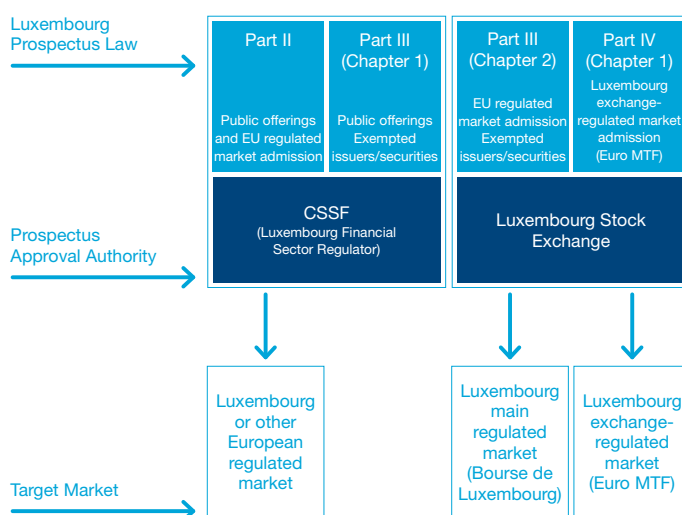
The first regime applies to “public offers” of securities within the scope of the Prospectus Directive and admission to trading on a regulated market by corporate issuers, which, in Luxembourg, is the Luxembourg Stock Exchange (LSE). In this case, the CSSF is the competent authority to ensure that the provisions of the law are enforced; i.e. that the prospectuses and any related addenda are approved when Luxembourg is the home Member State of the issuer. The filings of documents and notices are also within the purview of the CSSF. If a listing on another EU regulated market is also required, the CSSF is also the competent authority to approve the prospectus (“European passport”).

The prospectus must include all the necessary information on the particular nature of the issuer and on the securities offered to the public, to enable investors to make informed assessments of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities. The information shall be provided in a form easy to analyse and understand. Such a prospectus will also need to contain a summary conveying the essential characteristics and risks associated with the issuer, any guarantor and the securities, unless the securities offered are wholesale debt securities. In the case of a simplified prospectus, which is described below, a summary is not required.

The second regime applies to “public offers” of securities and other comparable instruments outside the scope of the Prospectus Directive; for these securities, simplified prospectuses have to be drawn up. These securities mainly include: (i) securities issued by EU Member States, their regional or local authorities or related entities; (ii) “small” issues (less than EUR 2.5 million) and certain debt securities issued by credit institutions for a total amount of less than EUR 50 million; and (iii) money market instruments with a maturity at issue of less than 12 months. As with the first regime, the CSSF is the competent authority for the approval of simplified prospectuses and any related addenda.

Simplified prospectuses however do not benefit from the European passport. The Luxembourg Stock Exchange shall be the competent authority for the approval of prospectuses according to the provisions of the law, as well as for admissions of these securities to trading on a regulated market operated by the Luxembourg Stock Exchange. Also the simplified prospectus must include all information necessary to enable investors to make an informed assessment of their investments.

The third regime deals with admission of securities to trading on a market not set out on the list of regulated markets published by the European Commission. For admission to the Luxembourg exchange regulated market, the Euro MTF market, the Luxembourg Stock Exchange remains the competent authority.



### 3.5.2 The Luxembourg capital markets

The Prospectus Law also establishes a flexible framework of financing opportunities through two main types of capital markets: i.e., through listing on the Luxembourg Stock Exchange’s main regulated market, Bourse de Luxembourg; or through the exchange-regulated market, the Euro MTF market.

The exchange-regulated market meets the financing needs of issuers who are looking for a sound regulatory framework but do not require a European passport as defined in the Prospectus Directive.

This market is outside the scope of the EU Prospectus and Transparency Directives. In addition, this represents an alternative for issuers that do not prepare their financial information in accordance with IFRS or equivalent accounting standards. There are no restrictions on the type of securities to be listed both on the main and exchange regulated markets. Issuers will need to comply with different requirements according to the chosen market. Official listing obligations are applicable to both markets.

The following table summarises the main benefits and constraints of the two markets:

	EU regulated market Bourse de Luxembourg	Exchange regulated market Euro MTF
<b>Main benefits</b>	<ul style="list-style-type: none"> <li>• European passport for the documentation when offering securities in more than one EU Member State</li> <li>• Higher degree of eligibility according to national legislation of the different EU Member States</li> </ul>	<ul style="list-style-type: none"> <li>• No obligation to comply with IFRS or equivalent accounting standards</li> <li>• Less stringent financial reporting obligations</li> <li>• Day to day supervision by the Luxembourg Stock Exchange in compliance with its own rules and regulations</li> </ul>
<b>Main constraints</b>	<ul style="list-style-type: none"> <li>• More demanding financial reporting requirements in terms of content and frequency once the Transparency Directive comes into force</li> </ul>	<ul style="list-style-type: none"> <li>• No EU passporting for the documentation</li> </ul>

### 3.6 Responsibilities and liabilities of the Board of Directors

The Securitisation Law does not define specific duties or responsibilities for the members of the Board of Directors of the securitisation companies or management companies of securitisations funds. Due to this, their responsibilities are governed by general rules, mostly defined by commercial company law, commercial and civil law and, of course, by the statutes of the relevant companies.

The core responsibilities of directors are to take any action necessary or useful to realise corporate objectives, within the powers invested by law and by the articles to the general meeting. Further, the company will be represented vis-à-vis third parties and in legal proceedings by the directors.

Regarding the day-to-day management of the business of the company and the power to represent the company, one or more directors (or officers, managers or other agents) may have the right to act either alone or jointly. Regarding transaction management, the directors approve and sign all transaction documents. Hence, they need to understand the structure and the cash flows of the securitisation vehicle and the underlying transaction documents to ensure that the operations of the securitisation vehicle comply with the transaction documents. To ensure this, they have to liaise with the originator, with the trustees and with the lawyers involved. The Board of Directors is also responsible for the preparation of the annual accounts and eventually, interim reporting. This requires liaising with the cash manager and the servicer and also with the auditors of the securitisation vehicle. To keep the accounts of the company, the directors need to have broad knowledge of the different accounting principles used, like IFRS and local GAAP, but also of US and UK GAAP.

As to general meetings, the Board of Directors has several rights, like convening the general meeting or adjourning the meeting for four weeks. Among their other responsibilities, directors are obliged to handle all the fiscal responsibilities (declaration, payment of taxes etc.) of the company.

The directors are subject to several liabilities. Their liability in the case of the violation of a statute or applicable law is obvious. According to the law, the directors of a company are commonly liable for all damages adversely affecting the company and third parties resulting out of contraventions to the Law of August 10, 1915 or the statute. Furthermore, directors are liable for all possible, avoidable administrative mistakes and/or failures made by management. Besides these liabilities, others can arise out of Luxembourg commercial law (e.g. in the case of bankruptcy) and Luxembourg civil law (e.g. towards damaged third parties).

# 4

## Glossary

**Arbitrage transactions:** Securitisation transactions of where assets are acquired from various originators, or from the market, and are securitised with the intention of making an arbitrage profit resulting from the difference between the average return of the assets and the average coupon on the liabilities.

**Asset-Backed Commercial Paper (ABCP):** Transactions, where normally short-term receivables (e.g. trade receivables) are pooled into a Special Purpose Vehicle (SPV). The SPV in turn issues Commercial Papers (normally remaining time to maturity 90 days to 180 days), which are called Asset-Backed Commercial Papers. The SPV may be established for a single seller of short-term receivables or for a pool of sellers (multi-seller ABCP conduit).

**Asset-Backed Securities (ABS):** Securities generally issued by an SPV, which are backed by assets rather than by a payment obligation. Securitised instruments are Asset-Backed Securities.

**Back-up servicer:** Normally, the originator of a securitisation transaction continues to service the original transaction. In pre-agreed circumstances the SPV can, however, obtain the authority to bring in a back-up servicer to replace the originator as servicer.

**Bankruptcy-Remote:** The term applied to an entity that is not likely to have an incentive to commence insolvency proceedings voluntarily and that is not likely to have an involuntary insolvency proceeding commenced against it by third party creditors.

**Beneficial interest:** In contrast to legal interest, beneficial interest means the right to stand to benefit, short of legal title. In a securitisation transaction, the receivables/cash flows or security interest thereon are legally held by the SPV or trust, for the benefit of the investors; that means the investors are beneficiaries and their interest is the beneficial interest.

**Cash collateral:** In a securitisation transaction, the originator may deposit some cash in the SPV in order to enhance creditworthiness for the investors. The cash deposit is normally not used by the SPV to acquire receivables from the originator.

**Cash Collateral Account (CCA):** A reserve fund that provides credit support to a transaction. Funds in a CCA are lent to the issuer by a third party, typically a letter of credit bank, pursuant to a loan agreement.

**Cash flow waterfall:** The rules by which the cash flow available to an issuer, after covering all expenses, is allocated to the debt service owed to holders of the various classes of securities issued in connection with a transaction.

**Clean up buyback or call:** An option providing the right to the originator to buy back the outstanding securitised assets, when the principal outstanding has been substantially amortised. The option is usually exercised when the outstanding principal is less than 10% of the original principal.

**Collateral:** Is the underlying security, mortgage, or asset for the purposes of securitisation or borrowing and lending activities. In respect of securitisation transactions, it means the underlying cash flows.

**Collateral manager:** The collateral manager manages the collateral that is purchased and sold by the SPV regularly (especially used in arbitrage transactions).

**Collateralised Bond Obligations (CBO):** Obligations, usually structured obligations, issued which are collateralised by a portfolio of bonds, transferred by an originator or purchased from the market with the intention to securitise them.

**Collateralised Debt Obligations (CDO):** A common name for Collateralised Bond Obligations and Collateralised Loan Obligations.

**Collateralised Fund Obligations (CFO):** Obligations, usually structured obligations, issued which are collateralised by a portfolio of hedge funds or equity fund investments, transferred by an originator or purchased from the market with the intention to securitise them.

**Collateralised Loan Obligations (CLO):** Obligations, usually structured obligations, issued which are collateralised by a portfolio of loans, transferred by an originator or purchased from the market with the intention to securitise them.

**Collateralised Mortgage Obligations (CMO):** A securitisation transaction where cash inflows of the SPV are divided into different tranches. The tranches, having different payback periods and priority profiles, repay the bonds issued by the SPV in line with the pre-determined payback periods and priority profiles of the bonds. On issue, the bonds are usually structured and served in accordance with objectives and risk profiles of the investors.

**Co-mingling:** When the originator in a securitisation acts at the same time as the servicer, the cash flows collected by the originator may sometimes co-mingle, or may intentionally be mixed up with that of the originator himself. Thus, a clear identification of the cash flows collected on behalf of the SPV is not possible anymore. This is called co-mingling.

**Commercial Mortgage-Backed Securities (CMBS):** A part of Mortgage-Backed Securities. The expression is used to avoid confusion with the term Residential Mortgage-Backed Securities (RMBS). Commercial mortgages represent mortgage loans for commercial properties, such as multi-family dwelling, shops, restaurants, showrooms, etc.

**Conduit:** A securitisation vehicle that is normally used by third parties as a ready-to-use medium for securitisation, usually for assets of multiple originators. Conduits are mostly used in case of Asset-Backed Commercial Paper, CMBS etc. There are two types, the single seller conduit and the multi-seller conduit.

**Covenant:** In terms of legal documents, a covenant is a promise to do or not to do something stipulated in the related agreement.

**Credit Default Swap (CDS):** In case predefined credit events that indicate credit default by a reference obligor occur, this credit derivative deal is executed, which means that either a specific obligation of the obligor will be swapped between the counterparties against cash or one party will pay a compensation to the other.

**Credit enhancement:** General term for measures taken by the originator in a securitisation structure to enhance the security, credit or rating of the securitised instrument. Among these measures are cash collateral, profit retention and third party guarantees. Credit enhancement devices can be differentiated as structural credit enhancement, originator credit enhancement and third party credit enhancement.

**Credit derivative:** A derivative contract whereby one party tries to transfer the credit risk or variation in returns on an asset, to another. Common types are credit default swaps, credit linked notes and synthetic assets.

**Credit Linked Note (CLN):** A note or debt security which allows the issuer to set off the claims under an embedded credit derivative contract from the interest, principal, or both, payable to the investor in such note.

**Credit enhancer:** A party that agrees to elevate the credit quality of another party or a pool of assets by making payments usually up to a specified amount, in the event that the other party defaults on its payment obligations or the cash flow produced by the pool of assets is less than the amounts contractually required because of defaults by the underlying obligors.

**Default:** A failure by one party to a contractual agreement to live up to its obligations under the agreement; a breach of a contractual agreement.

**Deferred purchase price:** A type of credit enhancement where a portion of the purchase price of the assets is reserved by the SPV to serve as cash collateral.

**De-recognition:** The action of removing an asset or liability from the balance sheet. In securitisation transactions, the term refers to derecognition of assets securitised by the originator when they are sold for securitisation. Before derecognition is permitted, certain conditions, stated in the accounting standards, have to be fulfilled.

**Eligibility criteria:** The choice of receivables that the originator assigns to the SPV. The eligibility criteria are usually stated in the receivables sale agreement with a provision that a breach of the criteria would amount to breach of warranties by the originator, obliging the originator to buy-back the receivables.

**Event risk:** The risk that an issuer's ability to make debt service payments will change because of dramatic unanticipated changes in the market environment, such as a natural disaster, an industrial accident, a major shift in regulation, a takeover, or a corporate restructuring.

**Excess spread:** Is the excess of the proceeds inherent in the asset portfolio of the SPV, over the interests payable to the investors and the expenses of the transaction.

**Expected maturity:** The time period within which the securities are expected to have been fully paid back. However, the expected maturity is not the legal final maturity as the rating of the transaction is not based on repayment by the expected maturity.

See also hard bullet, soft bullet.

**Extension Risk:** The possibility that prepayments will be slower than an anticipated rate, causing later-than-expected return of principal. This usually occurs during times of rising interest rates. Opposite of prepayment risk.

**External credit enhancement:** Credit support provided to a securitisation by a highly rated third party.

**First loss risk** In case when the risks in the asset portfolio of the SPV are segregated into several tranches, the first loss risk, to a certain extent, is borne by a particular class before it can affect the other classes. The first loss class must fully cover the loss before it affects the other classes. The first loss class can be compared to the equity of an entity and provides credit enhancement to the other classes.

**Future flows securitisation:** Securitisation of receivables which only arise in future periods.

**Guaranteed investment contract:** Contract in which a particular rate of return on investments is guaranteed.

**Issuer:** Within the framework of securitisations, the issuer is the SPV which issues the securities to the investors.

**Internal credit enhancement:** Structural mechanism or mechanisms built into a securitisation to improve the credit quality of the senior classes of securities issued in connection with the transaction, usually based on channelling asset cash flow in ways that protect those securities from experiencing shortfalls.

**Investment grade:** With respect to Standard & Poor's ratings, a long-term credit rating of BBB- or higher. With respect to Moody's ratings, a long-term credit rating of BBB3 or higher.

**Junior bonds:** Bonds that rank after senior bonds.

**Legal final maturity:** The final maturity by which a security must be repaid to avoid a default of the contractual obligation. Typically, in securitisation transactions, the legal maturity is set at some months after the expected maturity to allow for delinquent assets to pay off and to avoid contractual default which can lead to winding up of the transaction.

**Letter of credit:** An agreement between a bank and another party under which the bank agrees to make funds available to or upon the order of the other party upon receiving notification.

**Limited recourse:** The right of recourse limited to a particular amount or a particular extent. For example, in a securitisation transaction, the right of recourse being limited to the over-collateralisation or cash collateral placed by the originator is a case of a limited recourse.

**Liquidity facility:** A short-term liquidity or overdraft facility provided by a bank or by the originator of the SPV to meet the short-term funding gaps and pay off its securities. Liquidity facilities can sometimes be substantial and be the only basis of redemption of securities – for example, in case of ABCP conduits.

**Liquidity provider:** The provider of a facility that ensures a source of cash with which to make timely payments of interest and principal on securities if there is a temporary shortfall in the cash flow being generated by the underlying assets.

**Mezzanine bonds:** Bonds that rank after senior bonds in priority, but before junior bonds.

**Mortgage-Backed Securities (MBS):** Securities backed by cash flows resulting from mortgage loans. MBS can be divided into Residential Mortgage-Backed Securities and Commercial Mortgage-Backed Securities.

**Non-petition undertaking:** Legal provision meaning that investors and creditors may waive their rights to initiate a bankruptcy proceeding against the securitisation vehicle. This clause protects the vehicle against the actions of individual investors who would, for example, find an interest in a bankruptcy proceeding against the vehicle.

**Obligor:** The debtor from whom the originator has right to receivables.

**Offering circular:** A disclosure document used in marketing a new securities issuance to prospective investors.

**Originator:** The entity assigning assets in a securitisation transaction.

**Originator advances:** A liquidity facility provided by an originator to a securitisation transaction where the originator pays a certain month(s)'s expected collections by way of an advance and later appropriates the actual collections to reimburse them.

**Originator credit enhancement:** Credit enhancement granted by the originator, like cash collateral, over-collateralisation, etc.

**Orphan company:** A company without identifiable shareholders, e.g. an SPV owned by a charitable trust or a "Stichting". Such a company is often used to avoid consolidation of the SPV with any other entity.

**Over-collateralisation:** A type of credit enhancement in a securitisation transaction where the originator transfers additional collateral to the SPV to serve as security in the event of delinquencies, etc.

**Pass through:** A special payment method, where the payments made by the SPV to the investors take place in the same periods and are subject to the same fluctuations as the receivables. This means that the cash flows collected every month are passed through to investors, after deducting fees and expenses.

**Paying agent:** A bank of international standing and reputation that has agreed to be responsible for making payments on securities to investors.

**Pay through:** A special payment method, where the payments made by the SPV to the investors take place at a pre-fixed pattern and maturity, not reflecting the payback behaviour of the receivables. During the intervening periods, the SPV reinvests the receivables, mainly in passive and pre-defined kinds of investments.

**Pfandbriefe:** A German traditional secondary market mortgage product where the investor is granted rights against the issuer and also against the underlying mortgage.

**Prepayment risk:** The possibility that prepayments will be faster than anticipated rates. This can lead to a loss of interest. The SPV can either pass through the prepaid amounts to investors thus resulting into earlier payment of principal than expected and reduced income over time, or if the SPV reinvests the prepayments, the rate of return of the reinvestment is lower than the rate of return of the underlying receivables.

**Protection buyer:** In a transaction such as a credit default swap, the party transferring the credit risk associated with certain assets to another party in return for the payment of what is typically an up-front premium.

**Protection seller:** In a transaction such as a credit default swap, the party that accepts the credit risk associated with certain assets. To the extent that losses are incurred on the assets in excess of a specified amount, the protection seller makes credit protection payments to the protection buyer.

**Recourse:** The ability of an investor/purchaser to seek payment against an investment to the originator of the investment. For example, in a securitisation transaction, the right of the investor to seek payment from the originator.

**Regulatory arbitrage:** The possibility for banks to reduce their regulatory capital requirements of a portfolio of assets without any substantial reduction in the real risks inherent in the assets. For instance, this is the case of a securitisation transaction where the economic risks of the assets securitised have been substantively retained.

**Reserve account:** A funded account available for use by an SPV for one or more specified purposes. A reserve account is often used as a form of credit enhancement.

**Residential Mortgage-Backed Securities (RMBS):** RMBS are the most fundamental form of securitisations. These securities involve the issuance of debt, secured by a homogenous pool of mortgage loans that have been secured on residential properties.

**Retained interest:** Any risks/rewards retained by the originator in a securitisation transaction – for example, service fees, any retained interest strip, etc.

**Securitisation:** A securitisation is a type of structured finance in which a pool of financial assets is transferred to a Special Purpose Vehicle which then issues securities solely backed by those assets transferred and the payments derived by those assets.

**Senior:** Bonds that rank before junior bonds. These bonds or tranches of securities issued by an SPV have high or the highest claim against the SPV.

**Sequential payment structure:** A payment structure where the cash flows collected by the SPV are paid in sequence to the various classes. This means the cash flows are first used for the full payment to the investors of the senior-most class, and then used for the full payments of the second class and so on.

**Servicer:** The entity that collects principal and interest payments from obligors and administers the portfolio after transaction closing. It is very common in securitisation transactions that the originators act as servicers though this is not always the case. See also back-up servicer.

**SIC 12:** An accounting interpretation by the International Accounting Standards Board whereby SPVs which are supported or credit-enhanced by the originator, are to be treated as quasi-subsidiaries of the originator and, hence, consolidated with the originator.

**Special Purpose Vehicle:** The legal entity established especially in securitisation transactions with the purpose of acquiring and holding certain assets for the benefit of investors of the securities issued by the SPV. Hence, the investors have acquired nothing but the specific assets. The vehicle holds no other assets and has no other obligations.

**Structural credit enhancement:** A type of credit enhancement. It means the creation of senior and junior securities, thereby enhancing the credit rating of the senior securities.

**Subordination:** The technique to subordinate the rights of investors and creditors to payment to the prior payment of other securities or debts by the securitisation vehicle.

**Synthetic transaction:** In a synthetic securitisation transaction, instead of selling an asset pool to the SPV, the originator buys protection through a series of credit derivatives. Such transactions do not provide the originator with funding. These transactions are typically undertaken to transfer credit risk and to reduce regulatory capital requirements.

**Synthetic CDO:** A CDO-transaction in which the transfer of risk is affected through the use of a credit derivative as opposed to a true sale of the assets.

**Tax transparent entity:** The entity that is not subject to tax itself. The shareholders/partners of the entity will be taxed directly.

**Third party credit enhancement:** A credit enhancement provided in a securitisation transaction by third party guarantees, i.e. insurance contracts or bank letter of credit.

**Tranche:** Piece, fragment or slice of a deal or structured financing. The risks distributed on different tranches concerning losses, sequential payment of the cash flows, etc are different. That is the reason why the coupon on different tranches is also different.

**True sale:** In a true sale structure, the originator sells a pool of assets to a Special Purpose Vehicle, which funds the purchase through the issue of tranches of securities. If the sale is structured in a way that it will be considered as a sale for legal or tax purposes, it is defined as a true sale.

**Trustee:** A third party, often a specialist trust corporation or part of a bank, appointed to act on behalf of investors.

**Underwriter:** Any party that takes on risk. In the context of the capital markets, a securities dealer that commits to purchasing all or part of a securities issuance at a specified price.

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