

June 2019

Securitisation in Luxembourg

A comprehensive guide



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Preface

We are happy to present to you the 2019 update of our brochure “Securitisation in Luxembourg - A comprehensive guide” as a part of our series of publications related to securitisation in Luxembourg. With the Luxembourg Securitisation Law* being in place for 15 years now, this represents the 8th edition of our brochure, and we are delighted to have received many positive comments. This always motivates us to update and amend it, and make it the preferred reference guide for securitisation in Luxembourg.

There have been some important developments over the past year. Since 1 January 2019, the EU Securitisation Regulation and the Amendment of the Capital Requirements Regulation are effective. This streamlines the legislative framework and combines current sectoral legislations on securitisation in one single legal reference. The regulation also introduced the specific framework for simple, transparent, and standardised (“STS”) securitisations, and the first STS transactions were executed in March 2019 (more details are presented in section 5).

Another new regulation is the Anti-Tax Avoidance Directive (“ATAD”) legislation in Luxembourg, and the introduction of interest limitation rules, also effective as from 1 January 2019. Unfortunately, there is still some uncertainty among the securitisation market participants that needs to be cleared soon, as they get unsettled about the practical implementation of these new tax rules. For more details, please see section 4.5.

There are also changes in the Anti-Money-Laundering regulation introducing a central register of beneficial owners. We present more insights in section 6.1.

In 2018, with more than 160 new Luxembourg securitisation vehicles, the total number and the number of compartments increased again, thus maintaining its steady

growth. By the end of March 2019, more than 1,350 vehicles representing around 6,000 compartments existed in Luxembourg. Although the number of regulated securitisation vehicles decreased by one to 32, the volume increased slightly by 5% to EUR 44,6 billion by the end of 2018. We expect that this growth will continue in the next years, especially since the European Securitisation Regulation is in place and some uncertainty about it is gone. Albeit already expected for 2018, we expect an update of the Luxembourg Securitisation Law during 2019, taking into account the EU Securitisation Regulation and becoming even more flexible and reinforcing the well-known legal certainty. This should also help pushing the Luxembourg securitisation market further in the near future. These changes in the regulatory and tax environment have again increased the content of our brochure. Of course, we have also updated and amended the statistical part on the entities created under the Luxembourg Securitisation Law at the beginning of the brochure.

As in previous years, we have chosen to publish our brochure in an electronic version to facilitate its update and to stay in line with our corporate objective of minimising our carbon footprint. However, if you would like to receive a hardcopy, please let us know.

We hope that you will enjoy reading the 2019 edition of our brochure and that it will provide you with valuable insights into the securitisation market and related best practices in Luxembourg.



Holger von Keutz

* Law of 22 March 2004 on securitisation.

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1

Securitisation market overview

1.1 Recent developments

Beyond doubt, 2018 was *the* year of change for the securitisation business in Luxembourg and Europe. It was last year, when securitisation transactions could take place without being directly subject to European regulation. As from 1 January 2019, the EU Securitisation Regulation and the amendment of the Capital Requirements Regulation (“CRR Amendment”) are effective and have brought additional regulations to the securitisation market. The European Banking Authority (“EBA”) and the European Securities and Markets Authority (“ESMA”) completed the new regulatory environment by issuing guidelines and final drafts of regulatory technical standards (“RTS”) on definitions and terms of the EU Securitisation Regulation. These refer to terms like homogeneity, risk retention, disclosure, STS notification and verification, and data repositories. Currently, the majority of the RTS is not yet enacted, but is close to their final version. In the meantime, market players are getting ready for the new regulatory requirements. The first firms providing STS verification services like the PCS in the UK or the STS Verification International GmbH in Germany have been approved. The first STS securitisation was issued in March 2019 and at the end of April 2019, six STS securitisations were already published on the ESMA website. These are all positive developments enabling the European securitisation market to again become one of the preferred funding and risk transfer methods for a huge number of issuers and investors, and, as such, would be a major contributor to the well-functioning of the European capital markets as intended by the European Commission.

Another important topic, intensively discussed between the market participants and the Luxembourg authorities, was the transposition of the EU Anti-Tax Avoidance Directive

2016/1164 of 12 July 2016 (“ATAD 1”) into the Luxembourg tax legislation. All Luxembourg companies, including securitisation companies, are impacted by this recent tax regulation. On 18 December 2018, the Luxembourg Parliament voted the draft bill n°7318 (the “ATAD 1 Law”) introducing new provisions in the Luxembourg Tax Law that will limit the deduction of (net) interest expenses for Luxembourg taxpayers as from 1 January 2019. Some securitisation companies may be impacted by this, but, in our view and based on a thorough case-by-case tax analysis, the majority of securitisation companies should not be impacted or only to a limited extent based on the nature of their transactions. Currently, discussions on the application of this interest limitation rule are still ongoing as many details are not defined in the ATAD 1 Law and thus provide room for different interpretations. Therefore, market players are awaiting further guidelines and interpretation from the Luxembourg tax authorities who are supposed to issue a circular on this in the near future.

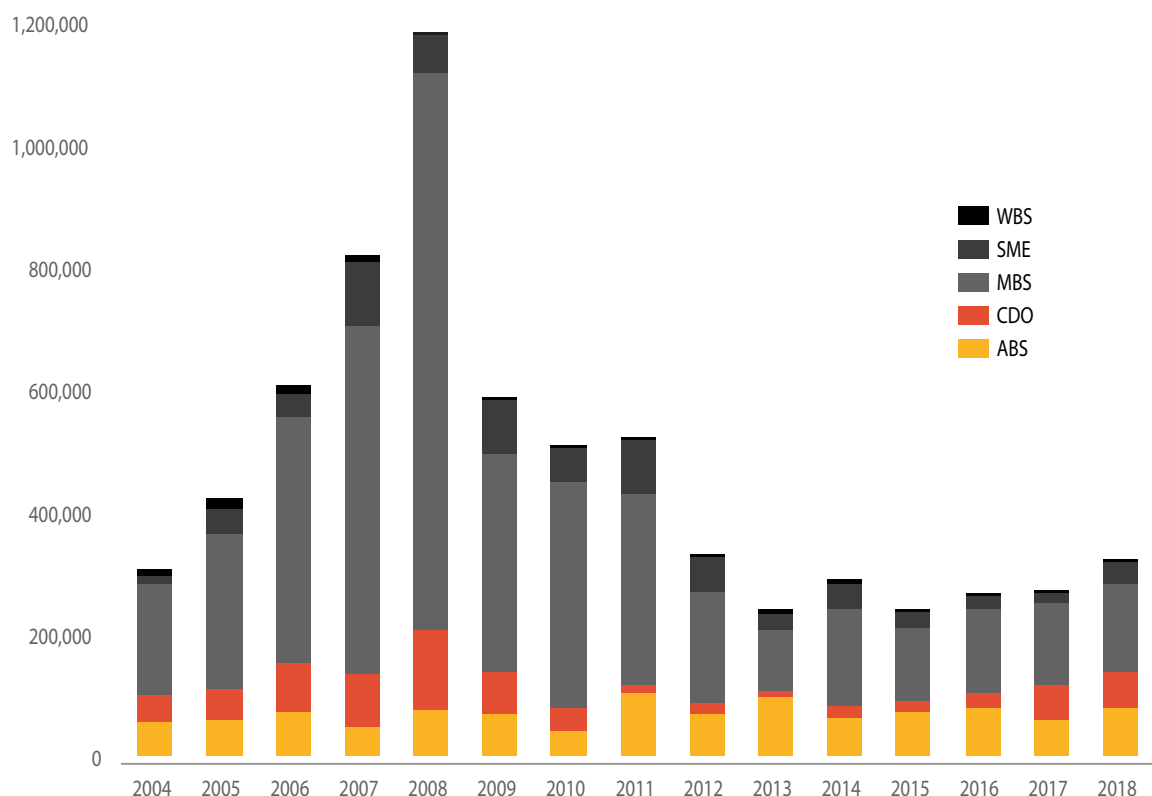
Another positive development on the Luxembourg securitisation market was the creation of the Luxembourg Capital Market Association (“LuxCMA”). LuxCMA represents the common interests of those who work in the capital markets industry in Luxembourg. The goal is to become the single point of contact for authorities, associations, market practitioners, and other stakeholders. The mission of this not-for-profit association is to promote Luxembourg’s capital markets, provide networking and collaboration opportunities, as well as foster innovation in the industry. It was constituted on 1 March 2019 by 34 founding members, including law firms, audit firms, corporate servicers, banks, and the Luxembourg Stock Exchange.

1.2 European market overview

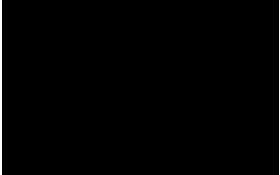
The development of the securitisation market in Europe can be analysed from two different angles: either taking into account transactions with the issuing vehicle domiciled in Europe, or looking at those with European collateral/underlying investment. For the former, we refer to the statistics published by the European Central Bank (“ECB”)

for the Euro zone and discuss this further in the next section. An analysis of the European market by collateral country and type is performed by the Association for Financial Markets in Europe (“AFME”) in cooperation with the Securities Industry and Financial Markets Association (“SIFMA”) on a quarterly basis and is presented hereafter.

Figure 1: European Securitisation Issuance (USD millions)



Source: SIFMA, Europe Structured Finance Issuance and Outstanding, as at 30 October 2018



The graph in Figure 1 illustrates that the yearly issuance volume was cut in half in the wake of the financial crisis in 2008. After further decline in subsequent years, the European securitisation issuances have finally stabilised during the last five or six years, and even started to recover since 2015 with an increase by more than 30% and +18% in 2018 compared to 2017. Overall, the 2018 issuance volume of USD 316.3 billion was significantly above the 2017 level of USD 267.6 billion. This made 2018 the strongest year since 2012. What is more, 2018 was the first time since the financial crisis where more than 50% of the issuances were actually placed.

Nevertheless, total outstanding volume (based on June 2018 figures) decreased further to below USD 1.5 billion by the end of 2018 (2017: USD 1.5 billion) but stabilised. Most of the collateral remains located in the United Kingdom, followed by the Netherlands, Spain and Italy. For the issuances in 2018, the origin of the collateral is similar, with UK and Pan-European collaterals being relatively more important, while France and Germany lost relative importance compared to previous years.

With regards to the type of underlying assets, residential mortgage loans remained the most significant asset class with about 40% of the European securitisation issuances (so-called “Residential Mortgage-Backed Securities” or “RMBS”) which is one of the lowest percentages since the financial crisis. On the other hand, Collateralised Debt Obligations (“CDO”) have again been strong with around 20% of all issuances in this period, which is a trend established since 2017 only (before, only around 10% of the issuances were CDO). Auto loans remained at a stable level

of around 11% of total issuances in 2018. As for the past, Commercial Mortgage-Backed Securities (“CMBS”) stayed relatively insignificant in Europe. Other Asset-Backed Securities (“ABS”) including asset types like consumer loans, credit card receivables, other leases together with the securitisation of whole businesses (“WBS”) and the financing of small and medium sized entities (“SME”) made up around 25% of the 2018 issuance (2017: 19.5%).

Despite the decreasing effect in new issuances described above, the total outstanding of European securitisations remains dominated by RMBS (56.8%) followed, albeit far behind, by other ABS (including auto loans) summing up to 17.5%, SME/WBS transactions (11.6%), CDO (10.0%), and other MBS (4.1%).

The above figures show us that European securitisation seems to have stabilised since the financial crisis, yet is still not recovering as fast as its peers from the US, even though historical default rates were significantly lower in Europe. One reason may be a different maturity of the respective capital markets, with European financing of the economy still largely dependent on bank loans. Another reason is the active role that the government-sponsored agencies play in the US with no equivalent in the EU. The European Commission has recognised this, and intends to foster the growth and integration of European capital markets with its Capital Markets Union initiative. Securitisation has been identified as one of the tools to achieve this union and growth for the real economy (see section 5.1). The next months and years will prove whether this initiative and the promotion of securitisation in Europe and Luxembourg will have the positive impact we expect.

1.3 Luxembourg market overview

Development of the Luxembourg securitisation market

The Luxembourg securitisation market continues to show a positive trend with almost 2,200 vehicles created under the Luxembourg Securitisation Law, with 1,362 existing as at 31 March 2019. This proves that Luxembourg remains a prime location for securitisation transactions in Europe. These figures are based on our in-depth research of the Luxembourg official journal ("*Mémorial*"), the company list published by the Luxembourg trade register ("*Recueil électronique des sociétés et associations*" or "RESA"), the ECB reporting on Financial Vehicle Corporations ("FVC") and other sources. As such, it remains an estimation and not an exact science even though we strive to make our list as comprehensive as possible.

Our research goes further than the statistics of the ECB since it focusses on Luxembourg undertakings incorporated under the Luxembourg Securitisation Law. In fact, the FVC reporting of the ECB does not include each Luxembourg securitisation undertaking, and some Luxembourg FVC are not subject to the Securitisation Law. This is due to the different definitions and reporting thresholds: e.g. an FVC is any entity that carries out securitisation transactions and issues securities (which does not have to be under the Securitisation Law); on the other hand, even though each Luxembourg Securitisation vehicle shall be deemed FVC (as per the interpretation of the *Banque Centrale du Luxembourg* ("BCL")), not all would be included in the regular reporting having a reporting threshold of EUR 70.0 million.

We have illustrated the development over time in Figure 2 which shows more than 1,350 active securitisation undertakings at the end of 2018 (2017: 1,284), with a net increase of almost 90 vehicles. This is less than the very strong years of 2016 and 2017 which had a net increase of around 100 vehicles.

With 162 newly created vehicles in 2018 (2017: 171), the gross number of creations was in line with the trend of more than 150 yearly creations in almost each of the last five years. On the other hand, we could identify 74 liquidations in 2018

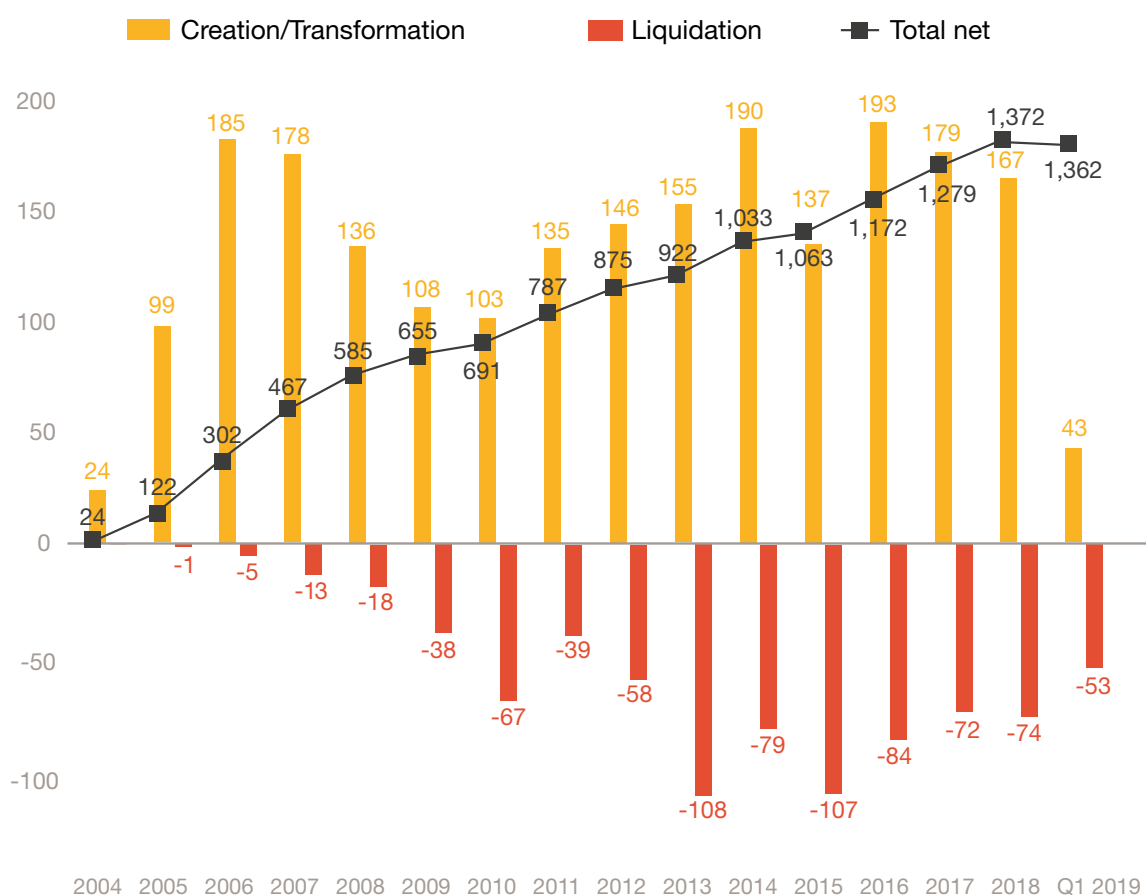
(2017: 72) which is normal due to the fact that securitisation transactions are usually structured for a limited period of time and the vehicles are liquidated thereafter. The average lifetime of the liquidated undertakings remained stable at around five years.

This year, we have been able to refine our research even further and identify not only securitisation companies but also securitisation funds (as well as their management companies). We assume to have around 30 securitisation management companies active in Luxembourg which are managing a total number of around 55 securitisation funds. This would mean that only around 4% of the undertakings under the Luxembourg Securitisation Law are set up as funds. It will be interesting to analyse if this percentage will increase during 2019 with new tax and regulatory requirements coming in place.

For the corporate securitisation vehicles, the majority of 54% is set up as SA (2017: 54%), followed by 42% as SARL (2017: 40%) and the remainder mainly in the form of an SCA. However, last year's trend of a majority of newly created securitisation companies being in the form of SARL has continued in 2018 with 55% as SARL and only 42% as SA (contrary to any previous year since the adoption of the Securitisation Law in 2004). This trend is continuing at the beginning of 2019. We believe that this is due to the reform of the Luxembourg Law of 10 August 1915 on commercial companies (the "Commercial Law") that permits public bond issuances of SARL since mid-2016.

As already highlighted in the past, the number of securitisation undertakings itself is not representative of the extent of securitisation transactions in Luxembourg. With the specificity of the Luxembourg Securitisation Law allowing for the creation of compartments (ring-fenced sub-division of the securitisation undertaking) it is easily, quickly, and cost-efficiently possible to have several securitisation transactions within one legal entity. We estimate that more than 6,000 transactions are executed in the currently active securitisation undertakings.

Figure 2: Yearly evolution of Luxembourg securitisation vehicles



Source: ECB Database, CSSF, RCSL, PwC Analysis

It is also worth mentioning that Luxembourg offers special investor protection for undertakings issuing securities to the public on a continuous basis. Such undertakings need to be supervised by the *Commission de Surveillance du Secteur Financier* ("CSSF"). As of 31 December 2018, only 32 (2017: 33) undertakings are supervised and have around EUR 44.6 billion securitised assets (2017: 42.4 billion), i.e. an increase of 5% or EUR 2.2 billion. In addition, EUR 4.2 billion have been securitised off-balance using fiduciary notes. It is interesting to see that those supervised entities make up only around 2.5% of the FVC registered in Luxembourg, but represent around 17% of

the total assets and almost 34% of the series issued (as an approximation to the number of compartments). In fact, in nearly all cases, the supervised securitisation companies have created several compartments and a majority issues certificates as investment products for retail investors (so called "structured products", paying the performance of an index or similar underlying synthetically received via a total return swap, also refer to section 2.2). In addition, around 60 Luxembourg securitisation undertakings (CSSF-supervised or not) have their securities issued admitted for trading on an EU-regulated market and are subject to the applicable European legislation.

Luxembourg's position in Europe

A look at the ECB statistics for international comparison (Euro area), clearly reveals that Luxembourg remains one of the leading centres for securitisation and structured finance vehicles. In fact, most of the FVC in the Euro area are incorporated in Luxembourg (as on 31 December 2018: 1,268 or 30.0%; 2017: 1,186 or 30.1%), followed by Ireland (2018: 1,123 or 26.5%; 2017: 950 or 24.1%) and Italy (2018: 700 or 16.5%; 2017: 644 or 16.4%), which remains the same order as in previous years (see Figure 3). However, since 2017, Ireland has demonstrated a significantly higher growth rate (in number of FVC) than Luxembourg.

With regards to the amount of securitised assets, the above mentioned top three countries were able to grow around 7% each. Furthermore, the FVC statistics offer insights on the number of "series" of securities issued, which can be seen as approximation for the number of transactions, compartments or silos within the entities. With 5,952 "series"

and an increase of 29.5% compared to prior year (2017: 4,597), Luxembourg strengthens its leading position, getting ahead of Ireland for the second time during the last five years. A complete overview of the top five Euro countries for securitisation in the Euro area can be found in Figure 4. Obviously, these statistics for the Euro zone do not include the UK, which is also one of the major players in the European securitisation market.

Asset types and financing in Luxembourg and Europe

When looking closer at the top three Euro area securitisation countries, the ECB statistics allow for a closer look into asset types (high level) and ways of financing. Luxembourg FVC securitise mainly loans (43%, 2017: 42%) and debt securities (27%, 2017: 24%), but a significant portion is also invested in equity and funds (15%, 2017: 17%). Irish and Italian FVC are also mainly investing in loans and debt securities (Ireland: 63%; Italy: 80%) while having only a minority holding fund or other equity interests (Ireland: 8%; Italy: 0%).

Figure 3: Number of FVC per country (in Euro area, as at 31 December 2018)

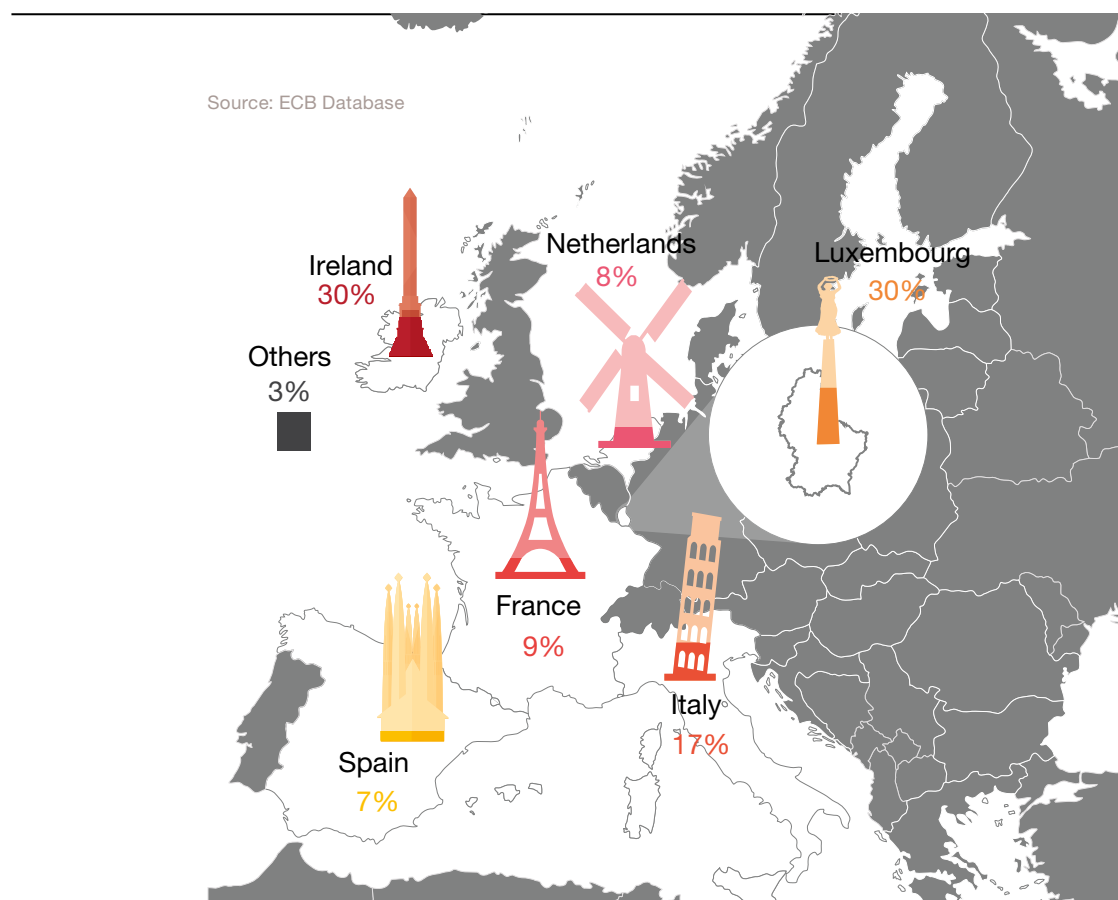


Figure 4: Top 5 Euro area countries for securitisation

	Number of FVC		"Series"		Total Assets (in EUR billion)	
	2018	2017	2018	2017	2018	2017
Grand Total	4,230	3,940	15,992	14,194	1,929	1,870
LU	1,268	1,186	5,952	4,597	266	249
IE	1,123	950	5,603	5,219	433	401
IT	700	644	2,151	2,040	403	377
FR	371	367	502	496	227	229
NL	357	359	362	363	261	255
ES	289	318	918	1,005	197	206
Other	122	116	504	474	143	153

Source: ECB Database

On the financing side, the statistics make quite clear that the vast majority of Luxembourgish and Irish FVC are financed by the issuance of debt securities (Luxembourg: 83%; Ireland: 58%; Italy: 45%) while Italian FVC are also financed by other liabilities (54%). Interestingly, only Luxembourg FVC are partly financed by equity (Luxembourg: 4%, Ireland and Italy: 0%), probably due to the flexibility in the Securitisation Law and favourable tax regime. On the other hand, Ireland allows for loan financing (19%) which is currently allowed for Luxembourg securitisation undertakings only under certain conditions (Luxembourg: 7%, Italy: 1%).

The Luxembourg securitisation market still features auto loans/lease receivables as well as mortgage loans (performing and non-performing) as main asset classes, together with trade receivables and repackaging/structured products.

Based on our observations, securitisation undertakings are more and more used as structuring alternatives or investment products for real estate or private equity groups. However, banks remain the main players as originators, arrangers, and investors. Furthermore, we have the impression that hedge funds and insurance companies or pension funds continue to show notable interest in Luxembourg securitisations. Besides this, Luxembourg and the local securitisation possibilities also attract the thriving industry of FinTech, be it for peer-to-peer lending or as a refinancing tool for institutional investors.

Outlook

We are confident that securitisation in Luxembourg will continue to be a success story. First of all, European markets have proven to be more stable, showing significantly lower default rates than the US. In addition, ten years after the financial crisis, politicians have now realised that securitisation is a tool worth being supported and have thus enacted the EU Securitisation Regulation (see section 5.1) in the context of the Capital Markets Union. These developments should give a further positive impulse to the securitisation markets in Europe. On the other hand, the EU Securitisation Regulation, applicable since January 2019, has also partly led to uncertainty of securitisation players on certain interpretation of the regulation. Similarly, recent changes in tax rules (notable interest limitation rules in the course of the Anti-Tax Avoidance Directive ("ATAD rules"), see section 4.5.1) without clear guidance have caused legal uncertainty which might have a slow-down effect on an otherwise fostering securitisation market. This is why we encourage market players and the tax administration to provide a clear interpretation of the ATAD rules and their application for Luxembourg securitisation vehicles. Any long-lasting uncertainty would have a negative impact on the Luxembourg securitisation market, which should be avoided.

We remain convinced that the legislator, the administration, and the market players will be able to continue setting a favourable environment to enable Luxembourg to remain the first place to be when doing securitisation in Europe.

2

Securitisation basics

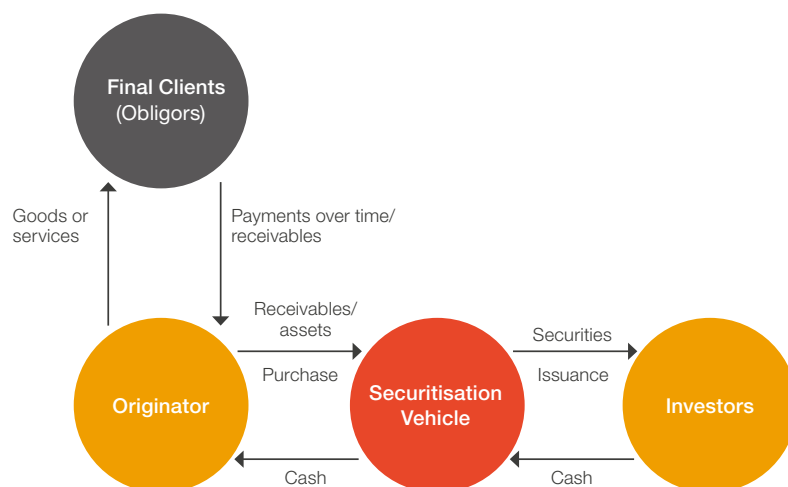
2.1 What is “securitisation”?

In a nutshell, securitisation is the pooling of various assets and financing the acquisition of these pooled assets with the issuance of securities. The first asset securitisation transactions took place in the 1970s in form of structured financing of mortgage pools. Over the years, securitisation transactions have become a mature and significant sector of the European capital markets with transactions using several asset types as collateral (e.g. residential mortgages, debt, trains, wagons, properties, and rent) as well as car loans, credit-card receivables, and consumer loans. Nowadays, securitisation is recognised more and

more as an efficient tool to provide funding to the market. In addition, structured-product securitisation vehicles - synthetically transferring the performance of reference assets through derivatives - have been established in order to issue certificates for retail clients.

Broadly speaking (and illustrated in a simplified way in Figure 5), a pool of cash generating financial assets is transferred from a so-called “Originator” to a “Special Purpose Vehicle” (“SPV”) or “Securitisation Vehicle” (“SV”). The SV finances the acquisition of these assets by

Figure 5: Securitisation process



the issuance of securities, whose interest and principle payments depend on and are backed by the assets transferred.

More generally, SVs may even only assume a risk without the acquisition of the reference assets (transferring the performance through derivatives instead).

From an originator's perspective, the securitisation transaction:

- enables the transfer of specific ownership risks to parties who have higher capabilities to manage these risks; and
- grants access to capital markets with a potentially better debt rating than the general corporate rating of the originator.

Further benefits are described in section 2.3 below.

The “structuring” process is one of the central elements of a securitisation transaction. Securitisation typically splits the credit risk into several tranches with different risk profiles. This allows 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 other tranches, often called subordinated, mezzanine or junior tranches. The most senior tranche is usually very high-rated and is protected from credit losses (up to a certain amount) by having priority on the cash flow received from the assets. The lower tranches are consequently rated lower and designed to absorb first credit losses. These tranches have higher margins to compensate for the additional risk.

The first-loss tranche (or so-called “first-loss piece”) is often held by the originator and offers a high risk/reward profile. The most probable credit losses of a securitisation transaction are concentrated in this tranche. The first-loss tranche is usually capped at “expected” or “normal” rates of portfolio credit losses, so all credit losses up to this point are effectively absorbed by this tranche. It typically receives all portfolio cash flow after expenses (which include expected losses) in the form of an excess spread.

The payment sequence follows the structuring concept and is called “waterfall”. It shows similarities to the well-known champagne waterfall we see at weddings, with various levels of glasses balanced on one another. The champagne waterfall may be transferred to securitisation as follows:

Figure 6: The “waterfall” payment sequence



The waterfall shows the order of the cash return on assets, which allows both interest and transaction-related fees to be paid and the repayment of the notes issued. The underlying portfolio's cash flow is used to fill or refill the requirements of the top tranche (senior tranche). The surplus cash flow then flows down to fill or refill the requirements of the second tranche (i.e. junior, mezzanine and subordinated), and so on. This process will last until the cash flow is exhausted. The first-loss tranche at the bottom will receive the residual cash flow after all 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.

2.2 Types of transactions

Different criteria can be applied to distinguish between different types of securitisation transactions. The list is not exhaustive, but the following criteria should help to distinguish the different kinds of transactions available and should make their purpose easier to understand. An overview is given in Figure 7.

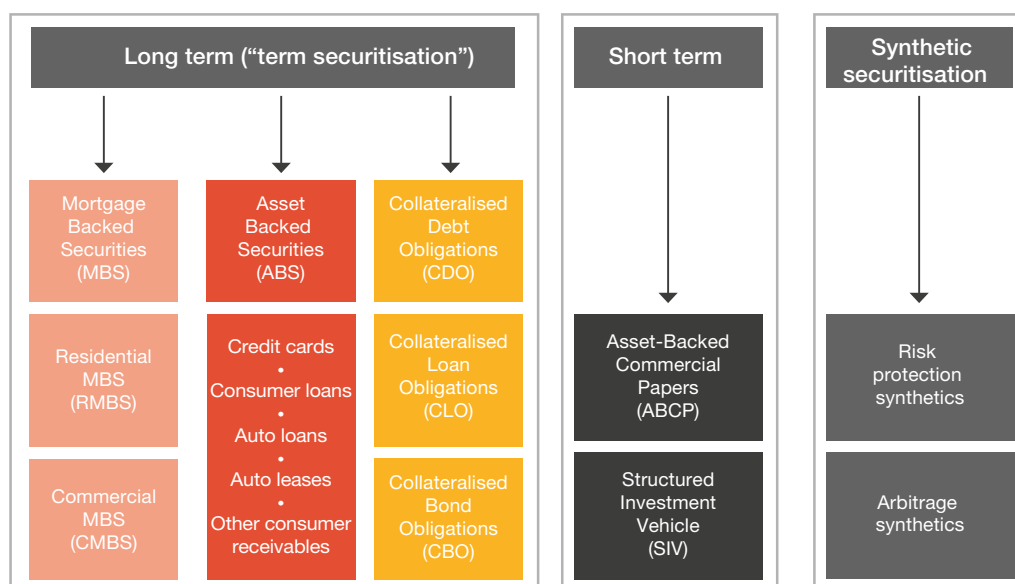
Term securitisation vs. securitisation via Asset-Backed Commercial Paper (“ABCP”)

Term securitisations are long-term placements on the capital market. When the underlying portfolio (assets or

loans) is paid back, the transaction is naturally closed. Term securitisations are usually classified by asset type as outlined below.

Securitisations issued via ABCP allow for short-term financing on a roll-over basis on the money market. These transactions are regularly set up for an unlimited period. A typical example is the revolving securitisation of trade receivables. Other short-term securitisations are Structured Investment Vehicles (“SIV”) refinancing long-term assets with short-term liabilities in order to gain on credit spread differences.

Figure 7: Transaction types according to maturity and underlying risk



Source: European Commission

Transactions by asset classes referring to the underlying risk

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

Mortgage-Backed Securities (“MBS”) are types of asset-backed securities collateralised by a pool of mortgages. Securities issued by the SV are backed up by the principal and interest of mortgage loans. Investors receive payments of interest and principal derived from payments which are received on the underlying mortgage loans. In addition, a differentiation between Residential MBS (“RMBS”) with underlying mortgages of individuals and Commercial MBS (“CMBS”) with underlying mortgage loans secured by commercial properties is possible.

Collateralised Debt Obligations (“CDO”) pool cash flow-generating assets, such as bonds, loans or credit derivatives. Common types of transactions are Collateralised Loan Obligations (“CLO”) or Collateralised Bond Obligations (“CBO”). These transactions can be classified into static or dynamic structures. In a static structure, the entire portfolio is fixed at the closing date of the transaction. As a result, the assets are not actively changed, irrespective of the performance of a single credit risk in the underlying portfolio. The underlying assets will only be changed in the event of full repayments or defaults, but defaults cannot usually be replaced. In dynamic or actively managed transactions, the responsible asset manager can replace one or more underlying assets to decrease the credit risks or to increase the performance. This means that the assets will be exchanged and credit events may be avoided.

Other Asset-Backed Securities (“ABS”) represent the residual part and also the wider range of the securitisation market, which is characterised by the heterogeneity of the underlying assets. The underlying of ABS transactions may vary from consumer loans, secured credit-card receivables, trade receivables, and student loans to the securitisation of life-insurance policies, intangibles, etc.

True sale vs. synthetic transactions

With regard to the transfer of rights of the assets, there are two forms of securitisation transactions:

(i) True sale transactions

A true sale transaction is the traditional form of a securitisation. The SV acquires receivables from an originator who transfers the assets to the SV. The assets are then removed from the balance sheet of the originator. The SV financed the purchase of these assets by issuing notes, which are usually rated by a rating agency. The notes rating reflects the fact that the SV is isolated from any credit risk of the originator and the credit enhancement of the pool. Therefore, the originator transfers both the legal and beneficial interest in the assets to the SV. As a result, the investor of the SV receives the legal and beneficial rights to the underlying assets.

(ii) Synthetic transactions

In a synthetic securitisation, the originator buys protection through a series of credit derivatives instead of selling the asset pool to the SV. 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 (the “Protection Buyer”) transfers the credit risk of a portfolio of assets (a “Reference Portfolio”) to another entity (the “Protection Seller”). Although the credit risk of the Reference Portfolio is transferred, its actual ownership remains with the Protection Buyer.

Credit risk may be transferred in a number of ways:

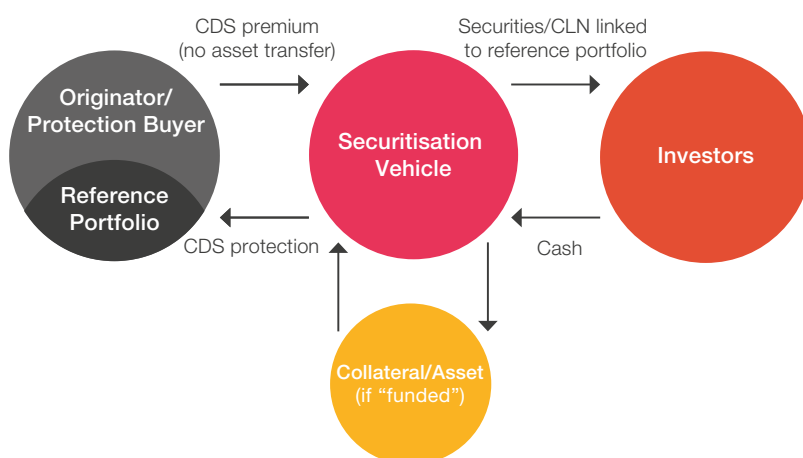
- The Protection Buyer might issue Credit-Linked Notes (“CLN”) to the Protection Seller. The terms of the notes would provide for a reduction in the Protection Buyer’s repayment obligation on the notes upon defaults or other credit events arising with respect to the Reference Portfolio.
- Alternatively, the Protection Buyer may enter into a Credit Default Swap (“CDS”), total return swap or other credit derivative transaction with the Protection Seller. In return

for certain payments, the Protection Seller agrees – in the event of default or another credit event in respect of a Reference Portfolio – to pay an amount to the Protection Buyer. This is calculated based on the amount of payment defaults or the reduction in market value of the defaulted Reference Portfolio.

The transaction may be funded or unfunded. In a funded transaction, the investors make an initial payment (e.g. to the counterparty or as cash deposit or to purchase a risk-free investment) that serves as collateral to cover the counterparty risk. In an unfunded transaction, no such initial cash flow is required.

Figure 8 illustrates a typical synthetic securitisation structure.

Figure 8: Typical synthetic securitisation structure



2.3 Benefits of securitisation

Even if setting up an SV – a separate legal entity requiring several service providers (see section 2.5 *Parties involved in securitisation transactions*) – incurs a certain amount of costs, for the involved parties the benefits outweigh the costs. Below we present a non-exhaustive list of the usual benefits of a securitisation transaction, which may be favourable to one or more of the various parties. However, securitisation transactions are complex structured financing methods and it is crucial that potential issuers understand the range of options and related implications in order to make an informed decision. While these benefits have varying degrees of importance for different originators, the common characteristic of securitisation is the demand 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:

- **Providing efficient access to capital markets:**

Structuring with high ratings is possible on most of tranches of notes issued. The non-existing link between originator's credit rating and the rating of the securitised assets reduces the funding costs; for instance, a company rated BBB but having an AAA-worthy cash flow from some of its assets, would be able to borrow at AAA rates. This is the main reason for the securitisation of cash flow to achieve significant impact on borrowing costs.

- **Minimising issuer-specific limitations on ability to raise capital:** Funding depends on the terms, credit quality, prepayment assumptions, servicing of the assets, and prevailing market conditions. Entities that are unable to fund themselves easily due to their individual credit quality, or that do so only at a significant cost, may be able to conduct securitisation transactions. This also applies to entities that are unable to raise equity.
- **Creating liquidity:** Assets that are not readily sellable may be combined to create a diversified collateral pool funded by notes issued by a securitisation vehicle.
- **Diversifying and targeting funding sources, investor base, and transaction structures:** Businesses can expand beyond existing bank lending and corporate debt markets by tapping into new markets and investor groups. The new funding sources may also reduce the costs of other types of debt by reducing the volume issued and allowing placements with marginal purchasers willing to pay a higher price. Especially for complex organisations, segmenting revenue streams or assets that back particular debt offerings enables issuers to market debt to investors based on their appetite for particular types of credit risk. At the same time, it allows these investors to minimise their exposure to unrelated issuer risks. 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.

- **Raising capital to generate additional assets or apply to other more valuable uses:** For example, it allows credit lines to be recycled quickly to generate additional assets, as well as freeing long-term capital for related or broader uses. The capital raised can be used for any allowable purpose, such as retiring debt, repurchasing stock, purchasing additional assets or completing capital projects.
- **Raising capital without prospectus-type disclosure:** Allows sensitive information about business operations to be kept more confidential, especially by issuing through a “conduit” or as a private placement.
- **Generating earnings:** When a true-sale securitisation transaction takes place between the originator and the SV, it must take place at the market value of the underlying assets. The transaction is reflected in the originator’s balance sheet, which will eventually boost earnings or lock the level of profit resulting from the sale of assets for the particular quarter or financial year by the amount of the sale while passing the risks on.
- **Completing mergers and acquisitions, as well as divestitures more efficiently:** It 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 debt issued, it may be possible to optimise the closure of business lines that no longer meet corporate objectives.
- **Transferring risk to third parties:** Assets in case of true sale transactions or risks in case of synthetic transactions can be partially or fully transferred to investors and credit enhancers.
- **Lowering capital requirements for banks and insurance companies:** The supervisory authorities set out minimum capital requirements for banks and insurance companies, in accordance with the size and nature of the risks borne by the company. By removing

assets from the company’s balance sheet, related capital requirements are released, which can then be used for other purposes. These capital requirements are described in more detail in section 5.

Benefits for investors

- **Broad possible combinations of yield, risk, and maturity:** Securitised assets are usually structured to meet investors’ investment strategies, requirements, and appetite for risk. With this flexibility, securitised assets offer a range of attractive yields, payment streams, and risk profiles.
- **Tailored investment sources:** Investors who would normally not invest directly in the originator’s securities would tend to have a different perspective and be attracted by the characteristics of securitised assets.
- **Portfolio diversification:** Some investors, like hedge funds or institutions, tend to invest in bonds issued by securitisation vehicles, which are uncorrelated to their other investments.
- **Higher returns:** Because of securitised assets and underlying risk-return-maturity profile, investors may 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 to variable-rate debt, without overexposing themselves to interest rate risk. Credit card lenders can originate very large loan pools for a diverse customer base at lower rates.

2.4 Types of credit enhancements

Defined as initiatives taken by the originator to enhance the creditworthiness of the securities issued 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. In addition, this increases the probability of the investors receiving the cash flow to which they are entitled, and gives the securities a higher credit rating than the originator. Accordingly, both internal (techniques structured within the transaction) and external (insurance-type policies purchased to protect investors in the event of default) mechanisms are typically built into the structure.

Setting up credit enhancements is an essential step of the structuring process that drives the ultimate rating of the securities issued. Most structures contain a combination of one or more of the enhancement techniques described below. From an issuer's point of view the objective is to find the most practical and cost-effective credit-protection method for the securities' desired credit rating and pricing. Most securities also contain performance-related features designed to protect investors (and credit enhancers) from portfolio deterioration. The originator will often negotiate type and size of the internal and external credit enhancements with the rating agencies. The following example illustrates a credit enhancement: as usual, a rating of AAA implies, with almost absolute certainty, that the interest and principal on the debt issued will be paid on time. Although it is highly unlikely that an entire pool of residential mortgage loans will have such a rating, it is possible that a large portion of the portfolio will do. The remaining portion of the portfolio is divided into different tranches, from A and BBB to the unrated first-loss piece

(which is typically held by the originator). Losses on the portfolio are first allocated to the unrated position and then, usually, to the lower-rated securities up to the senior AAA position.

Common types of credit enhancements can be summarised as follows:

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 asset portfolio is higher than the face value of the securities it backs. In other words, the securities issued are over-collateralised. So even if some of the payments from the underlying assets are late or defaulted, principal and interest payments on the securities issued can still be arranged.

Subordination

Subordination means that a class of securities with rights that are subordinated to the rights of other classes of securities are issued in connection with the same transaction. Subordination usually relates to the rights of investors to receive promised payments, particularly in situations where there is not sufficient cash flow to pay promised amounts to all investors. However, it may also relate to the investors' right to vote on issues concerning the operation of the transaction. Subordinated securities are repayable only after other classes of securities with a higher

ranking have been satisfied (“waterfall payment”). The payments of senior tranches are protected by subordinated tranches in the event of loss.

Excess spread

The excess spread is the net amount of interest payments received from underlying assets after transaction administration expenses and investors’ interest payments have been executed. The excess can be used to cover losses and top up reserve funds.

Reserve fund

A reserve fund is an account available for use by the SV for one or more specified dedicated 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.

External credit enhancements

Third-party/Parental guarantees

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

Letters of credit

With a letter of credit (“L/C”), a financial institution – usually a bank – is paid a fee for providing a specified amount of cash to reimburse the SV for any cash shortfalls from the collateral – up to the required credit support amount. L/Cs 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 L/C-provider banks in the fixed-income sectors. Because notes enhanced with L/Cs from these lenders faced possible downgrades as well, issuers began to use cash collateral accounts instead of L/Cs in cases where external credit support was needed.

Surety bonds

These are policies provided by a rated insurance company to protect principal and interest payments for certain investors. Surety bonds are granted on investment-grade securities provided that other forms of credit enhancement are used as well. The ratings of securities paired with surety bonds are the same as those of the surety bond’s issuer.

2.5 Parties involved in securitisation transactions

In addition to the parties directly involved, there are many others, generally defined as service providers, that are usually involved in the securitisation process. Below is an overview of the most relevant parties:

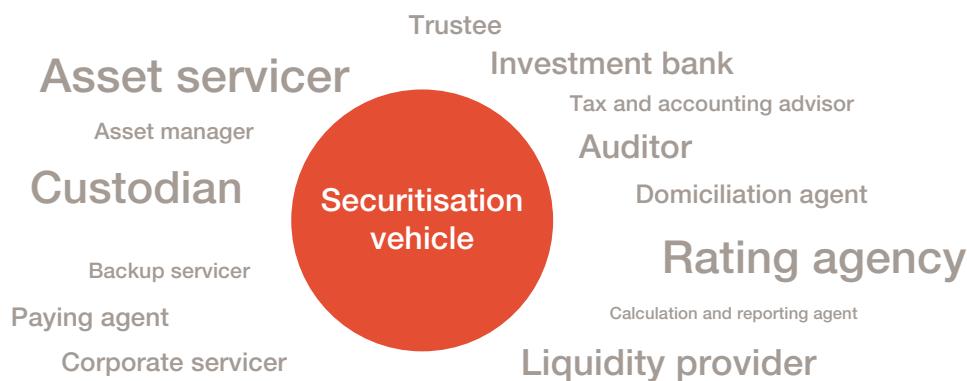
Obligor/Borrower

Obligors owe the originator payments on the underlying loans/assets and are therefore ultimately responsible for the performance of the issued securities. As obligors are often not informed about the sale of their payment obligation, the originator often maintains the customer relationship as servicer.

Originator

The originator is the entity to assign assets or risks in a securitisation transaction. It is usually the party (lender) who originally underwrites and securitises the claims (loans). The obligations arising from such loans are originally owed to this entity before the transfer to the SV takes place. Occasionally, the originator may be a third party who buys the pool with the intention to securitise it later; in this case, the originator may also be named as “sponsor”. Originators include captive financial companies of the major car manufacturers, other financial companies, commercial banks, building societies, manufacturers, insurance companies, and securities firms.

Figure 9: The securitisation service providers



Investor

Investors buy the securities issued by the SV, and are thus entitled to receive the repayments and interest based on the cash flow generated by the underlying assets. Collaterals ensure the pecuniary claims from these assets. The largest investors in securitised assets are typically pension funds, insurance companies, investment funds, family offices, and – to a lesser extent – commercial banks. The most compelling reason for investing in Asset-Backed Securities is their higher rate of return compared to other assets with a comparable credit risk.

Asset servicer

The asset servicer is the entity to collect principal and interest payments from obligors and administer the portfolio after the transaction has closed. Regularly, the originator acts as asset servicer, but not always. 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 further include default management, liquidising collateral, and preparing monthly reports. The asset servicer is typically compensated with a fixed or variable servicing fee.

Backup servicer

If the original servicer defaults, the backup servicer replaces them. They take over all the responsibilities allocated to the servicer.

Corporate servicer/administrative agent

The corporate servicer is the entity in charge of the administration, accounting, investor reporting, and annual accounts of the SV. Furthermore, the corporate servicer files the annual accounts and the tax returns and may provide local directors.

Domiciliation agent

The domiciliation agent provides the legal registered office for the SV. The domiciliary agent is responsible for the performance of functions and duties associated with the physical domicile, such as the provision of office space, handling all correspondence addressed to the SV, and arranging the settlement of bills on its behalf.

Trustee

Acting in a fiduciary capacity, the trustee is primarily concerned with preserving investors' rights. The trustee's responsibilities will vary from one case to the next and are described in a separate trust agreement. Generally, the trustee oversees the receipt and disbursement of cash flow as prescribed by the indenture or pooling and servicing agreement, and monitors other parties of the agreement to ensure that they comply with the appropriate covenants. If problems occur in the transaction (e.g. defaults), the trustee pays particular attention on the obligations and performance of all parties associated with the securities issued, notably the servicer and the credit enhancer. Throughout the lifetime of the transaction, the trustee receives periodic financial information from the originator/servicer detailing 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 flow to serve the securities issued. The trustee is also responsible for declaring default or amortisation events.

Investment bank

Investment banks mainly structure, underwrite and market the securitisation transaction.

Tax and accounting advisor

These advisors provide assistance on the accounting and tax implications respectively of the proposed structure of the transaction. Issuers usually aim to choose structures that will allow the tax impact on the securities issued to be minimised.

Rating agencies

The securities issued are usually assessed by a rating agency to allocate a rating to them. A wide range of investors requires a minimum rating of investment grade or higher. The rating process is dominated by Big Three rating agencies Standard & Poor's, Moody's, and Fitch. They use their accumulated expertise, data and modelling skills to assess the expected loss of debt securities issued by the securitisation vehicle. But there is also a high number of other rating agencies which have been registered or certified in accordance with the EU Credit Rating Agencies Regulation (see <https://www.esma.europa.eu/supervision/credit-rating-agencies/risk>).

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 flow (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 paying agent is the bank that has agreed to settle the payments on the securities issued to investors. Payments are usually made via a clearing system.

Legal advisor

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

Credit enhancement provider

Credit enhancement is used to improve the credit rating of the issued securities. Therefore, credit enhancement providers are third parties agreeing to elevate the credit quality of another party or a pool of assets by making payments, usually up to a specified amount. This provision is made in case that the other party defaults on their payment obligations or the cash flow generated by the pool of assets is less than the amounts contractually required due to defaults of the underlying obligors.

Calculation and reporting agents

This entity calculates the waterfall principal and interest payments due to creditors and investors.



Liquidity provider

Liquidity providers are usually banks that provide the SV with the necessary cash to avoid any unsteadiness of the cash flow to the investors. It is a kind of bridge loan and short-term facility, and it is not used for defaults within the underlying asset portfolio.

Asset manager

Asset managers are responsible for selecting underlying assets, monitoring the portfolio and, if foreseen, replacing underlying assets. They are common in CDO/Structured Credit transactions.

Custodian

The custodian bank is responsible for safekeeping the securitisation vehicle's liquid assets and transferable securities, including the pool of assets transferred in the event of true sale transactions.

Auditor

In Luxembourg, the annual accounts of securitisation vehicles have to be audited by one or more independent auditors ("*Réviseurs d'entreprises agréés*") appointed, as the case may be, by the management body of the securitisation company or the securitisation fund's management company.

3

The Luxembourg Securitisation Law

3.1 Scope of Luxembourg securitisation vehicles

3.1.1 Broad definition of securitisation

Compared to the definition in the European legislation, the Luxembourg Securitisation Law provides a rather broad and flexible approach on securitisation. While the EU Securitisation Regulation¹, Capital Requirements Regulation (CRR)², and Solvency II Directive³ require that the securities issued by a securitisation vehicle transfer credit risk and are split in multiple tranches, the Luxembourg Securitisation Law does not contain such restrictions. 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 in all or part of the activities of third parties, and
- issues transferable securities (shares, bonds or other transferable securities) whose value or yield depends on such risks.

To qualify as a Luxembourg securitisation vehicle governed by the Luxembourg Securitisation Law, entities must only state in their Articles of incorporation or management

1 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

2 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

3 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

regulations (for securitisation funds) that they are subject to the provisions of the Luxembourg Securitisation Law (“opt-in”).

3.1.2 Few limits for securitisation activities

The Luxembourg Securitisation Law allows a wide range of assets to be securitised, such as trade receivables, mortgage loans (commercial or residential), shares, bonds, commodities, and essentially, any tangible or intangible asset or activity with a reasonably ascertainable value or predictable future stream of revenue to be securitised. Furthermore, the Luxembourg Securitisation Law does not prescribe any specific diversification requirements. A securitisation vehicle transforms these assets or risks into registered or bearer securities (e.g. shares, bonds, certificates, etc.).

Luxembourg securitisation transactions may be achieved by transferring the legal ownership of the assets (“true sale”) or by only transferring the risks linked to the assets, e.g. via derivatives or guarantees (“synthetic”). They can be set up either as a long-term securitisation or as a short-term Commercial Paper Programme (“Asset-Backed Commercial Paper” or “ABCP”).

The specific nature of the securitisation undertaking’s activity requires that the risks it securitises result exclusively from assets, claims, or obligations assumed by third parties or are inherent in all or part of the third parties’ activities.

They cannot be generated by the securitisation undertaking or result as a whole or in part from the securitisation undertaking itself acting as entrepreneur.

The role of the securitisation undertaking is limited to administering financial flows linked to the securitisation transaction itself and to the “prudent-man” management (in contrast to “active management”) of the securitised risks, while any activity likely to qualify the securitisation undertaking as an entrepreneur is prohibited.

The Luxembourg Securitisation Law itself gives only limited guidance to what exactly has to be understood by those terms. Therefore, the CSSF has interpreted them in a “Frequently Asked Questions” section published on its website.⁴

Any active management of the securitised assets or risks by the securitisation undertaking that could create an additional (management) risk on top of the risk already inherent in the assets or risks, would be incompatible with the purpose of the Luxembourg Securitisation Law. Similarly, any activity which aims to create additional wealth or promote the commercial development of the securitisation undertaking’s activities would be prohibited.

A securitisation undertaking can only assign/sell its assets in accordance with the provisions laid down in its Articles of incorporation or its management regulations. However, those transactions shall not aim to take advantage of short-term fluctuations of market prices. Furthermore, according to the CSSF, the issue documents must specify for each issue how and by whom the decisions relating to the sale of assets will be made. The delegation of the actual management of the assets and risks to an external service provider does not change this conclusion.

In this context, the following types of transactions would still qualify as securitisation structures under the Luxembourg Securitisation Law:

- Granting loans instead of acquiring them on the secondary market, provided that the investor is sufficiently informed and that the securitisation vehicle is not acting on its own account, i.e. that those loans are set up upstream by or through a third party;
- Securitising existing portfolios of partially drawn credits and of automatically revolving credits under predefined conditions which does not lead by any means to the securitisation vehicle performing a professional credit activity in its own name;
- Acquiring goods and equipment and structuring the transaction in a way similar to a leasing transaction;
- Repackaging structures consisting in setting up platforms for structured products;
- Holding shares and fund units, provided that the securitisation vehicle does not actively intervene in the management of such entities, acts solely as a financial investor interested in receiving cash flow (e.g. dividends), and is not misused as group holding company.

However, in the context of ongoing discussions on the modernisation of the Luxembourg Securitisation Law, there is a tendency to soften this restriction in the future and allow some active management for securitisation vehicles holding loan, bond, and potentially also fund portfolios (so-called “CLO”, “CBO” and “CFO” structures).

⁴ This interpretation is primarily addressed to securitisation vehicles supervised by the CSSF (see section 3.3). Nevertheless, in practice, it serves as reference interpretation of the Luxembourg Securitisation Law.
<https://www.cssf.lu/en/supervision/ivm/securitisation/faq/>

3.2 Flexible and robust legal environment

The legal aspects described in this chapter illustrate some of the main characteristics of the Luxembourg Securitisation Law, including high flexibility, investor protection, and efficiency for the originator.

3.2.1 Several possible legal forms

Modelled on the well-known investment fund regime in Luxembourg, the Luxembourg Securitisation Law introduced securitisation vehicles in the form of both corporate entities and securitisation funds managed by a management company and governed by management regulations. Figure 10 provides an overview of the legal types of Luxembourg securitisation vehicles.

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

- “*Société anonyme*” (“SA”, equivalent to a public limited company); or
- “*Société à responsabilité limitée*” (“SARL”, equivalent to a private limited liability company); or
- “*Société en commandite par actions*” (“SCA”, partnership limited by shares); or
- “*Société coopérative organisée comme une SA*” (“Scoop SA”, a cooperative company organised as a public limited company).

As described in section 1.3, the main legal forms are the *Société anonyme* and the *Société à responsabilité limitée*.

Securitisation companies are not subject to a specific regulatory minimum capital requirement, but only to the

minimum capital prescribed for the respective legal form (e.g. EUR 30,000 for an SA, and EUR 12,000 for an SARL). This minimum share capital refers to the whole legal entity and not to each single compartment.

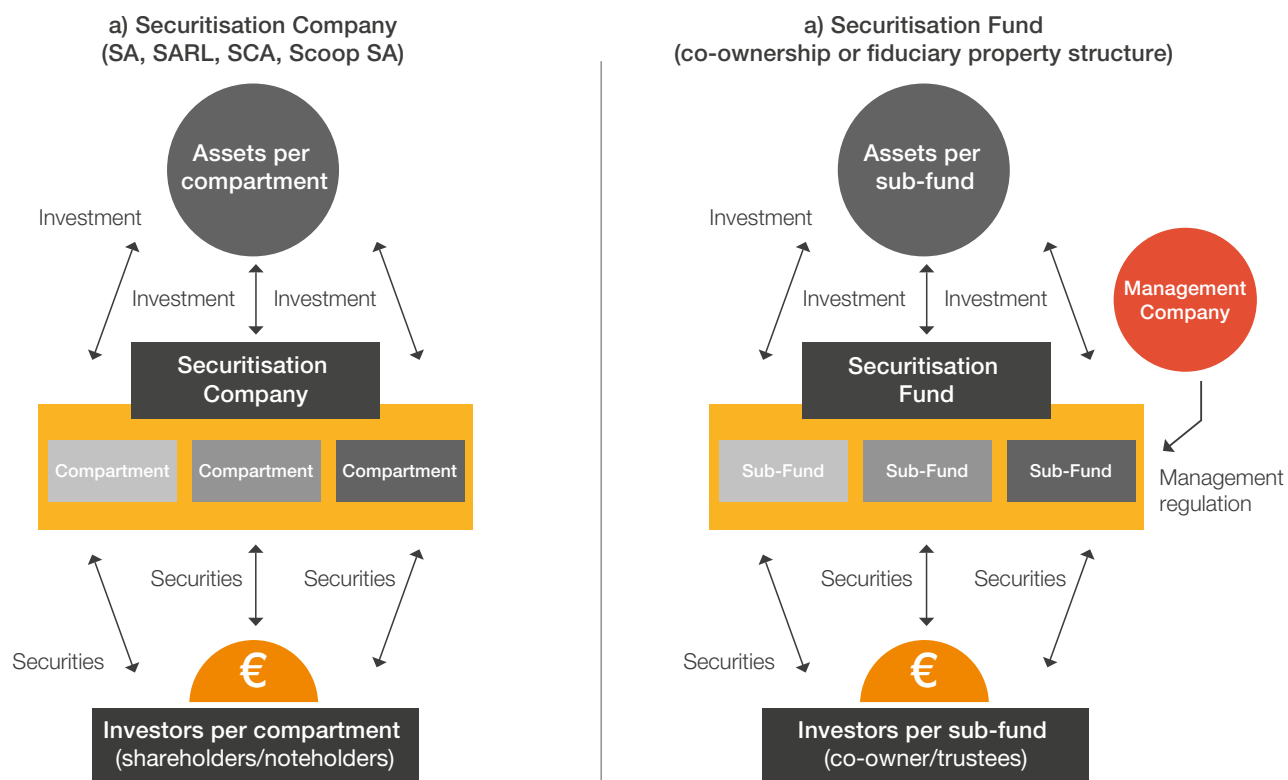
In cases of public offerings or listing of the securities issued by the securitisation vehicle, the legal form had to be SA or SCA until 2016, since SARLs were not allowed to make public issues. This restriction has been repealed with the 2016 amendment⁵ of the Luxembourg Company Law which allows public bond issues for SARLs. This has increased the number of securitisation companies created as SARL compared to SA in the last years.


In contrast to setting up a company, a securitisation vehicle can also be organised in a purely contractual form as a securitisation fund. The securitisation fund does not have a legal personality. It will, however, be entitled to issue units representing the rights of investors, in accordance with the management regulations. A securitisation fund may also issue debt instruments. Similar to a securitisation company, a securitisation fund can be created with a small number of fund units and financed almost entirely by the issue of debt instruments.

In the absence of legal personality, the securitisation fund may be organised as one or several co-ownership(s) or one or several fiduciary estate(s). In both cases, the securitisation fund will be managed by a management company, which is a commercial company with a legal personality in Luxembourg. As for the securitisation company, the fund may be split into distinct segments each being part of the same umbrella securitisation fund

⁵ Law of 10 August 2016 on the modernisation of the amended Law of 10 August 1915 on commercial companies.

Figure 10: Legal form of securitisation vehicles and creation of compartments





structure (“sub-funds”), which may then again be liquidated separately. The characteristics and rules applicable to each sub-fund may be governed by separate management regulations.

Securitisation funds are not subject to any minimum capital. Only the management company must meet the minimum capital requirement, which depends on the chosen legal form. Thus, the required capital ranges between EUR 12,000 for an SARL and EUR 30,000 for an SA.

3.2.2 Ability to create compartments

One of the main advantages cited by many market participants is the possibility to create several compartments within one legal entity or fund. This concept is adapted from the popular umbrella-fund structure and permits a time- and cost-efficient solution for frequent issuer vehicles. Precondition for the creation of multiple compartments is simply that the securitisation company's Articles of incorporation or the management regulations of a securitisation fund authorise the Board of Directors to create separate compartments or sub-funds, respectively. This allows each compartment to correspond to a distinct portion of assets financed by distinct securities. The compartments allow a pool of assets and corresponding liabilities to be managed separately, so that the result of each pool is not influenced by the risks and liabilities of other compartments. Each compartment can be liquidated separately.

The compartment segregation of the securitisation vehicle – a technique initially applied to investment funds in Luxembourg – also characteristically illustrates the combination of great flexibility and legal certainty that securitisation transactions in Luxembourg provide. Notably, this compartment segregation technique is either not applied or is not regulated by law in many other jurisdictions.

Compartment segregation means that the assets and liabilities of the vehicle can be split in different compartments, each of which is treated as if it were a separate entity executing distinct transactions. The rights of investors and creditors are limited to the risks of a given compartment's assets. There is no recourse against the assets allocated to other compartments in the event that the claims under the securities held by the investors are not fully satisfied with the assets of the compartment in which they have invested. 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. If the securitisation vehicle is a corporate entity, all compartments can be liquidated without necessarily liquidating the whole vehicle (while the liquidation of the last sub-fund of a securitisation fund would entail the securitisation fund's liquidation).

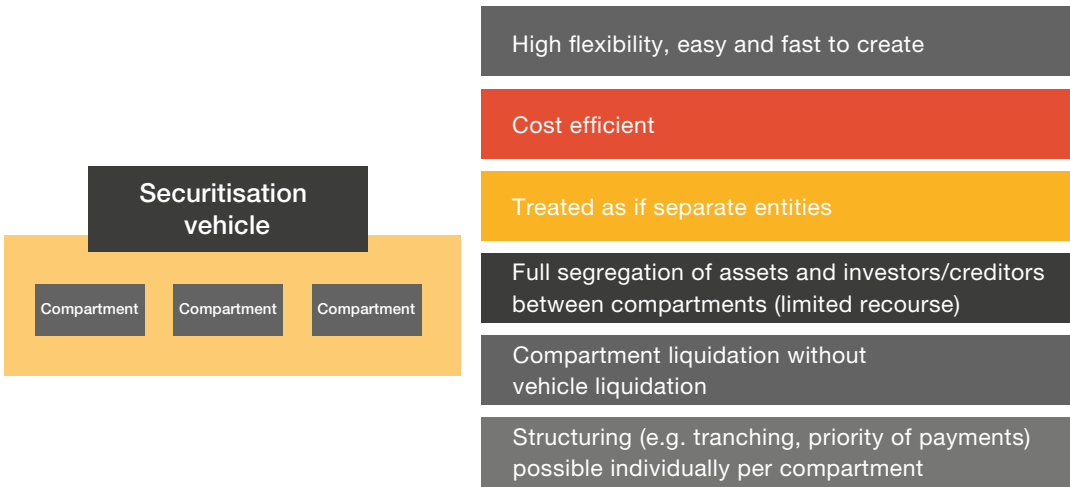
In addition, the securitisation vehicle or one of its compartments may issue several tranches of securities corresponding to different collaterals/risks and providing

different values, yields and redemption terms. Limited recourse, subordination, and priority of payment provisions, contractually agreed upon between the investors of tranches, may freely organise the rights and the rank between the investors and the creditors of a same compartment. However, this is only possible if provided for in the Articles of incorporation, management regulations or issuance agreement. In the 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.

3.2.3 Ability to issue fiduciary notes

The Law of 27 July 2003 related to trust and fiduciary contracts allows securitisation vehicles to act as a fiduciary and to issue notes on a fiduciary basis in its own name but at the sole risk and for the exclusive benefit of the noteholder. In this case, the securitisation vehicle issues fiduciary notes that incorporate a fiduciary contract between the securitisation vehicle (“fiduciary”) and the noteholder (“fiduciant”). Under the fiduciary contract, the noteholder transfers the ownership of certain assets (“fiduciary estate”) to the fiduciary and instructs the fiduciary how to invest the issuance proceeds. The assets purchased by the securitisation vehicle in a fiduciary capacity and the returns generated by the assets are transferred to the noteholder. The notes issued by a securitisation vehicle on a fiduciary basis do not constitute

Figure 11: Compartment segregation



debt obligations by the securitisation vehicle but are solely fiduciary obligations of the fiduciary and may be satisfied only out of the fiduciary assets.

Pursuant to the law, the fiduciary assets (initial issuance proceeds and assets acquired) are segregated from all other assets of the fiduciary as well as from other fiduciary estates and noteholders recourse against the fiduciary is limited to the fiduciary assets.

Similar to the creation of compartments, a securitisation vehicle may create several fiduciary estates in connection with the issue of series of notes issued by it. There is no recourse of investors and creditors against the assets allocated to other fiduciary estates.

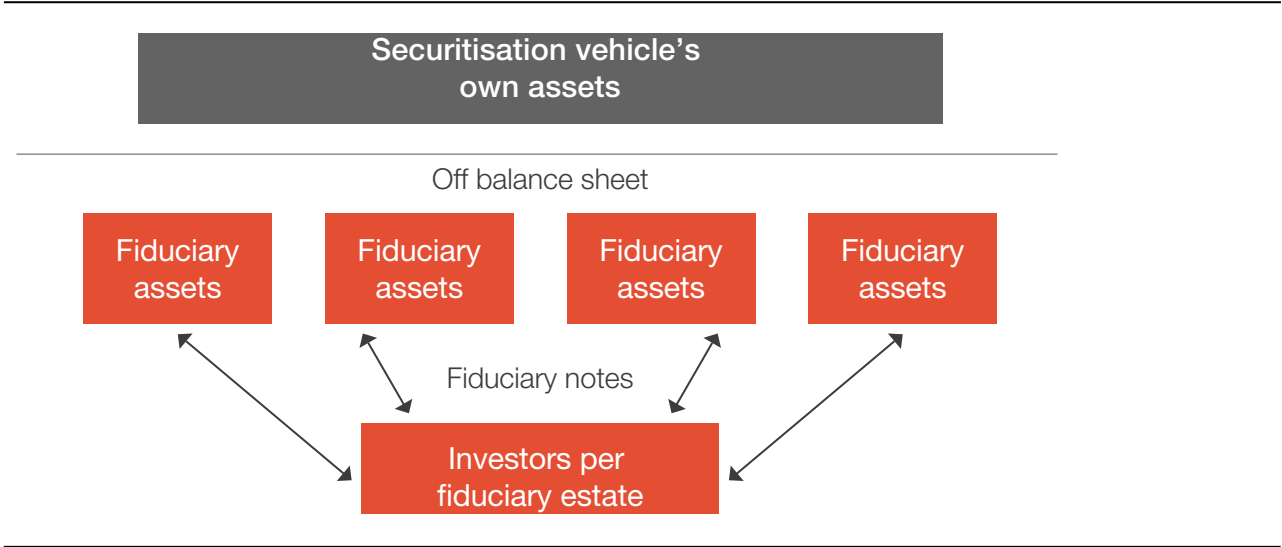
The fiduciary transactions are recorded off balance sheet by the securitisation vehicle.

3.2.4 Numerous asset classes allowed

Another aspect of the Luxembourg Securitisation Law’s great flexibility is the wide range of asset classes that qualify for securitisation. The Luxembourg Securitisation Law does not limit securitised assets. In its early phases and in other jurisdictions, the securitisation market essentially covered assets like loans and receivables acquired from financial institutions, such as mortgage-backed loans, credit card receivables, and student loans.

Today, however, and especially in Luxembourg thanks to the flexibility of the dedicated Securitisation Law, securitisation transactions also include tangible asset classes, such as aircrafts, railcars and commodities, as well as intangible assets, such as intellectual property or any type of rights.

Figure 12: Fiduciary structure





Under the Luxembourg Securitisation Law, it is also possible to securitise risks only, without acquiring the referring asset (so-called “synthetic” transactions). The securitised risks may relate to assets (whether movable or immovable, tangible or intangible) or result from obligations assumed by third parties. They may also be related to all or part of the activities of third parties. Thus, a securitisation vehicle can assume risks by acquiring the underlying assets themselves (“true sale”), or by guaranteeing the third party’s obligations or committing itself in any other way, e.g. via derivatives (“synthetic”) (see Figure 13).

A securitisation vehicle may not only securitise existing claims, but also future claims. The latter may arise (i) from an existing or future agreement, provided that such claims can be identified as being part of the assignment at the time they come into existence; or (ii) from future claims originating from future contracts, provided that such claims are sufficiently identified at the time of the sale or any other agreed time.

As outlined in section 1.3, the main asset classes securitised through Luxembourg securitisation vehicles are securities, loans, mortgages, non-performing loans, car loans, lease receivables, trade receivables, receivables in

connection with real estate or loans in relation with SME financing. In recent years, “Trackers” certificates, directly or indirectly linked to the value of an index or another underlying asset and structured for retail investors, have afforded great success in Luxembourg. Over the past few years, Fintech related activities, e.g. marketplace lending and crowdfunding using a Luxembourg securitisation vehicle, have also been developed.

3.2.5 Different forms of risk transfer and transaction types possible

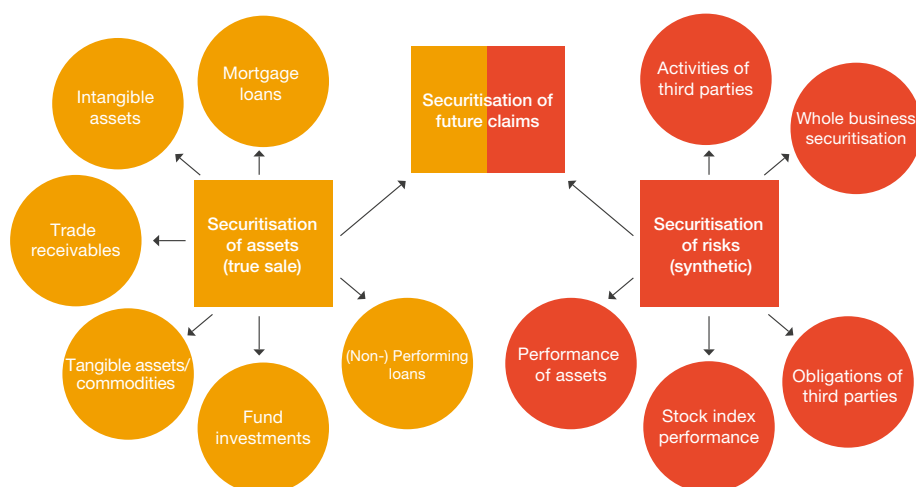
True sale vs. synthetic

Securitisation transactions can be executed in the two forms already described in section 2.2 *Types of transactions*. Within the scope of a “true sale” transaction, the originator sells the ownership in a pool of assets to a securitisation vehicle. Within the scope of a “synthetic” transaction, however, the originator buys credit/market risk protection (through a series of credit derivatives or swaps, guarantees or similar), without transferring the ownership of the underlying assets.

Single vs. two-tier structure

As shown in Figure 13, it is possible to structure securitisation transactions as single or as two-tier structures. In a single-tier structure, the purchase of the assets or risks, as well as the issuance of the securities is made by one single securitisation vehicle. In contrast, in a two-tier structure, the functions of acquisition of assets/risks and issuing of securities would be split among two or more vehicles. They would be referred to as “acquisition vehicle” and “issuing vehicle”, respectively, while the latter is back-to-back financing the former. The repayment of the securities issued by the issuing vehicle would be linked to the assets/risks and liabilities of the acquisition vehicle. In a two-tier structure under the Luxembourg Securitisation Law, the acquisition vehicles can also be established in the countries of the originators or in the countries where the transferred assets are located, which may be advantageous for legal, tax or operational purposes.

Figure 13: No restrictions for asset classes and risk transfer



3.3 Supervision of securitisation vehicles

3.3.1 Preconditions for authorisation requirement

The Luxembourg Securitisation Law differentiates between authorised and non-authorised entities. Authorised securitisation vehicles are authorised and supervised by the CSSF, which is responsible for ensuring that they comply with the Luxembourg Securitisation Law and fulfil their obligations.

A securitisation vehicle is subject to mandatory CSSF supervision if it issues securities (i) to the public and (ii) on a continuous basis. In order to be subject to mandatory supervision, each of the two conditions must be met.

Since neither the Luxembourg Securitisation Law nor parliamentary works define the notion of “public”, the CSSF has published the following criteria to clarify the concept:

- Issues to professional clients within the meaning of Annex II to the MiFID Directive (2004/39/EC) are not issues to the public.
- Issues whose denominations equal or exceed EUR 125,000 are assumed not to be placed with the public.
- The listing of an issue on a regulated or alternative market does not ipso facto imply that the issue is deemed to be placed with the public.

- Issues distributed as private placements, whatever their denomination, are not considered to be issues to the public. The CSSF assesses whether the issue is to be considered a private placement on a case-by-case basis according to the communication means and the technique used to distribute the securities. However, the subscription for securities by an institutional investor or financial intermediary for a subsequent placement of such securities with the public constitutes a placement with the public.

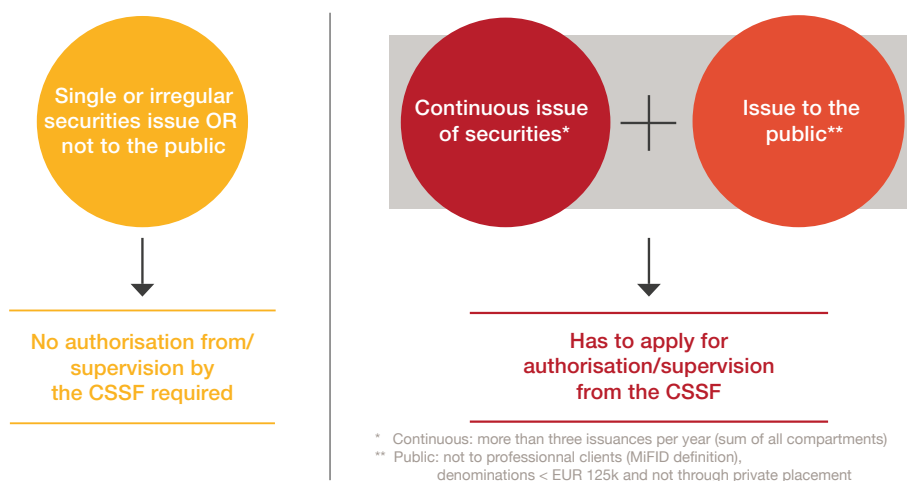
Therefore, issues to professional investors and private placements are not considered to be issues to the public.⁶

The CSSF considers that the notion “on a continuous basis” is met from the moment the securitisation vehicle issues securities more than three times per calendar year. In the case of a multi-compartment securitisation vehicle, the CSSF clarified that the number of issues per year has to be determined on the level of the securitisation vehicle and not on compartment level. Furthermore, when issuing securities under an issuance programme, each series is assumed to be a distinct issue to be counted separately for this purpose (unless further analysis of programme and series leads to the conclusion that they rather demonstrate the characteristics of one single issue).

However, because of the cumulative nature of the two conditions, a one-off issue of securities to the public as well as the continuous issue of securities with a denomination above EUR 125,000 may be carried out without prior approval from the CSSF.

⁶ Please note that the definition of the term “public” in the area of securitisation is not the same than the one of the Law of 10 July 2005 on prospectuses for securities, which defines the notion “offer to the public” and whose determining criterion is that of a proactive approach of solicitation and a specific offer adopted by the banker.

Figure 14: CSSF supervision



3.3.2 Initial authorisation by the CSSF

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. The same procedure applies for existing securitisation vehicles that have not been authorised before but now intend to issue securities to the public on a continuous basis.

To grant approval, the CSSF must be informed on the identity of the members of the securitisation vehicle's administrative, management, and supervisory bodies. In case of a regulated securitisation fund's management company, the shareholders in a position to exercise significant influence need to be named. The directors or managers of a securitisation company or a management

company of a securitisation fund must be of good reputation and have adequate experience and means required to perform their duties. The CSSF requires at least three directors for authorised securitisation vehicles, but allows legal persons to act as directors. In such cases, a natural person needs to be designated to represent this legal person and the CSSF will assess the criteria regarding the directors' competence and reputation at the level of the representatives of the legal persons acting as directors.

Securitisation companies and management companies of securitisation funds must have an adequate organisation and human and material resources to exercise their activities correctly and professionally. Structuring and management of the assets can be delegated to other professionals, including in foreign countries. Yet in such a case, an appropriate information exchange mechanism between the delegated functions and the Luxembourg

based administrative body must be established. The organisational structure must allow the external auditor and the CSSF to exercise their supervisory tasks.

The prudential supervision exercised by the CSSF aims to ascertain whether the authorised securitisation vehicle complies with the Luxembourg Securitisation Law and its contractual obligations. Any change to the securitisation vehicle's Articles of incorporation, managing body, or external auditor must be reported to the CSSF immediately and is subject to the CSSF's prior approval. Any change in the control of the securitisation vehicle or management company is subject to the CSSF's prior approval.

A further requirement for authorised securitisation vehicles is that their liquid assets (e.g. cash) and securities must be held in custody by a Luxembourg credit institution.

For the authorisation process, at least the following elements must be included in the approval file to the CSSF:

- the securitisation vehicle's Articles of incorporation or management regulations, or their drafts;
- the identity of the members of the Board of Directors of the securitisation vehicle or its management company, as well as the identity of the other managers of the securitisation vehicle or its management company, their CVs and extracts from their police records;
- the identity of the shareholders who are in a position to exercise a significant influence on the business conduct of the securitisation vehicle or its management company and their Articles of incorporation;
- the identity of the initiator and, where applicable, its Articles of incorporation;
- information concerning the credit institution responsible for the custody of assets;
- information concerning the administrative and accounting organisation of the securitisation vehicle;
- the agreements or draft agreements with service providers;
- the identity of the external auditor;
- the draft documents relating to the first issue of securities, or, for active securitisation vehicles, the agreements relating to the issue of securities and other documents relating to securities already issued.

In addition to the approval file, the CSSF usually requires the initiator to present the intended securitisation transaction.

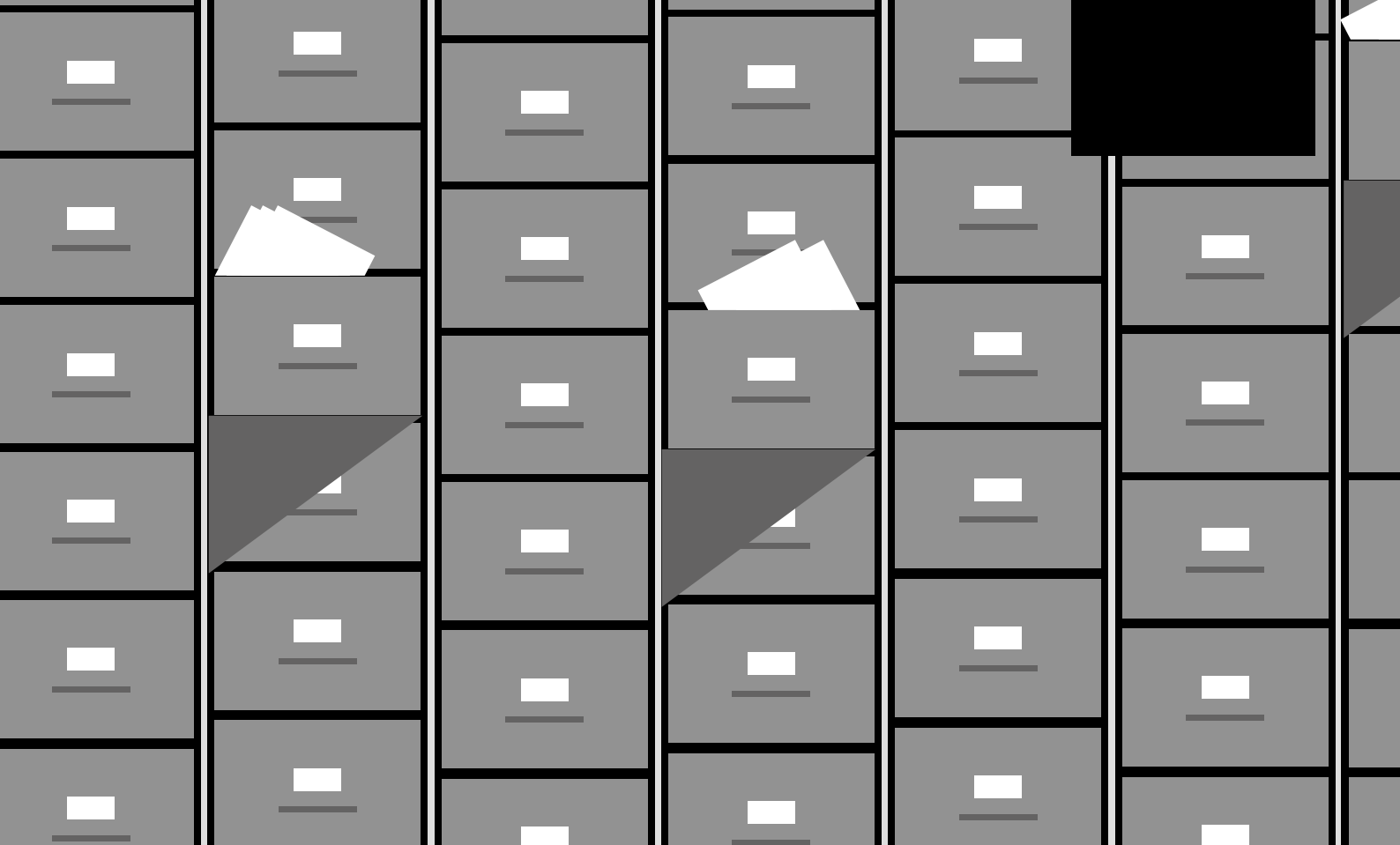
After authorisation, the CSSF enters the authorised securitisation vehicle on an official list. Being mentioned on that official list shall establish authorisation by the CSSF and the status as supervised securitisation vehicle; the securitisation vehicle is notified accordingly. This list and any amendments are published on the CSSF website under the "Supervision" section, type "Securitisation undertakings".

3.3.3 Continuous supervision by the CSSF

The Luxembourg Securitisation Law has vested the CSSF with the authority to perform ongoing supervision of authorised securitisation vehicles. It has wide investigative powers regarding all elements likely to influence the security of investors. For this purpose, the CSSF has defined specific legal reporting requirements, which can be classified into three categories:

(i) The following documents need to be submitted to the CSSF ad-hoc as soon as they are finalised initially or updated thereafter:

- the final issue documents relating to each issue of securities;
- a copy of the financial reports 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 the annual accounts (including the management letter or, where no such management letter has been issued, a written statement from the external auditor confirming that fact);
- information on any change of service provider and substantive provisions of a contract, including the conditions applicable to the issued securities; and
- information on any change relating to fees and commissions.



(ii) On a semi-annual basis, the CSSF requires the securitisation vehicles to provide, within 30 days, 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 securitisation vehicle should report the nominal amount issued, the nature of the securitisation transaction, the investor profile and, where applicable, the compartment concerned. In addition, the semi-annual report should include a brief statement of the securitisation vehicle's financial position and notably a breakdown (by compartment, where applicable) of its assets and liabilities. There are no special requirements regarding the submission format or information medium used.

(iii) In addition, at financial year-end, a draft balance sheet and a profit and loss account (by compartment, where applicable) must be added and provided within 30 days. The audited annual accounts and the management letter issued by the auditor must be provided to the CSSF within six months of the financial year-end.

The CSSF may also require any other information or perform on-site inspections and review any document of the securitisation company, the management company of a securitisation fund, the corporate servicer, or the credit institution in charge of safekeeping the assets of the securitisation undertaking. This allows the CSSF to verify compliance with the provisions of the Luxembourg Securitisation Law and the rules laid down in the Articles of incorporation or management regulations and securities issue agreements, as well as the accuracy of the communicated information.

3.4 Luxembourg as attractive marketplace

3.4.1 Enhanced investor protection

As there is no limitation on the investor basis, investments into a Luxembourg securitisation vehicle are open to all types of investors. Therefore, one of the most important aspects of the Luxembourg Securitisation Law is to ensure enhanced investor protection. The bankruptcy remoteness principle separates the securitised assets from any insolvency risks of the securitisation vehicle or of the originator, service provider, and all other involved parties. In the event of bankruptcy of the originator or the servicer to whom the securitisation vehicle has delegated the collection of the cash flow from the assets, the Luxembourg Securitisation Law states that the securitisation vehicle is entitled to claim the transfer of ownership of the securitised assets and any cash collected on its behalf before liquidation proceedings are opened.

Moreover, the Luxembourg Securitisation 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, consequently enhancing the securitisation vehicle's protection as follows.

- Subordination provision: Investors and creditors may subordinate their rights to payment to the prior payment of other creditors or other investors. This provision is crucial for tranching the securitisation transaction.
- Non-recourse provision: Investors and creditors may waive their rights to request enforcement. This means, for example, that if a payment of interest is in default, the investor may agree to wait for payment and not initiate legal action, as the situation is known or temporary.

- 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 may have, for example, an interest in a bankruptcy proceeding against the vehicle.

In addition, the Luxembourg Securitisation Law provides that the assets are exclusively available to satisfy investors' claims in the securitisation vehicle or in a compartment in case of several compartments, and to satisfy creditors' claims in connection with such assets. Therefore, compartment segregation prevents insolvency contamination between different compartments.

3.4.2 Qualified service providers

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

3.4.2.1 The custodian

The custodian is an important player in the securitisation vehicle's business activities. The custodian is responsible for keeping the documentation proving the existence of securitised assets and guaranteeing that these assets, in the form of cash or transferable securities held by a securitisation vehicle, are kept under the best conditions for the investor.

To guarantee this, the Luxembourg Securitisation Law requires that authorised securitisation vehicles must entrust the custody of their liquid assets and securities in a credit institution established or having its registered office in Luxembourg. As there is no specific regime for the custody of the assets, the custodian of an authorised securitisation vehicle is not subject to any supervisory duty, but only to the duty of properly safekeeping the assets entrusted under custody. A different custodian may be designated for each compartment.

There are no such requirements for unauthorised vehicles.

3.4.2.2 The auditor

Irrespective of their legal form and the accounting framework adopted, securitisation vehicles must be audited by an approved independent auditor ("*Réviseur d'entreprises agréé*") appointed by the management body of the securitisation vehicle or by the management company of the securitisation fund. For an authorised securitisation vehicle supervised by the CSSF, the approved independent auditor must be authorised by the CSSF.

The EU audit legislation⁷ introduced more detailed requirements regarding the statutory audit of Public Interest Entities ("PIEs").⁸ The requirements have been enacted in Luxembourg with the Law of 23 July 2016 concerning the audit profession and apply since the first financial year

which started on or after 17 June 2016. The general rule under the new EU audit legislation is that all PIEs, i.e. all securitisation vehicles having securities listed on an EU-regulated market, must rotate their auditor after a maximum period of ten years, with the possibility of a further ten year extension based on a tender (or 14 years in case of joint audit). Transition arrangements for the new rotation requirement are implemented by the legislator depending on the date that the auditor was appointed.

3.4.2.3 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 is laid down in a contractual document to be concluded with the investors and creditors, whose interests the fiduciary representatives are to 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.

⁷ Directive 2014/56/EU and Regulation (EU) 537/2014.

⁸ Public Interest Entities means: (a) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 21 of Article 4 paragraph 1 of Directive 2014/65/EU; (b) credit institutions as defined in point 12 of Article 1 of the law of 5 April 1993 (as amended) related to financial sector; (c) insurance and reinsurance undertakings as defined under points 5 and 9 of Article 32 paragraph 1 of the Law of 7 December 2015 on insurance sector.

Fiduciary representatives also require authorisation by the Minister with responsibility for the CSSF. 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.

Even if the Luxembourg Securitisation Law has been in place for many years and although the Luxembourg Securitisation Law provides a special legal framework for such independent professionals, who are responsible for representing investors' interests, no fiduciary representative is registered in Luxembourg.

3.4.3 Defined liquidation process

As mentioned in section 3.2.2, each of the compartments of a securitisation company can be liquidated separately (by a simple board resolution) without any negative impact on the vehicle's remaining compartments, i.e. without triggering the liquidation of other compartments or the company itself (while the liquidation of the last sub-fund of a securitisation fund would entail the securitisation fund's liquidation). Usually, a securitisation vehicle is voluntarily liquidated once its transaction matures and all obligations have been repaid, except if it is re-used for another transaction. In Luxembourg, there are two different procedures for the standard voluntary liquidation of a company (not specific to securitisation vehicles): a normal procedure and a simplified procedure (for vehicles with a single shareholder).⁹

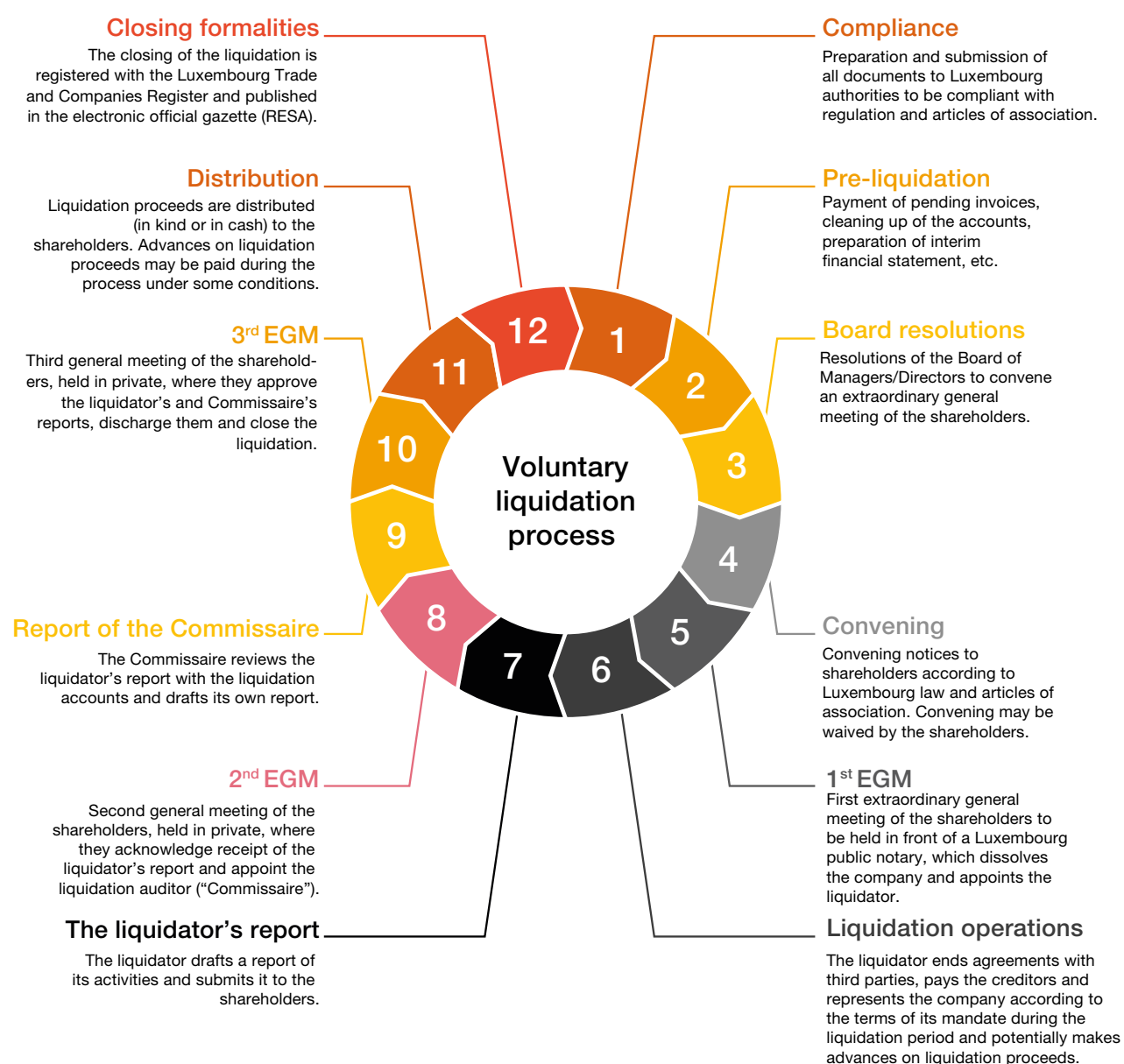
Within the normal liquidation procedure, liquidation is performed in three steps: a first extraordinary general meeting of the shareholders ("EGM") takes the decision to dissolve the company and appoints a liquidator. The company now has to indicate in its documents that it is "in liquidation". The liquidator is responsible for preparing a detailed inventory of the vehicle's assets and liabilities, realising the assets, paying the debts and distributing the remaining balance (if any) to the creditors or other appropriate parties. After completion of the liquidation, the liquidator presents a report to the shareholders in a second EGM, which also appoints an auditor as "*Commissaire à la liquidation*". The *Commissaire à la liquidation* reviews the work performed by the liquidator and prepares a report for the attention of the shareholders in a third EGM which then finally decides on the dissolution of the company.

For a simplified liquidation to be applicable, all shares must be held by a sole shareholder. Furthermore, certain certificates from the Central Social Security Office, the direct tax administration, and the registration tax and VAT administration must be obtained. Such certificates must confirm that the company is in compliance with its obligations to these bodies. The sole shareholder may then resolve to dissolve the company without liquidation and all assets and liabilities of the company will be transferred to him.

If the vehicle is supervised by the CSSF, the liquidators must be authorised by the CSSF, and have the necessary good repute and professional qualifications, and the liquidation is subject to CSSF supervision.

⁹ Art. 1100-1 (2) of the Luxembourg Commercial Law.

Figure 15: Liquidation process of a Luxembourg company



4

Accounting & Tax aspects

4.1 Accounting - LuxGAAP

The Luxembourg Securitisation Law itself does not contain any provisions with respect to accounting. Instead, it refers to other laws depending on the legal form of the securitisation vehicle. In addition to these, further industry practices have been developed.

4.1.1 Securitisation company accounting

General accounting framework

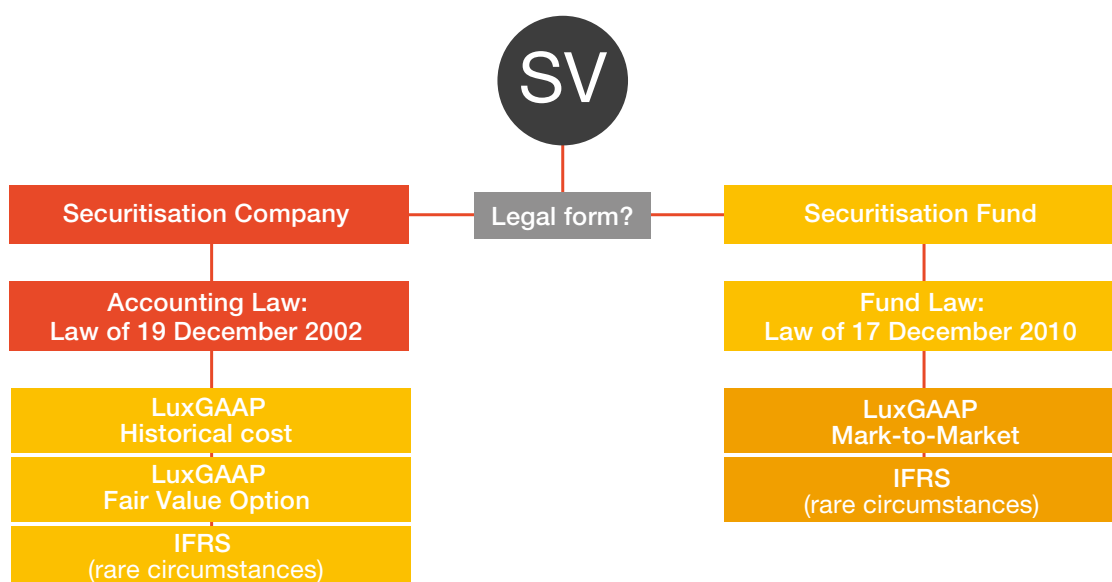
Securitisation vehicles established as securitisation companies must comply with the provisions of chapters II and IV of title II of the Law of 19 December 2002 on the trade and companies register and the accounting and the annual accounts of companies, as amended (hereafter the “Accounting Law”). The Accounting Law sets the legal framework for the accounting principles applied to Luxembourg companies, the Luxembourg Generally Accepted Accounting Principles (“LuxGAAP”).

An interesting feature for securitisation companies is the flexibility that LuxGAAP offers to the preparers of annual accounts. The Accounting Law provides a choice between different accounting frameworks: (i) LuxGAAP under the historical cost model, (ii) LuxGAAP under the fair value model or (iii) International Financial Reporting Standards (“IFRS”) as adopted by the European Union. Further guidance on LuxGAAP accounting and disclosure can be found in our publication *Securitisation in Luxembourg - Illustrative financial statements* and, more generally, our *Handbook for the preparation of annual accounts under Luxembourg accounting framework*, both available on our website www.pwc.lu.

Under LuxGAAP (historical cost model), a securitisation company’s assets are valued either at their acquisition cost or at the lower value attributed to them. Under the historical cost convention, a valuation above the acquisition cost, e.g. based on higher market values, is generally not feasible. However, when the value attributed to a fixed asset is lower than the acquisition cost, a value adjustment must be made for durable value depreciations (“cost less impairment”). A value adjustment may be made for any such decrease in value (“lower of cost or market value” or “LOCOM”).

In addition, LuxGAAP offers the possibility to value most financial instruments at fair value without being subject to further provisions of the IFRS (fair value option). Nevertheless, some additional disclosure on the fair value instruments and valuation models, if any, must be made in the notes to the annual accounts. For some instruments, e.g. investments in subsidiaries and associates and some non-financial assets, the fair value option can only be applied when complying with the full valuation and disclosure requirements of the relevant IFRS standards.

Figure 16: Luxembourg Accounting Law's flexibility



The third option for securitisation companies is to prepare their annual accounts according to IFRS, instead of preparing LuxGAAP accounts (still remaining subject to some additional disclosure requirements foreseen by the Accounting Law). Currently, tax accounts would still have to be prepared based on LuxGAAP. In practice, only a few securitisation vehicles prepare their annual accounts under IFRS.

Management report and listed entities

A securitisation company is required to prepare a management report if the size criteria of Article 35 of the Accounting Law are exceeded, 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 position that could affect investors' rights. In cases where a securitisation company has

its securities listed on an EU-regulated market, the management report must also include (or refer to) a corporate government statement that contains a description of the principal characteristics of internal control system and risk-management procedures regarding financial reporting. For further details and an illustrative management report, you can refer to our *Handbook for the preparation of annual accounts under the Luxembourg accounting framework*.

Securitisation companies having issued transferable securities that are listed on an EU-regulated market may also have to comply with further disclosure requirements pursuant to the Transparency Directive¹⁰ and/or the Prospectus Regulation¹¹. For example, the Prospectus Regulation requires the financial information to contain a cash flow statement, which may have to be added to the annual accounts under LuxGAAP. However, the stand-alone financial information may still be prepared according to national accounting standards, i.e. LuxGAAP. An obligation to use IFRS in this context exists only for consolidated financial statements, which a securitisation vehicle would usually not have to prepare.

¹⁰ Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 ("Transparency Directive").

¹¹ Regulation 2017/1129 of the European Parliament and of the Council of 14 June 2017 ("Prospectus Regulation").

4.1.2 Securitisation fund accounting

A securitisation fund managed by a management company and governed by management regulations is subject to the accounting and tax regulations (except for the annual subscription tax) applicable to undertakings for collective investments (“UCIs”) provided by the Law of 17 December 2010 on undertakings for collective investment, as amended (the “Fund Law”). The Securitisation Law does not refer to specific Articles in the Fund Law but our understanding is that provisions related to recognition, measurement and disclosure should be read as “accounting regulations”.

This implies valuation of assets on the basis of the last known representative stock exchange quotation or the probably realisation value estimated with care and in good faith, i.e. a fair market valuation, unless otherwise stated in the management regulations. Thus, fair valuation is the default option but can be overridden by the management regulations, e.g. prescribing the use of historical cost or other valuation models.

The layout of the semi-annual and the annual report would be geared to Article 151 (3) and (4) of the Fund Law, thus containing:

- a balance sheet or a statement of assets and liabilities,
- a detailed income and expenditure account for the financial year,
- a report on the activities of the past financial year,
- the other information provided for in Schedule B of Annex I of the Fund Law (e.g. net asset value per unit and units in circulation; analysis of the asset portfolio by economic, geographical, currency or other appropriate criteria), and
- any significant information necessary for investors judgement on the development of the activities and the results of the fund.

In our separate publication “Illustrative financial statements” within our series “Securitisation in Luxembourg”, we present an example of the financial statements of a securitisation fund.

4.1.3 Multi-compartment vehicles

One of the distinctive features of Luxembourg’s asset management industry - the possibility to create sub-funds - was also included in the Luxembourg Securitisation Law and provides securitisation vehicles the possibility to segregate the assets and liabilities into one or more separate compartments or sub-funds, each corresponding to a distinct part of its assets financed by distinct securities. A compartment’s assets are available exclusively to satisfy the rights of investors in relation to this very compartment and the rights of creditors whose claims have arisen in connection with the creation, operation or liquidation of that compartment.

As far as accounting is concerned, the CSSF confirmed that multi-compartment securitisation companies should present their annual accounts and related financial notes in such a way that the financial data for each compartment is clearly stated. It is possible, however, to combine the notes to the annual accounts of several compartments. As a result, for accounting purposes, a securitisation vehicle with several compartments is regarded as a combination of several “companies” under one legal entity. In order to achieve a true and fair view of a multi-compartment securitisation vehicle’s activities and financial position, it is required to provide information on compartment level, and not only a combined balance sheet and a combined profit and loss account. In practice, separate balance sheets and profit and loss accounts for each compartment are disclosed as part of the notes to the annual accounts. Alternatively, the notes to each asset, liability, income and charges position should give sufficient detail per compartment. In our separate publication “Illustrative financial statements” within our series “Securitisation in Luxembourg”, we present an example of the annual accounts of a securitisation company, including an example of how to meet the disclosure requirements for a multi-compartment structure.

Under certain circumstances, an additional separate audit opinion can be expressed on parts of the securitisation vehicle’s annual accounts (e.g. for one compartment only). However, this does not prevent the securitisation vehicle from preparing and publishing audited annual accounts for the entity as a whole.

4.1.4 Treatment of (unrealised) gains and losses for the security holders (“equalisation provision”)

From the investors’ perspective, the securitisation vehicle is bankruptcy remote. A bankruptcy remote structure provides reasonable certainty that the securities issued are collateralised by a pool of assets that have been legally isolated from the transferor in all possible circumstances, including insolvency. Therefore, no recourse can be made by the transferor’s creditors or liquidator to the securitisation vehicle’s assets.

On the other hand, the recovery of the securities issued is entirely dependent on the securitisation vehicle’s asset pool generating sufficient cash flow, as the investors usually have no recourse to the transferor beyond its structural support, should the asset cash flow be less than originally anticipated. The repayable amount of the securities issued is thus not a fixed amount but variable depending on the value or repayment of the securitised risks or assets.

An investor’s risk is often further reduced by the structuring of the securitisation vehicle and securities issued. This is most typically achieved by issuing at least one senior and one subordinated security (“tranching”), each having a different seniority with regards to payment from the cash flow of the pool of assets. When the cash flow from the asset pool is collected, it is firstly used to meet the obligations of the most senior security holders. Any residual cash flow after payment of the most senior class is then again used to pay the less senior security holders. This mechanism is known as the “waterfall” or “priority of payments” and has the effect of allocating potential cash flow shortfalls to the most junior debt holders or investors (cf. section 2.1).

This implies that any recognised value decrease of the assets (impairment loss) will be borne by the security holders through a reduced repayable amount¹². The adjustment of the repayable amount of the securities issued is usually referred to as “equalisation provision” and clearly disclosed as such in the notes to the annual accounts (a reduced repayment obligation would result in a gain for the securitisation vehicle). As a result (and not per se for securitisation vehicles), the total net effect on the profit and loss account will be close to nil. The equalisation provision

should not be confused with a write-off of the securities repayment obligation; the obligation remains based on the notional and the repayment formula or waterfall; only the estimated repayable amount changes.

To enable a better understanding, a description of the valuation method used to calculate the equalisation provision should be given in the notes to the annual accounts, as well as a summary of the waterfall structure and the consumption of the waterfall.

The reverse effect applies when the repayable amount of the securities issued increases with an increase in asset value. A securitisation vehicle is usually bound by agreements to distribute all the cash flows received to the investors (e.g. as variable interest or as an increased repayable amount) or to other involved parties (e.g. arranger), but not necessarily in the same period in which the profit takes place. Nevertheless, the liability for the increased payment obligation already incurred and thus a higher reimbursement value must be shown in the annual accounts.

However, neither Accounting Law nor electronic annual accounts filing formats (“eCDF”) foresee a caption called “equalisation provision”. Therefore, it has become market practice to directly deduct or add the total equalisation provision from the securities value and to disclose the effects in the profit and loss account under “other operating income” and “other operating charges” respectively (as it is the consequence of the securitisation vehicles activity rather than an interest charge). Further explanation should be given in the notes to the annual accounts. Our publication *Securitisation in Luxembourg - Illustrative financial statements* provides an example for a possible disclosure.

¹² Sometimes an additional subordinated loan might be granted to serve as credit enhancement by the arranger or the originator, which would then bear the first losses.

4.1.5 Legal reserve/subscribed capital for compartments

Another regular question, especially for equity financed securitisation companies, concerns the treatment of the legal reserve within a multi-compartment securitisation vehicle. Neither Accounting nor Commercial Law provide detailed guidance on this as a multi-compartment structure is a specificity of the Luxembourg Securitisation Law and not further covered by Accounting and Commercial Law.

In general, the Commercial Law states in Articles 461-1 and 710-23 that a company is required to allocate a minimum of 5% of its annual net profit to a legal reserve, until this reserve equals 10% of the subscribed share capital.

As most of the securitisation vehicles in Luxembourg are debt financed and do not make any profit, a legal reserve will not be built up. However, equity-financed structures or securitisation transactions leaving a profit margin in the company would have to allocate a legal reserve until it reaches 10% of the subscribed capital of the company.

For a multi-compartment vehicle, this Article can create some confusion as the compartments are fully segregated from each other but the overall result of the company equals the total of all profits and losses of the compartments. Not only is the allocation of the legal reserve concerned but also the possibility to distribute profits from the profit-making compartments. Therefore, applying a true and

fair view and considering the compartment segregation, the compartments should be treated as if they would be separate legal entities. Consequently, profit-making compartments that are financed by equity and, therefore, disclosing compartments' subscribed capital must allocate at least 5% of the net profit to the legal reserve until reaching 10% of the compartments' subscribed capital.

An example of an equity financed three-compartment vehicle is outlined in Figure 17 below. This example illustrates that, although the company is in total (i.e. in its combined figures) in a loss position, the single profit-making compartments need to allocate part of their profits to a legal reserve. In addition, compartments 1 and 3 are able to distribute a dividend of EUR 9,500 and EUR 4,750 respectively to their shareholders, given that the distribution is adequately approved by the general meeting of the shareholders of the compartment. In this context, it is important to clearly define, for example in the Articles of incorporation, that only the shareholders of a respective compartment can decide on a dividend distribution of that compartment and not on other compartments.

Figure 17: Legal reserve - example

Compartment	Subscribed capital	Result of the year	Minimum allocation to legal reserve
1	EUR 100,000	EUR 10,000	EUR 500
2	EUR 200,000	EUR (20,000)	EUR 0
3	EUR 100,000	EUR 5,000	EUR 250
Combined	EUR 400,000	EUR (5,000)	EUR 750

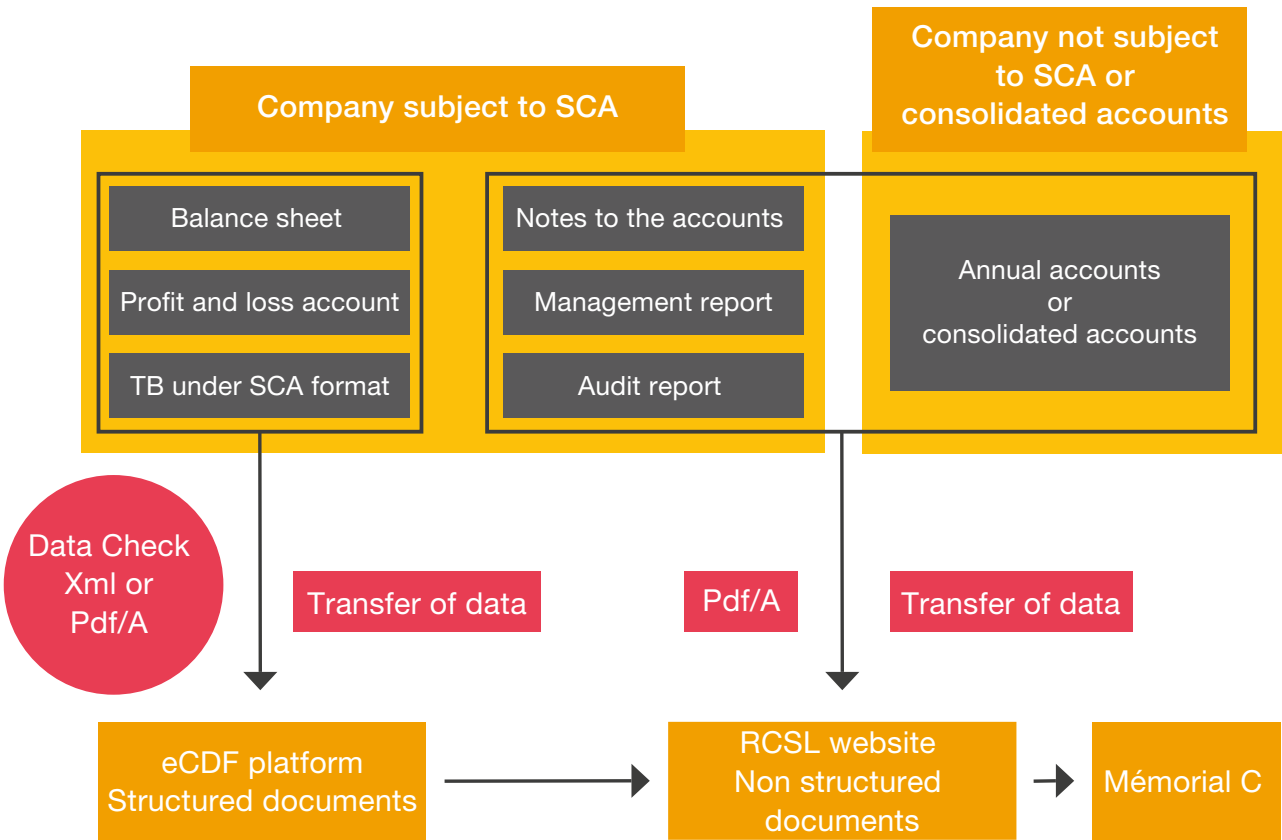
4.1.6 Standard Chart of Accounts and electronic filing

In Luxembourg, legislation prescribes the use of a Standard Chart of Accounts (“SCA”) and eCDF for most companies. All securitisation companies that do not fall under CSSF supervision are, among other companies, obliged to use SCA and eCDF. Companies that prepare and publish their annual accounts under IFRS are exempted from filing their trial balance and annual accounts under the SCA and the eCDF respectively.

For the annual accounts of multi-compartment vehicles, best practice is to present a combined balance sheet and combined profit and loss account in the SCA/eCDF format and, additionally, to disclose a separate balance sheet and profit and loss account for each compartment (or similar compartment-specific information) as part of the notes to the annual accounts.

As per Article 75 of the Accounting Law, all Luxembourg-based companies are required to file their annual accounts with the Luxembourg trade and company register (“RCSL”) electronically as illustrated in Figure 18.

Figure 18: e-filing procedure



4.2 Accounting - IFRS

Accounting based on International Financial Reporting Standards (“IFRS”) is becoming increasingly important for Luxembourg securitisation vehicles, even though the vast majority still uses LuxGAAP for preparing their mandatory stand-alone financial statements.

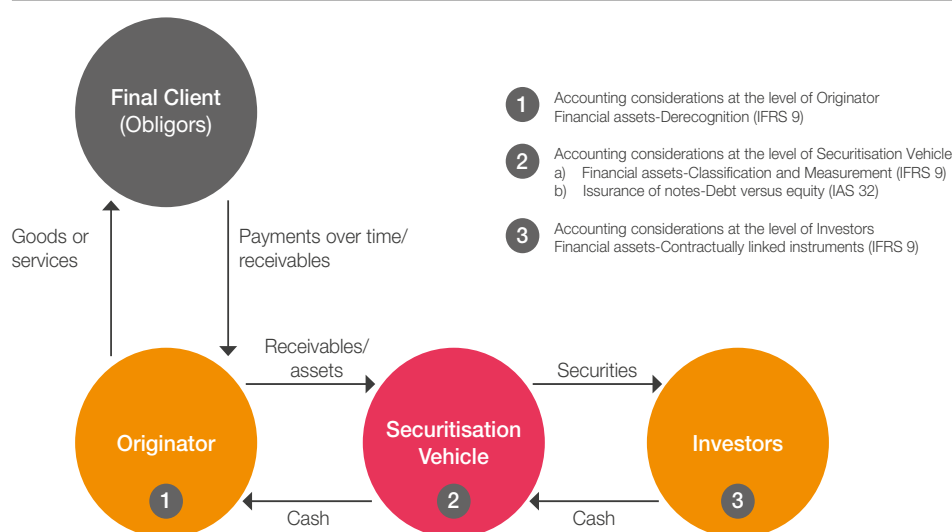
Some securitisation vehicles opt to prepare their stand-alone financial statements under IFRS, which is an option in the Luxembourg Accounting Law. In addition, other securitisation vehicles become part of a consolidation group, which prepares its financial statements under IFRS or have investors requiring financial reporting under international standards. In such cases, the securitisation vehicle does usually not prepare a full set of financial statements under IFRS, but a dedicated reporting package applying only the relevant IFRS requirements.

Due to the nature of the securitisation business, the assets of the securitisation vehicle mainly comprise financial instruments while the liabilities are formed of notes issued. Therefore, we have highlighted below the key challenges the securitisation vehicle (or another involved party) may face when preparing IFRS accounts. Due to the nature of the assets and liabilities, i.e. forming financial instruments, accounting is mainly prescribed by IFRS 9.

Consolidation requirements are derived from IFRS 10.

The purpose of this section is to give a first guidance on what may be the most relevant factors in the context of a securitisation transaction; it shall not be seen as a detailed commentary on IFRS 9, IFRS 10, or IFRS as a whole.

Figure 19: Different accounting considerations for different actors



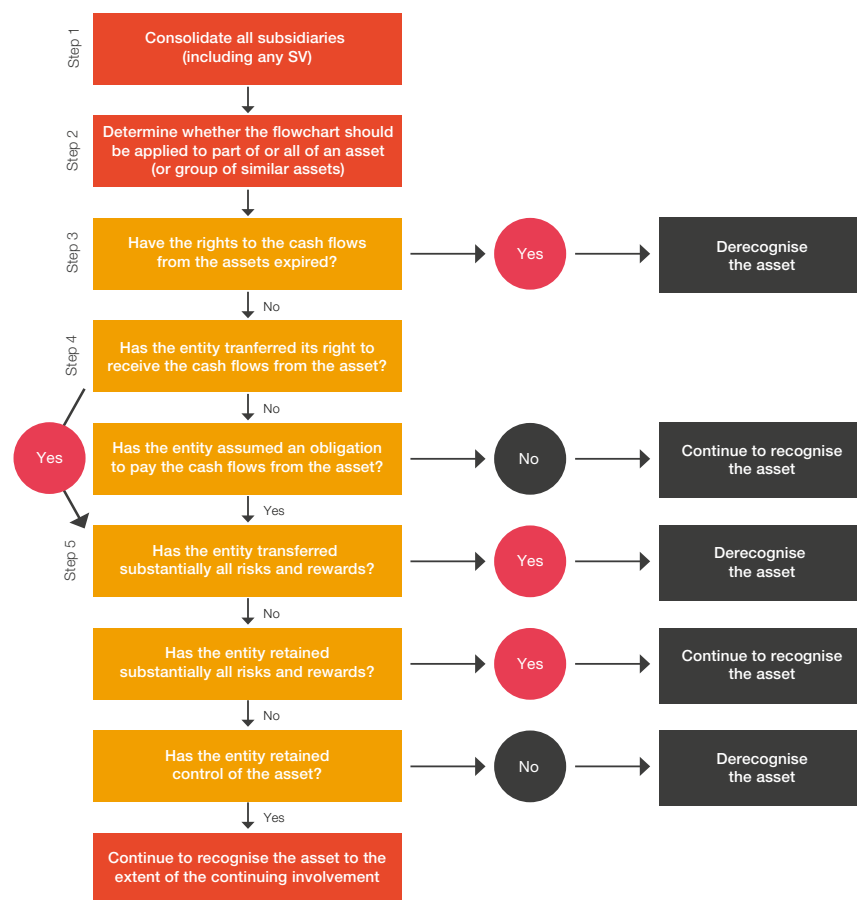
4.2.1 Originator – Derecognition of financial assets

One of the challenges faced by the originator or an objective he may want to achieve is the ability to derecognise the securitised assets from his balance sheet. The rules on derecognition of financial instruments under IFRS are defined in IFRS 9 and summarised in the chart below.

When transferring their assets to a securitisation vehicle in order to derecognise them from their own balance sheet, originators need to pay attention to:

- credit enhancements provided to the securitisation vehicle (e.g. subordinated retained interests, credit guarantee, total return swap with transferee, excess spread, etc.); and
- continuing involvement in transferred assets (e.g. full or partial guarantees of the collectability of receivables, conditional or unconditional agreements to re-acquire the transferred assets, written or held options, retained servicing depending on fee, etc.).

Figure 20: Rules of derecognition under IFRS 9



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With the effective date 1 January 2018, *IFRS 9 – Financial instruments* replaces the guidance in *IAS 39 – Financial instruments: Recognition and measurement* and brings significant changes and new perspectives to the international financial reporting.

IFRS 9 represents an important step of alignment between accounting and business practice. Classification and measurement of financial assets are assessed based on the instrument's nature (debt or equity), features (characteristics of contractual cash flows), and underlying business model (how an entity manages its financial assets to generate cash flows and create value for the entity).

- Amortised cost (“AC”), when contractual cash flows represent solely payments of principal and interest (“SPPI”) and the entity’s business model is “hold to collect” (mainly collecting the contractual cash flows);
- Fair value through other comprehensive income (“FVOCI”), when contractual cash flows are SPPI and the entity’s business model is “hold to collect and sell” (a mix model of collecting the contractual cash flows and realising capital gains through sells); and
- Fair value through profit or loss (“FVPL”), the residual category.

Investments in equity instruments are always measured at fair value. However, in order to reduce the volatility of the profit and loss account ("P&L"), the entity can make an irrevocable election on an instrument-by-instrument basis to present changes in fair value in other comprehensive

income (“OCI”), provided the instrument is not held for trading. If the equity instrument is held for trading, changes in fair value must be affected to P&L.

For designated equity instruments at fair value in OCI there is no recycling of amounts from OCI to P&L– for example, on sale of an equity investment – nor are there any impairment requirements.

Expected credit loss model

Debt instruments classified at “Amortised cost” and “Fair value through other comprehensive income”, as well as lease receivables, contract assets, as well as for loan commitments, and financial guarantees not measured at fair value are subject to impairment loss assessment. IFRS 9 introduced a model for the recognition of impairment losses – the expected credit losses (“ECL”) model. The ECL model seeks to address the criticisms of the incurred loss model that arose during the economic crisis and to better incorporate the information needs of investors.

In practice, the new rules mean that entities will have to record a day 1 loss based on the probability of assets to default in the next 12 months. The impairment assessment under IFRS 9 also considers the change in credit quality of financial assets since initial recognition which is divided in three stages: (i) materially unchanged credit risk,

(ii) significantly increased credit risk, (iii) objective evidence of impairment. A significant increase in the credit risk of assets will further trigger a higher provisioning (for the lifetime expectation of default).

A simplified approach is used for trade receivables and contract assets that result from transactions that are within the scope of IFRS 15 without significant financing component, and it can be used for trade receivables and contract assets with significant financing component as well as for lease receivables.

IFRS 9 establishes a simplified impairment approach for qualifying trade receivables, contract assets within the scope of IFRS 15 and lease receivables (see Figure 22 below). For these assets an securitisation structures can, or in one case must, recognise a loss allowance based on lifetime ECLs rather than the two step process under the general approach.

Some securitisation structures were designed to hold portfolios of sub-prime loans. Such instruments are bought at a substantial discount from their nominal value, as most of the loans are not performing. If the vehicle intends to hold the loans to collect the contractual cash flows, and not to sell, the business model is “hold to collect”.

Figure 22: Scope of the simplified approach

Trade receivables and contract assets within the scope of IFRS 15	Basis of application
Do not contain a significant financing component, or the entity applies the practical expedient to measure the asset at the transaction price under IFRS 15	Mandatory
Contains a significant financing component	Policy choice
Lease receivables	Basis of application
Finance leases	Policy choice
Operating leases	Policy choice

An entity may select its accounting policy for trade receivables, lease receivables, and contract assets independently of one another.

The general impairment model does not apply to purchased or originated credit-impaired assets. A financial asset is considered credit-impaired on purchase or origination if there is evidence of impairment at the point of initial recognition. Impairment is determined based on full lifetime ECL on initial recognition for purchased or originated credit-impaired financial assets. Lifetime ECL are included in the estimated cash flows when calculating the effective interest rate on initial recognition. The effective interest rate for interest recognition throughout the life of the asset is a credit-adjusted effective interest rate. As a result, no loss allowance is recognised on initial recognition. Any subsequent changes in lifetime ECL, both positive and negative, will be recognised immediately in the income statement, even if the lifetime ECL are less than the amount of ECL that were included in the estimated cash flows on initial recognition.

b) Financial liabilities – classification and measurement

Initial recognition

IFRS 9 foresees two categories for financial liabilities:

- Fair value through profit or loss, if held for trading or designated upon initial recognition. Such designation is permitted if it eliminates an accounting mismatch or a group of financial liabilities (and assets) is managed

and its performance is evaluated on fair value basis. For designated liabilities, the movement in fair value due to the deterioration of its own credit risk is to be recognised in OCI, so that P&L is impacted only by appropriate components of movements in fair value.

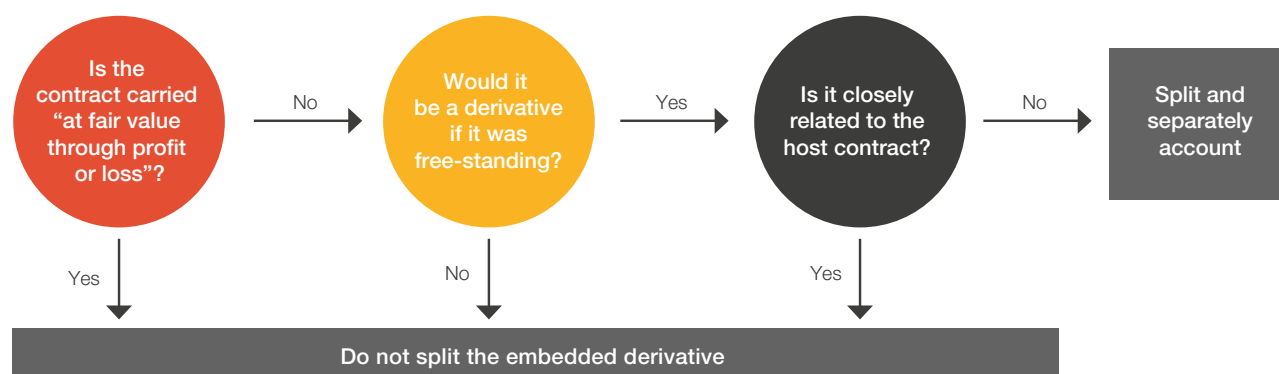
- Amortised cost, residual category.

Debt versus equity

Securitisation vehicles are issuing financial instruments that have particular features to satisfy the investors' needs in term of desired level of risk and returns. Under IFRS, such features might affect classification between debt and equity. *IAS 32 – Financial instruments: Presentation* contains the principles for distinguishing between financial liabilities and equity.

A contractual agreement's substance takes precedence, resulting in some situations where instruments that qualify as equity for regulatory, tax or legal purpose, on closer examination, are financial liabilities for reporting purposes. Contractual features that lack substance are not to be considered regardless of whether such features would significantly affect the classification. These aspects might be attractive for investors.

Figure 23: Treatment of derivatives embedded in financial liabilities under IFRS 9



Other features such as interest/dividend payments triggered/conditioned by other classes of instruments have to be closely considered as they might have an impact on assessing if an instrument is debt or equity or components of such instruments have different classifications.

Embedded derivatives

There might be embedded call, put, or pre-payment options in the notes issued by securitisation vehicles. In general, such options are not closely related to the debt host as they relate to factors other than interest rate risk and credit risk of the issuer. However, there might be situations in which, after a close analysis, the conclusion imposes itself that they are closely related (and therefore no need of split accounting/bifurcation), if the exercise price of the call/put is approximately equal, on each exercise date, to the host debt instrument's amortised cost; or the exercise price of the pre-payment option reimburses the noteholder for lost interest for the host contract's remaining term.

Interest and principal payments that are linked to an equity index are not closely related to the debt host contract, unless the index is a non-financial variable specific to the entity. Close attention needs to be paid to these aspects, if the securitisation vehicle is providing structured products.

If the securitisation vehicle issues convertible bonds, the equity conversion option is an equity instrument for the issuer provided that it meets the conditions for equity classification under IAS 32. This embedded derivative is not closely related and the securitisation vehicle would have to separate the embedded derivative from the host contract (the note itself). A decision tree is illustrated in Figure 23.

c) Disclosure requirements

IFRS requirements in terms of disclosures were designed to provide useful information to investors and other financial statement users, such as:

- significance of financial instruments in relation to an entity's financial position and performance;
- nature and extent of risks arising from financial instruments to which the entity is exposed (i.e. market risk, liquidity risk, credit risk) and how these risks are managed;
- fair value measurement hierarchy. These disclosure

requirements are also partly applicable under LuxGAAP if the fair value option described in section 4.1.1 is used.

4.2.3 Investors – Look-through approach

Contractually linked instruments

In a securitisation transaction, the risk of a pool of assets in which the structured entity is investing is passed to investors through particular features of instruments issued like “tranching”. The degree and extent to which the cash flows of the debt instruments issued are modified to incorporate the exposure to specific risks of the underlying assets varies upon the seniority of tranches. Furthermore, more senior tranches are repaid in priority to the more junior ones from collections made on the related pool of assets.

Under IFRS, such instruments are called “contractually linked instruments”. Investors holding these types of instruments have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy any higher-ranking tranches.

Accountingwise, the classification and implicitly the measurement criteria for the holder of these tranches should be assessed by using a “look through” approach. This approach looks at the terms of the instrument itself, as well as through to the pool of underlying instruments. The assessment considers both the characteristics of these underlying instruments and the tranche's exposure to credit risk relative to the pool of underlying instruments.

Non-recourse assets

Notes issued by a securitisation vehicle usually include a non-recourse provision, i.e. an agreement that, if the securitisation vehicle (or one of its compartments) defaults on the secured obligation, the investor can look only to the securing assets (whether financial or non-financial) to recover its claim. The investor has no legal recourse against the securitisation vehicle's other assets.

The fact that a financial asset is non-recourse does not necessarily preclude the financial asset from meeting the SPPI criterion (see section 4.2.2). However, the investor is required to assess (that is, to “look through to”) the particular underlying assets or cash flows to determine

whether the financial asset's contractual cash flows are SPPI. If the instrument's terms give rise to any other cash flows, or if they limit the cash flows in a manner that is inconsistent with the SPPI criterion, the instrument will be measured in its entirety at FVTPL.

4.2.4 Consolidation of securitisation vehicles

At the level of the Originator and the Investors

In the context of a securitisation transaction, IFRS may oblige one of the involved parties to consolidate the assets and liabilities of the securitisation vehicle as investee. The consolidation considerations may affect both the originators and the investors. From an accounting perspective, one question needs to be addressed: who of the originator(s) or investor(s) controls the investee, and therefore has to consolidate it in its consolidated financial statements¹³? It is also possible that the result of such analysis concludes that nobody controls the securitisation vehicle; in that case, it remains stand-alone.

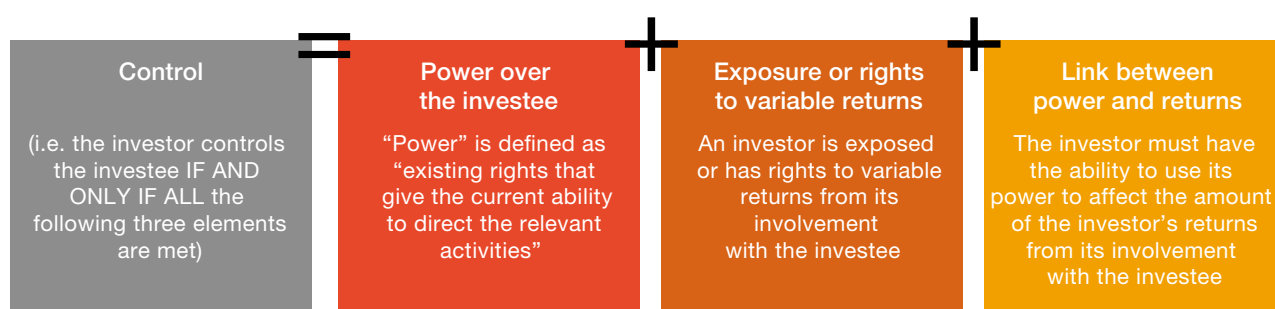
The answer to this question has major consequences, as the entity consolidating the securitisation vehicle will disclose in its consolidated financial statements the assets and liabilities held by the securitisation vehicle.

Consolidation – general considerations

The guidance regarding control is provided by *IFRS 10 – Consolidated Financial Statements*. However, a securitisation transaction does not have the same characteristics of a standard group (defined as “parent and its subsidiaries”). A securitisation vehicle is considered a structured entity, as it fulfils (some or all) the following features or attributes as described in *IFRS 12 – Disclosure of interests in other entities*:

- Restricted activities.
- A narrow and well defined objective, such as:
 - to effect a specific structure like a tax efficient lease;
 - to perform research and development activities; or
 - to provide a source of capital or funding to an entity or to provide investment opportunities for investors by passing risks and rewards associated with the assets of the structured entity to investors.
- Thin capitalisation, i.e. the proportion of “real” equity is too small to support the structured entity's overall activities without subordinated financial support.
- Financing in the form of multiple contractually linked instruments to investors that create concentrations of credit risk or other risks (tranches).

Figure 24: Consolidation requirements under IFRS 10



¹³ Reference to investee in this chapter corresponds to the securitisation vehicle, and investors to the originator or the investor.

Although having different and specific characteristics, the assessment of who controls a structured entity is determined using the same framework of IFRS 10, i.e. someone “controls” the SV. This means, cumulatively, (i) having power over the investee, (ii) having exposure or rights to variable returns, and (iii) having a link between power and returns (see Figure 24). This all means that the following indicators need to be considered when assessing control:

- The purpose and design of the structured entity.
- What the relevant activities are.
- How decisions about these activities are made.
- Whether the rights of the investor give it the current ability to direct the relevant activities.
- Whether the investor is exposed, or has rights, to variable returns from its involvement with the investee.
- Whether the investor has the ability to use its power over the investee to affect the amount of the investor’s returns.

Nevertheless, there is a key difference regarding structured entities: often, the voting or similar rights are not the means by which it is controlled; rather the relevant activities of the structured entity are directed by means of contractual arrangements. If these contracts are tightly drawn, it may appear that none of the parties has power. In cases for which a detailed analysis leads to this conclusion, there is no party to consolidate the structured entity.

IFRS 10 provides a wide range of other factors to consider when the control situation remains unclear after considering all the above factors. These include non-contractual powers and “special relationships”. The key is to ensure that a holistic assessment of all relevant facts and circumstances is carried out. These factors should be considered in aggregate. Not all the factors need to be satisfied for an investor to have power. However, it also does not mean that satisfying any one of these factors will always be sufficient.

Consolidation - Silos (Compartments)

Another important consideration in relation to securitisation vehicles is the potential for the existence of silos. Silos consist of specific assets and liabilities of an entity that might, in certain circumstances, be ring-fenced from the entity’s other assets and liabilities. A silo typically has no separate legal entity, but consists of a portfolio of assets and liabilities that are contractually separated from (and do not share risk with) other assets and liabilities in the same legal entity. In practice, silos can be set up to provide other financial benefits to the investors in such structures. The assets of each individual silo are not available to the creditors of any other part of the same entity. A compartment of a Luxembourg securitisation vehicle perfectly matches this definition and would usually be treated as “silo” under IFRS.

Where the conditions set out below are met, the silo is viewed as a “deemed separate entity” for the purpose of applying IFRS 10 – that is, an investor in the silo assesses whether it has control of the silo rather than assessing control at the level of the broader legal entity. This can result in the originator or the investor consolidating only a part of the securitisation vehicle.

IFRS 10 contains guidance for identifying when a silo should be accounted for as a deemed separate entity, from a consolidation perspective. It states that an investor should treat a portion of an investee (i.e. a silo) as a deemed separate entity only if the following conditions are satisfied:

- The investee’s specified assets (and any related credit enhancements) are the only source of payment for specified liabilities of, or specified other interests in, the investee.
- Parties other than the investee with the specified liability do not have rights or obligations related to the investee’s specified assets or to residual cash flows from those assets.
- In substance, none of the returns from the investee’s specified assets can be used by any remaining investee, and none of the liabilities of the deemed separate entity are payable from the assets of any remaining investee.

- In substance, all of the assets, liabilities, and equity of the deemed separate entity are ring-fenced from other investors.

If it is concluded that the investor has control, it should consolidate the silo. The other investors in the entity will then need to exclude that portion of the investee in their own assessment of control.

The exception to consolidation: Investment entity

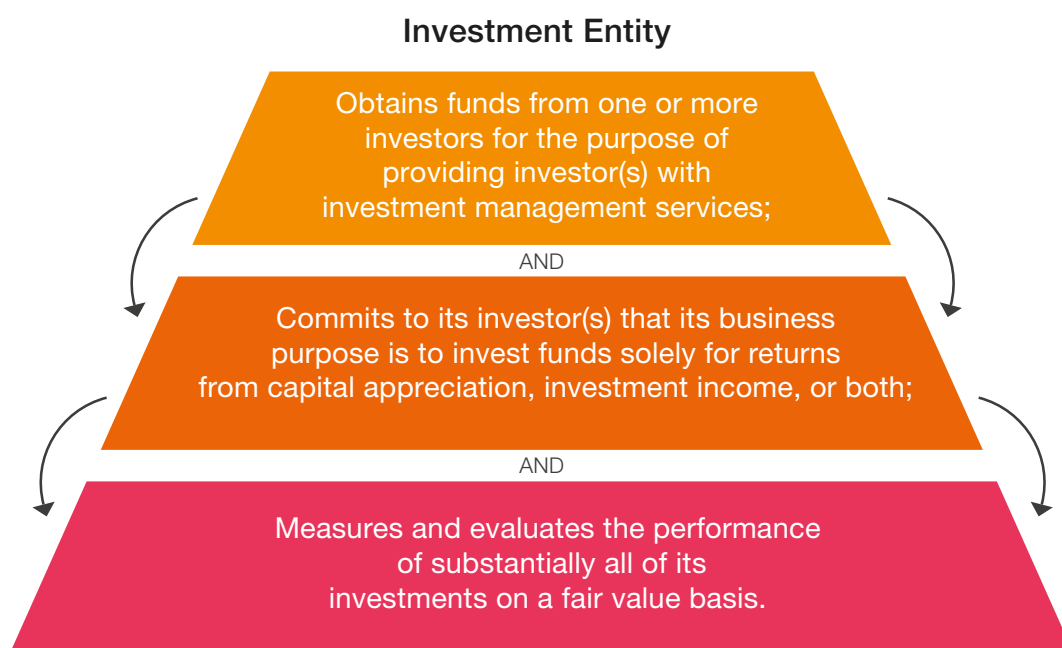
Assuming that the analysis conducted to the conclusion that a certain securitisation vehicle is controlled by one of the parties (the originator or the investor), then normally that entity shall consolidate the vehicle. However, IFRS 10 includes an exception to this rule for the parent entities considered as “investment entities”. If the criteria of an investment entity are fulfilled, as described in Figure 25, then IFRS 10 prohibits from consolidating its subsidiaries/

investments and requires these to be accounted for at fair value through profit or loss. This requirement does not apply to subsidiaries that are not themselves investment entities and whose main purpose is to provide services relating to the investor’s investment activities.

An investment entity is an entity that holds investments for the sole purpose of capital appreciation, investment income (such as dividends, interest or rental income), or both. The most useful information for such an entity is provided by measuring all investments, including investments in subsidiaries, at fair value. Based on these characteristics, and looking at a securitisation transaction, the investor entity is more subject to be considered as an investment entity than the originator.

See Figure 25 below for a definition of an investment entity according to the standard.

Figure 25: Definition of an investment entity



For an entity to qualify as investment entity, the above definition must be met. The following typical characteristics of an investment entity must also be considered:

- holding more than one investment (this might refer to both equity (share investments) and debt (receivables) investments);
- having more than one investor;
- having investors that are not the entity's related parties; and
- having ownership interests in the form of equity or similar interests.

The above typical characteristics are indicative and supplement the definition to allow the use of judgement in assessing whether an entity qualifies as an investment entity. If management concludes that the entity is an investment entity in the absence of one or more of the typical characteristics above, it is required to explain in the financial statements how far the definition of an investment entity is met. It is highly unlikely that an entity will meet the definition of an investment entity if it shows none of the typical characteristics.

Therefore, an investor controlling a securitisation vehicle shall firstly assess if it is an investment entity before consolidating the respective subsidiaries/investments.

Consolidation – Disclosures

IFRS 12 contains disclosure requirements for consolidated financial statements, and intends to give relevant information to users to help them understand judgements and assumptions made, such as in regards to controlling another entity. However, even if a securitisation vehicle is not consolidated, IFRS 12 requires transparency about the risks that an entity is exposed to due to its involvement with structured entities, which was highlighted during the global financial crisis. These main requirements include:

- disclosure of qualitative and quantitative information relating to involvement with these unconsolidated structured entities;
- disclosure of recognised assets and liabilities relating to involvement with the structured entities;
- disclosure of maximum exposure to loss, how this is determined and comparison to recognised assets and liabilities;
- disclosure of any financial support provided to the unconsolidated structured entity.

4.3 Other reporting requirements

The ECB has adopted several EU regulations concerning statistical reporting on the assets and liabilities of financial vehicle corporations engaging in securitisation transactions in order to provide the ECB with adequate statistics on the financial activities of the FVC subsector. Subsequently, the BCL has developed a data collection system for securitisation vehicles, which is defined in the BCL Circular 2014/236.

These regulations are directly applicable to Luxembourg securitisation vehicles subject to the Luxembourg Securitisation Law, as well as to commercial companies outside the scope of the Luxembourg Securitisation Law but conducting securitisation transactions.

The circular defines a concerned securitisation vehicle as an undertaking whose principal activity meets both of the following criteria:

- (a) it intends to carry out, or carries out, one or more securitisation transactions and its structure is intended to isolate the payment obligations of the undertaking from those of the originator, or the insurance or reinsurance undertaking; and,
- (b) it issues, or intends to issue, financing instruments and/or legally or economically owns, or may own, assets underlying the issue of financing instruments that are offered for sale to the public or sold on the basis of private placements.

In this context, three types of securitisation are identified for statistical purposes:

a) Traditional securitisation, referring to a securitisation involving the economic transfer of the exposures being securitised to a FVC which issues securities. This is accomplished by the transfer of ownership of the securitised exposures from the originator or through sub-participation. The securities issued do not represent payment obligations of the originator.

b) Synthetic securitisation, referring to a securitisation where the tranching is achieved by the use of credit derivatives or guarantees, and the pool of exposures is not removed from the balance sheet of the originator.

c) Other, referring to FVC that do not fall in the first two categories.

Therefore, each vehicle falling under the definition must comply with the following BCL reporting requirements.

In order to receive an identification code from the BCL, each concerned Luxembourg securitisation vehicle shall spontaneously inform the BCL of its existence within one week after its incorporation date. A registration form in Excel format requesting legal information about the securitisation vehicle, the nature of securitisation, ISIN codes of securities issued and information about the reporter (i.e. the entity submitting the data) is available on the BCL website.

Afterwards, the securitisation vehicles must provide the BCL regularly with information about their assets and liabilities and the transactions made. This information must be filed with the BCL within 28 working days in the form of the following three reports:

- Quarterly: S 2.14: Quarterly statistical balance sheet of securitisation vehicles;
- Quarterly: S 2.15: Transactions and write-offs/write-downs on securitised loans of securitisation vehicles;
- Monthly: TPTTBS "Security by security reporting of securitisation vehicles".

The BCL establishes and publishes on its website a calendar of remittance dates on which the monthly and quarterly statistical reports must be submitted to the BCL.

A vast amount of information must be provided about the securitised assets, including a breakdown of the country and economic sector of the counterparts, the currency and maturity as well as nominal values. Also, information about the issued securities needs to be reported.

Therefore, the reporting entity must ensure that all the data is made available in time in order to comply with the BCL requirements.

The BCL has exempted securitisation vehicles from the reporting requirement, given that the securitisation vehicles contributing to the quarterly aggregated assets/liabilities account for at least 95% of the aggregated assets of all Luxembourg securitisation vehicles. Currently, and unchanged since 2014, this threshold amounts to EUR 70 million.

In addition, all securitisation vehicles concerned, even those exempted from regular reporting, have to provide their annual accounts to the BCL if they are not public, e.g. published in the Luxembourg Trade and Companies' Register within the legal deadline of seven months after closure. The BCL also accepts draft balance sheets, but the signed Financial Statements must be provided as soon as they are available.

Since July 2016, the ECB and the BCL have been monitoring the compliance of reporting obligations more stringently. All infringements to the minimum requirements are recorded into a database. Sanctions may be imposed in case of failure to comply.

Since 1 January 2019, entities falling in the scope of the EU Securitisation Regulation¹⁴ need to do additional extensive and standardised reporting under the transparency requirements of this regulation. This is described in more detail in section 5.1.

¹⁴ Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

4.4 Taxation

The Luxembourg Securitisation Law has been successful in achieving almost complete tax neutrality. The following scheme shows the different tax types applicable to the two types of securitisation vehicles, securitisation companies and securitisation funds.

4.4.1 Tax specificities of securitisation companies

Securitisation vehicles organised as corporate entities are, as a rule, fully liable to corporate income tax (“CIT”) and municipal business tax (“MBT”) at an aggregate tax rate of 24.94% (tax rate applicable for 2019 for entities based in Luxembourg City, taking into account the solidarity surcharge of 7% on the corporate income tax rate of 17% and including the 6.75% municipal business tax rate).

Securitisation companies are in principle taxed on their net accounting profits (i.e. gross accounting profits minus expenses). According to the Luxembourg Securitisation Law, a securitisation company’s commitments (normally to be materialised by a decision of the Board taken before year-end) to remunerate investors for issued bonds or shares and other creditors qualify as interest on debt even if paid as return on equity. Accordingly, they shall be considered as operating expenses for CIT and MBT purposes, so the tax liability should be rather limited. However, it may be vital to secure the tax treaty benefits depending on the nature of the assets. In that case, structuring the cash flow in a way that taxable arm’s length remuneration is left in the securitisation company, could play a crucial role in this respect and should be analysed from the source country perspective on a case-by-case basis.

In the presence of a fiduciary structure, assets held by the fiduciary for the account of the fiduciant are regarded as held by the fiduciant for Luxembourg CIT, MBT and NWT (net wealth tax) purposes. As a consequence, only the fiduciant will be taxed on the income, gains and wealth derived from the assets when resident in Luxembourg. In the presence of a non-Luxembourg resident fiduciant, such fiduciant will be taxable in Luxembourg only on Luxembourg sourced income unless it holds these assets through a Luxembourg permanent establishment.

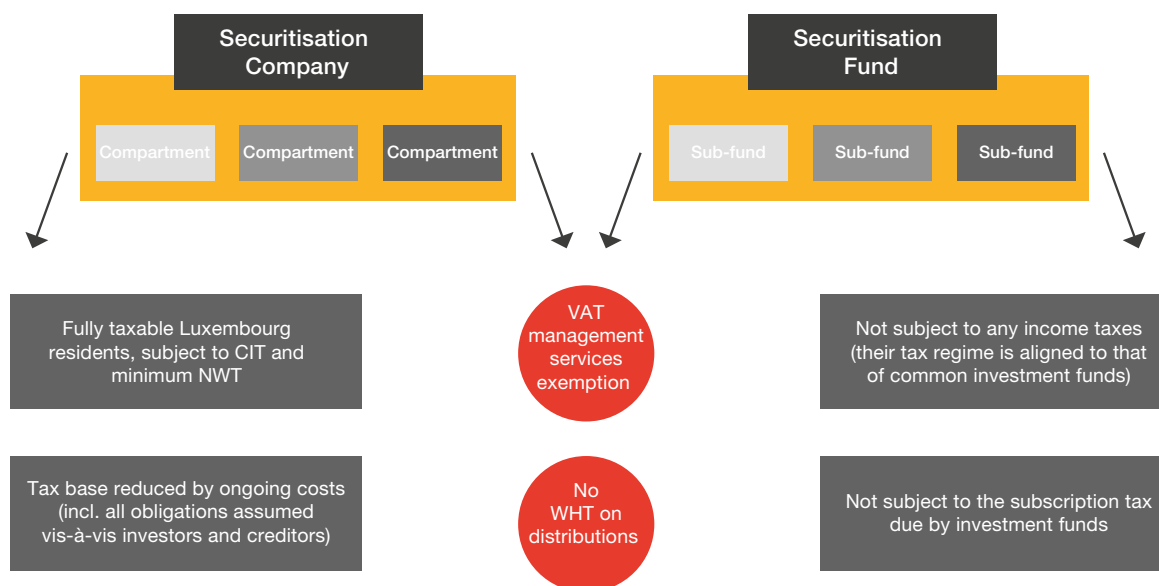
The shareholders of the securitisation company are treated like bondholders. Dividend distributions made by a securitisation company are thus exempt from withholding tax. Interest payments are also exempt from withholding tax.

In addition, all securitisation companies, though excluded from the general net worth tax rates, fall within the scope of the minimum NWT.

Specifically, contingent to their annual commercial accounts, either the annual fixed minimum NWT (EUR 4,815 for financial years starting on or after 1 January 2017) or the annual progressive minimum NWT between EUR 535 and EUR 32,100 should apply.

The annual fixed minimum NWT applies to companies with total gross assets above EUR 350,000 whose sum of fixed financial assets, transferable securities and cash at bank (as presented in their commercial accounts presented in the standard Luxembourg form) exceed 90% of their total gross assets. In any other case, the annual progressive minimum NWT should apply.

Figure 26: Tax types applicable to the two securitisation forms



4.4.2 Transfer pricing aspects

In recent years, a general transfer pricing regime has been introduced applying to all transactions between associated companies. The legislation restates the arm's length principle, which becomes more aligned with the OECD¹⁵ Model Tax Convention. The provisions provide for both upward and downward profit adjustments where transfer prices do not reflect the arm's length principle. In addition, the legislation clarifies that the current disclosure and documentation requirements for taxpayers to support their tax-return positions also apply to transactions between associated enterprises.

As from 1 January 2017, a new Article 56bis was introduced in the Luxembourg tax code to embed in the domestic tax law the OECD Transfer Pricing Guidelines which have been substantially rewritten between 2013 and 2015 as part of the OECD's BEPS¹⁶ Project. In addition, a new circular providing guidance on transfer pricing considerations applicable to companies engaged in intra group financing activities took effect as from 1 January 2017.

This is not a radical change but these new provisions rather further codify the arm's length principle in Luxembourg.

Nevertheless, and on the basis that the securitisation company is not involved into intra-group financing activities (i.e. it does not hold loan receivables from related parties), the transfer pricing rules should not have a significant impact on the securitisation companies and related tax treatment. However, it is recommended to undertake detailed analysis to verify that approach, including the analysis from the source country perspective, on a case-by-case basis.

4.4.3 Access to Double Tax Treaties

Since securitisation companies are fully taxable resident companies, they are expected to benefit from Luxembourg's tax treaty network and from the EU Parent-Subsidiary Directive. At present, Luxembourg has concluded the following 83 treaties and 12 others are under negotiation (see Figure 27).

¹⁵ Organisation for Economic Co-operation and Development.

¹⁶ Base erosion and profit shifting.

Figure 27: Luxembourg Double Tax Treaty (DTT) network

Europe		Americas	Asia and Oceania		Africa
Albania*	Lithuania	Argentina*	Armenia	Saudi Arabia	Botswana*
Andorra	Macedonia	Barbados	Azerbaijan	Singapore	Egypt*
Austria	Malta	Brazil	Bahrain	South Korea	Mauritius
Belgium	Isle of Man	Canada	Brunei	Sri Lanka	Morocco
Bulgaria	Moldova	Mexico	China	Syria*	Senegal
Croatia	Monaco	Panama	Georgia	Thailand	Seychelles
Cyprus	Netherlands	Trinidad and Tobago	Hong Kong	Taiwan	South Africa
Czech Rep.	Norway	United States	India	Tajikistan	Tunisia
Denmark	Poland	Uruguay	Indonesia	UAE	
Estonia	Portugal		Israel	Uzbekistan	
Finland	Romania		Japan	Vietnam	
France	Russia		Kazakhstan		
Germany	San Marino		Kyrgyzstan*		
Greece	Serbia		Kuwait*		
Guernsey	Slovakia		Lebanon*		
Hungary	Slovenia		Laos		
Ireland	Spain		Malaysia		
Iceland	Sweden		Mongolia		
Italy	Switzerland		New Zealand*		
Jersey	Turkey		Oman*		
Kosovo*	United Kingdom		Pakistan*		
Latvia	Ukraine		Quatar		
Liechtenstein					

- 83 DTTs enforced
- 12 under negotiation (*)

4.4.4 Tax specificities of securitisation funds

Since securitisation funds are treated in the same way as investment funds in Luxembourg, they are exempt from CIT and MBT. Securitisation funds furthermore benefit from a subscription tax (“*taxe d’abonnement*”) exemption.

The unit holders of the securitisation fund are treated like bondholders. Dividend distributions and payments on fund units are thus exempt from withholding tax.

Lastly, from the investors’ tax perspective, the securitisation funds are likely to be treated as tax transparent vehicles (though it would need to be verified with the relevant analysis on a case-by-case basis).

4.4.5 FATCA/CRS

FATCA

The Foreign Account Tax Compliance Act (“FATCA”) rules have been incorporated in the US Internal Revenue Code and in the Final Regulations and entered into force on 1 July 2014. The purpose of these provisions is to fight tax evasion by US persons holding accounts or investments abroad.

The regulations impose documentation due diligence, an identification of “US accounts” and a reporting and withholding obligation on Foreign Financial Institutions

“FFIs”) that enter into an agreement with the Internal Revenue Service (“IRS”). FFIs that do not enter into such agreements would be subject to a 30% withholding tax on certain US source income (notably interests and dividends) and possibly on some non-US source income in the future (notion of pass-thru payment reserved for future guidance). In order to help Luxembourg Financial Institutions to comply with FATCA, Luxembourg signed an Intergovernmental Agreement (“IGA”) with the US. The IGA was ratified by the Law of 24 July 2015. According to the IGA, Financial Institutions in Luxembourg should report information about US accounts to the Luxembourg tax authorities, who will then transfer this data to the IRS.

Based on the Circular ECHA n°2 issued by the Luxembourg tax authorities, an authorised securitisation vehicle should qualify as FI (i.e. Investment Entity) for FATCA purposes. In this case, we recommend conducting a FATCA analysis to assess whether a Non-Reporting FI status might be applicable.

With respect to a securitisation vehicle that is not authorised by the CSSF, it would need to be analysed on a case-by-case basis whether the securitisation vehicle might be considered as an Investment Entity or whether it might qualify as Non-Financial Foreign Entity (NFFE). Depending on the result of the analysis, different obligations will arise.

CRS

In 2014, the OECD released the full version of the Standard for Automatic Exchange of Financial Information in tax matters (Common Reporting Standard, “CRS”). Like FATCA, the CRS requires Financial Institutions around the globe to play a central role in providing tax authorities with greater access and insight into taxpayers’ financial account data, including the income earned on these accounts.

In short, the CRS is intended to be a standardised, cost effective model for the bilateral and automatic exchange of tax information.

The standard provides for annual automatic inter-governmental exchange of financial account information,

including balances, interest, dividends, and sales proceeds from financial assets, as reported to tax authorities by Financial Institutions and covering accounts held by individuals and entities, including trusts and foundations. It sets out the financial account information to be exchanged, the Financial Institutions that have to report, the different types of accounts and taxpayers to be covered, as well as common due-diligence procedures to be followed by Financial Institutions.

The CRS has been incorporated in the amended Directive on Administrative Cooperation (“DAC 2”) officially adopted by the European Council on 9 December 2014. The Luxembourg CRS Law of 18 December 2015 enacted the CRS into Luxembourg law (the “CRS Law”).

Depending on its activities, nature of assets, the number and volatility of its investors as well as its regulation, a securitisation vehicle might be considered as Financial Institution for CRS purposes as well. In order to assess the potential effects and obligations derived from the CRS status of the vehicle, a thorough analysis will definitely be required.

4.4.6 Value-added Tax (VAT)

4.4.6.1 VAT status of Luxembourg securitisation vehicles

Securitisation vehicles qualify as VAT taxable persons in Luxembourg. The VAT status of securitisation vehicles is indirectly due to the Court of Justice of the European Union’s (“CJEU”) case Banque Bruxelles Lambert (“BBL”) that has been implemented in Luxembourg by the VAT Authorities through the Circular 723. Although the BBL case dealt with the VAT status of SICAVs, the VAT Authorities extended the reasoning of this case to all vehicles listed in Article 44.1.d) of the Luxembourg VAT Law¹⁷ (notably the securitisation vehicles).

¹⁷ Law of 12 February 1979 on Value-added Tax.

Due to their VAT taxable person status, securitisation vehicles are required to register for VAT in Luxembourg and to file VAT returns if:

- they perform activities allowing input VAT recovery (e.g. portfolio of interest bearing loans directly held with non-EU counterparts); or
- in absence of activities allowing input VAT recovery, they receive taxable services from non-Luxembourg suppliers on which they are liable to self-account for Luxembourg VAT under the reverse-charge rule (or in the unlikely event they acquire goods transported to Luxembourg from another EU Member State and those acquisitions exceed EUR 10,000¹⁸ in a calendar year).

VAT on costs incurred by a securitisation vehicle that are directly linked to activities allowing input VAT recovery is deductible, whereas VAT on costs directly linked to activities not allowing input VAT recovery is not deductible. The input VAT recoverable on overhead expenses incurred by a securitisation vehicle should be determined on a case-by-case basis, based on the activities or the investments performed by the securitisation vehicle.

Securitisation vehicles without input VAT recovery right and liable to self-assess Luxembourg VAT under the reverse charge mechanism are only required to file a single short-form VAT return per calendar year to declare their expenses from abroad. However, the VAT authorities can request the filing of periodic and annual recapitulative VAT returns if certain thresholds of reverse chargeable services received by the securitisation vehicle (or goods acquired and transported from another EU Member State to Luxembourg) are exceeded.

It is also important to note that a securitisation vehicle that, at its own risk, purchases defaulted debts at a price below their face value does not perform activities in the scope of VAT when the difference between the face value of those debts and their purchase price reflects the actual economic value of the debts at the time of their assignment. A careful analysis of the activities performed by each securitisation vehicle should therefore be made to determine the VAT status of such entity and their reporting requirements correctly.

4.4.6.2 VAT exemption of management services rendered to securitisation vehicles

Article 135 1(g) of the VAT Directive (2006/112/EC) provides that the management of special investment funds as defined by Member States is exempt from VAT. Article 44.1.d) of the Luxembourg VAT Law lists the eligible funds/vehicles. As this list includes securitisation vehicles, management services rendered to Luxembourg securitisation vehicles are consequently VAT exempt.

The concept of “management services” is, however, not clearly defined, though the management of investment funds has been clarified. In addition to managing the portfolio, some administrative services can benefit from the VAT exemption. In April 2010, the Luxembourg VAT authorities issued Circular letter 723bis (“Circular n° 723bis”) aiming to clarify the VAT exemption of outsourced fund management services. Circular n° 723bis also recalls some principles provided by the CJEU in the Abbey National case. In order for outsourced services to be VAT-exempt, they must constitute a distinct whole and be specific and essential to the management of special investment funds. In this circular, the VAT authorities add that if one single type of service is outsourced, the VAT exemption would, in principle, not apply. Investment management services are also regarded as “management services” benefiting from the VAT exemption according to the CJEU in the Gesellschaft für Börsenkommunikation mbH case.

So far, Luxembourg has widely applied the exemption. Still every service rendered to the securitisation vehicle should be carefully analysed. The documentation, services agreement, and invoices should be reviewed to determine if the conditions for a VAT exemption might apply. This is particularly relevant for services such as origination, asset servicing, asset management, calculation and report, valuation, etc. If properly structured, a Luxembourg securitisation vehicle is able to significantly reduce the amount of irrecoverable VAT and operational costs.

¹⁸ No threshold for certain specific goods.

4.5 BEPS initiative/ Anti-Tax Avoidance Directive

The international tax system is changing due to coordinated actions taken by governments and unilateral measures designed by individual countries, both intended to tackle concerns over base erosion and profit shifting (“BEPS”) and perceived international tax avoidance techniques of high-profile multinationals. The recommendations of the BEPS project led by the OECD and published in October 2015 are at the root of much of the coordinated activity, although the timing and methods of implementation vary.

Furthermore, EU followed the above trend with the Anti-Tax Avoidance package, i.e. Anti-Tax Avoidance Directive 2016/1164 of 12 July 2016 and the Anti-Tax Avoidance Directive 2017/952 of 29 May 2017 (“ATAD”).

4.5.1 Anti-Tax Avoidance Directive

ATAD basically sets out minimum standards that the Member States need to adhere to in several areas covered by the OECD works on the BEPS initiative including, inter alia, (i) rules on the deductibility of interest limitations and (ii) rules on how to tackle hybrid mismatches (between EU Member States as well as between EU Member States and non EU countries). Whereas the ATAD stipulates minimum standards to be applied to all taxpayers subject to corporate tax in one or more Member States, it does not prohibit other anti-avoidance rules designed to give greater protection to the corporate tax base.

On 18 December 2018, the Luxembourg Parliament voted a law (the “ATAD Law”) to transpose the EU Anti-Tax Avoidance Directive 2016/1164 into Luxembourg domestic tax law. The Law introduced (i) interest limitation rules and (ii) anti-hybrid mismatch rules between EU Member States.

4.5.1.1 Interest limitation rules

The aim of the interest limitation rules is to limit the tax deduction of interest expense that exceeds the amount of interest income or income economically equivalent to interest (i.e. exceeding borrowing costs) to 30% of the EBITDA of the taxpayer. Tax-exempt revenues like dividend income and capital gains derived from qualifying participation shall be excluded when computing the EBITDA of the taxpayer.

As the interest limitation rules apply only to entities subject to Luxembourg corporate tax, securitisation funds set up in the form of FCPs are not subject to these new interest limitation rules.

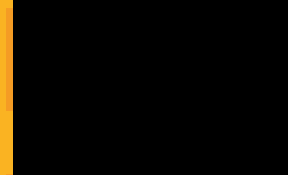
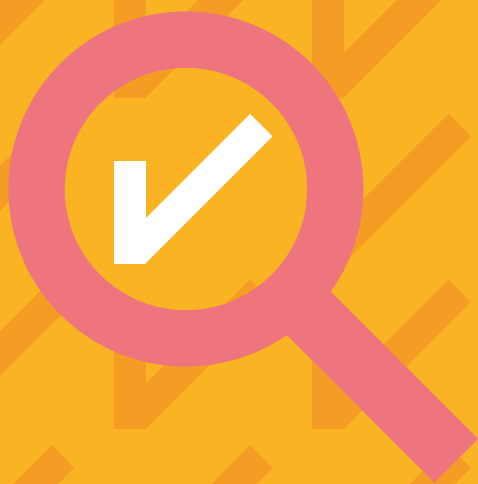
However, securitisation vehicles with corporate form (e.g. SA, SARL, SCA, Scoop SA) which are fully subject to tax are in scope of the new interest limitation rules, unless an exemption applies.

4.5.1.1.1 Available exemptions

The ATAD Law provides for multiple exemptions as follows:

De minimis rules of EUR 3 million per year

The exceeding borrowing costs incurred during the financial year are deductible without any limitation up to EUR 3 million. This amount needs to be calculated at the company level and not only at the compartment level.



Grandfathering for debt instruments concluded before 17 June 2016

When determining the amount of exceeding borrowings costs, a taxpayer may exclude borrowings costs arising from borrowings concluded before 17 June 2016. The exclusion shall not extend to any subsequent modification of the debt instrument or agreement, which means that the amount of deductible borrowing costs should be computed as if no amendments took place. Therefore, interest expense on debt instruments issued before 17 June 2016 (subject to review of their potential amendments and their effects on the initial debt) should not be subject to these interest limitations rules.

Stand-alone entity

The ATAD Law provides that a stand-alone entity is exempted from the interest limitation rules. Based on common understanding, securitisation companies whose shares are held by a trust, foundation, or Stichting are usually considered as “orphan”. However, the ATAD Law defines a stand-alone entity as a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise (to be understood as an entity which includes trusts, foundations, and Stichtings holding directly or indirectly more than 25% of the taxpayer) or non-Luxembourg permanent establishment.

As a result of the provisions of the ATAD Law, a securitisation company fully held by a single trust, foundation, or Stichting should not be regarded as stand-alone entity and should thus be in scope of the interest limitation rules.

EU securitisation vehicles

Securitisation companies in the meaning of Article 2 point 2 of the Regulation (EU) 2017/2402 (“EU Securitisation Regulation”) are out of scope of the interest deduction limitation rules. In substance, this will suppose the existence of securitisation of credit risk and the subordination through tranching.


Alternative Investment Funds

Alternative Investment Funds (“AIF”) in the meaning of the AIFM Directive 2011/61/EU (“AIFMD”) are out of scope. Therefore, a securitisation company qualifying as an AIF in the meaning of the AIFMD, it should not be subject to the interest limitation rules.

4.5.1.1.2 Importance of the definition of exceeding borrowing costs

When the securitisation company cannot rely on any of the above exemptions, it is important to compute the amount of exceeding borrowing costs. Borrowing costs are defined in the Law as interest expenses on all forms of debt and other costs economically equivalent. The rule applies to any financing, irrespective of whether provided by related parties or third parties. The ATAD Law provides the following non-exhaustive list of borrowing costs:

- Remuneration due under profit participating loans;
- Imputed interest on instruments such as convertible bonds and zero coupon bonds;
- Amounts disbursed under alternative financing arrangements, such as Islamic finance;
- Finance cost element of finance lease payments;
- Capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest;
- Amounts measured by reference to a financial return under transfer pricing rules where applicable;
- Notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
- Certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- Guarantee fees for financing arrangements;
- Arrangement fees and similar costs related to the borrowing of funds.



In practice, securitisation companies not having significantly more interest expenses than interest income should thus not be substantially impacted by the interest limitation rules.

One of the issues for some securitisation companies comes from the fact that the ATAD Law does not provide a clear definition or guidance for interpretation of what constitutes interest revenue and other economically equivalent taxable revenue which leaves some room for interpretation, especially with regard to gains made from non-performing loans.

4.5.1.1.3 Practical implications

For the time being, the definition of exceeding borrowing costs, interest revenues, and other revenues economically equivalent in the ATAD Law has not been clarified by the Luxembourg tax authorities. However, we expect that at least some of the topics will be addressed in a circular issued by the tax authorities in the coming months.

We have analysed the most common securitisation transactions with regards to the potential implications the ATAD Law might have on the transactions. The following is our view based on the text of the ATAD Law and OECD BEPS Action 4 which inspired the ATAD. It cannot be excluded that the tax authorities may adopt a different view in their tax circular.

Transactions paying (or accruing) regular interest income in the hands of the securitisation vehicle should not be adversely impacted by ATAD Law. Indeed payments to noteholders would thus remain deductible up to that amount. Typical interest receiving transactions are mainly securitisations of bonds, performing loans, trade or leasing receivables. Also discounts received on those assets are usually accounted for as interest to which they are economically linked. For non-performing loans, the situation

is more complex and the tax treatment of gains from repayments above acquisition costs of the non-performing loans as interest revenue or economically equivalent revenue is controversially discussed in the market.

We also see repackages of investment funds refinanced by notes issued. If these funds are paying dividends which are distributed as variable interest under the notes, we expect a negative impact of the interest limitation rule due to the asymmetry of the type of cash flows. On the other hand, if the repayable amount of the notes tracks the fair value of the underlying funds, the realisation of the asset will result in a capital gain (loss) which will be paid out to the note holder in form of an increased (decreased) repayment amount, i.e. a capital loss (gain) for the issuer. Based on the principle of symmetry, we expect that the capital results neither from assets nor from notes issued would be treated as interest revenue or borrowing costs, and therefore the interest limitation rule should not apply.

An important part of the Luxembourg securitisation market is made of structured products, i.e. the issuance of performance linked certificates. Typically, the proceeds of the certificates issued are invested into debt instruments, like a bond or a deposit. The interest from the debt instrument is then swapped into the performance promised to the certificate holders. For structures with a debt instrument as underlying, the amount received is booked as interest revenue and in our view as the swap or derivative instrument payments are hedging this income, any payment made and received under the swap of the derivative instrument should be regarded as respectively borrowing costs and interest revenue. Therefore, as in this scenario only interest revenue is received by the securitisation vehicle, all borrowing costs accruing under the notes issued should remain fully tax deductible. For other forms of underlyings, this may be less obvious and we recommend performing an in-depth analysis as tax implications may vary on a case-by-case basis.



4.5.1.2 Anti-hybrid mismatch rules

The ATAD Law also introduced anti-hybrid mismatch rules covering only intra-EU hybrid instruments and intra-EU hybrid entity mismatches.

There can be a hybrid instrument when an instrument (e.g. note, certificate, warrant) issued by a securitisation company is characterised differently in the hands of the EU investor (i.e. debt at the level of the securitisation company and equity at the level of the EU investor) which leads to a deduction at the level of the securitisation company and an absence of inclusion at the level of the EU investor.

There can be a hybrid entity when an EU investor subscribes to an instrument (e.g. note, certificate, warrant) through a hybrid entity which is regarded as tax transparent in its jurisdiction of residence and as a taxable entity under the laws of the jurisdiction of the EU investor which leads to a deduction at the level of the securitisation company and an absence of inclusion at the level of the EU investor.

However, such anti-hybrid mismatch rules only apply between associated enterprises which supposes that the EU investor holds directly or indirectly a participation of more than 25% in the securitisation company in terms of voting rights, capital ownership, or entitlement to profits. Such percentage is set at 50% when the EU investor holds the participation in a securitisation company through a hybrid entity.

As in practice EU investors are often not meeting the conditions to be regarded as associated enterprises, such anti-hybrid mismatch rules provided by the ATAD Law should have limited implications for the majority of the securitisation companies.

It is worth noting that the Anti-Tax Avoidance Directive 2017/952 of 29 May 2017 which will need to be transposed into Luxembourg tax law by 31 December 2019 will cover a wider range of intra-EU mismatches, but also mismatches with third countries. Implications of the ATAD Law that will transpose such second directive will have to be monitored in due time.

4.5.2 Multilateral Instrument

In 2017, Luxembourg was one of the original 68 jurisdictions to sign the OECD-sponsored Multilateral Convention to implement Tax Treaty Related Measures to prevent base erosion and profits shifting – commonly referred to as the “Multilateral Instrument” or “MLI”.

The aim of the MLI is to supplement existing double tax treaties concluded by participating jurisdictions in order to include anti-tax treaty shopping provisions like the Principal Purpose Test. Under the Principle Purpose Test, a benefit under a double tax treaty shall not be granted in respect of an item of income or capital if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provision of this double tax treaty.

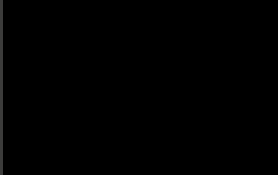
On 14 February 2019, Luxembourg Parliament ratified the MLI which will take effect on 1 January 2020. As a consequence, once the relevant treaty co-signatory has also ratified the MLI, any Luxembourg securitisation company claiming benefit from a double tax treaty will have now to pass the Principal Purpose Test to secure the benefit from reduced or nil withholding taxes at source.

As the vast majority of securitisation companies have been set up for genuine economic reasons, just a few should be impacted by the entry into force of the MLI.

4.5.3 Mandatory Disclosure Requirements

On 25 May 2018, a new Council Directive 2018/822 has been adopted which introduces a mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements implemented after 25 June 2018. Such so-called Sixth Directive on Administration Cooperation (“DAC 6”) implements the recommendation made by the OECD in the BEPS Action 12. The DAC 6 needs to be transposed by Member States before 31 December 2019 and requires in substance that EU tax intermediaries report cross-border arrangements that are potentially aggressive tax planning arrangements.

The DAC 6 provides that only cross-border arrangements that include some specific hallmarks are reportable. As a consequence, a case-by-case analysis shall be conducted to determine whether arrangements involving a securitisation vehicle are reportable under DAC 6.



5

Regulatory aspects

5.1 EU Securitisation Regulation

Since 1 January 2019, the EU Securitisation Regulation¹⁹ (the “Regulation”) is applicable to EU securitisation transactions (see definition below) whose securities are issued on or after that date. Securities issued before that date are not in scope of the Regulation until 1 January 2020.

The Regulation is a key element of the European Commission’s Capital Markets Union (“CMU”) and shall support the development of the European securitisation market. The purpose is to promote securitisation as an important element of well-functioning financial markets, diversifying funding sources and allocating risk more widely, without repeating the mistakes made leading to the 2008 financial crisis. It allows for a broader distribution of financial-sector risk and can help freeing up originators’ balance sheets to enable further lending to the real economy.

Overall, the Regulation recognises that securitisation can improve efficiencies in the financial system and provide additional investment opportunities.

With the Regulation, the European Union aims to streamline the legislative framework on securitisation into one single legal reference. Consequently, the Regulation applies to several parties involved in a securitisation transaction, namely institutional investors (in principle no distribution to retail clients) and originators, sponsors, original

lenders, and securitisation special purpose entities. The Regulation is divided into two parts. The first general part defines the term securitisation and the related concepts. It establishes, among others, due-diligence, risk-retention, and transparency requirements for parties involved in any securitisation that falls within the definition of the Regulation. In its second part, the Regulation creates an additional specific framework for simple, transparent and standardised (“STS”) securitisation.

In addition, the EBA and the ESMA have published so-called Level 2 regulation on several aspects of the Regulation in order to specify them in detail and give further guidance. Currently, some of them are still in a draft version. The Level 2 regulation covers, for example, risk retention, disclosure and certain STS criteria such as homogeneity.

¹⁹ Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

5.1.1 General framework for all EU securitisations

Definition of securitisation in the meaning of the Regulation (“EU Securitisation”)

In the context of the Regulation, the term “securitisation” is to be understood as a transaction or scheme, whereby a credit risk is tranching, having the following characteristics:

- i Payments are dependent upon the performance of the underlying exposure.
- ii The subordination of tranches determines the distribution of losses during the ongoing life of the transaction.
- iii The transaction shall not constitute a specialised lending to finance or operate physical assets as defined in Article 147 (8) of Regulation (EU) no 575/2013.

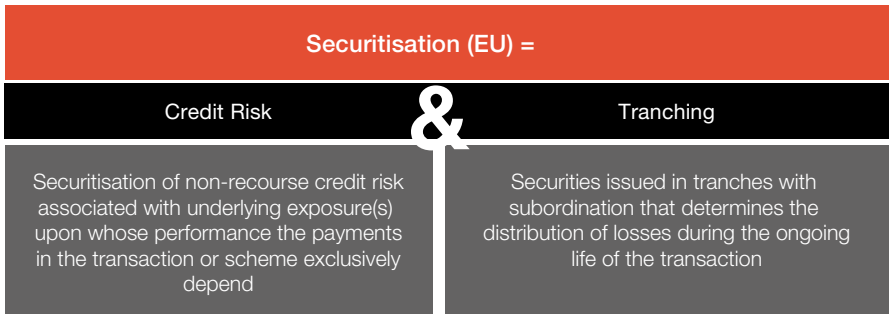
On top of this, and because of the financial crisis, the securitised risk shall not be another securitisation, i.e. the Regulation prohibits in general re-securitisation.

This definition seems to be rather simple with only credit risk and tranching as key criteria. However, in practice, especially the notion of tranching gives room to interpretation. We have outlined the three main discussion points that came up during the past months:

- Does tranching only refer to different transferable securities issued but not include other ways of subordination? Even though the recitals and some Articles of the Regulation refer to “securities”, the securitisation and tranching definitions themselves do not make such restriction. This implies that also subordinated loans or other forms of distribution of credit losses would be seen as tranching.
- Is the share capital of a securitisation vehicle (in addition to one single note issued) be seen as tranching? In our reading of the Regulation, reference is made to “contractually” separate tranches, while the share capital rank is legally defined. Therefore, this alone would not trigger tranching. Nevertheless, each transaction should be analysed individually since a structuring within an entity’s share capital (e.g. differently ranked share types or classes) would most likely be seen as tranching.
- Is it tranching if all tranches are held by the same investor? In our view, it is not relevant who the investor is. One needs to analyse from a transaction/vehicle point of view, not investors’ angle. Therefore, having issued several tranches with different ranking with regards to credit risk would imply tranching in the meaning of the Regulation, regardless of the investor.

Furthermore, multi-compartment structures are not explicitly dealt with in the Regulation, i.e. it does not clarify if it shall be applied on an entity or compartment basis. In our opinion, each compartment should be treated separately being legally ring-fenced silos with clear segregation of

Figure 32: EU securitisation definition



assets and liabilities. This implies that any below mentioned obligation would have to be fulfilled for compartments falling in the scope of the Regulation, not for all.

Parties subject to the Regulation

An institutional investor in the meaning of the Regulation may be a European Union-based:

- insurance or a reinsurance undertaking;
- institution for occupational retirement provision;
- alternative investment fund manager (“AIFM”);
- undertaking for the collective investment in transferable securities (“UCITS”) if internally managed, or otherwise its management company;
- credit institution or investment firm.

The role of a sponsor in the meaning of the Regulation is limited to credit institutions (whether located in the European Union or not) and EU investment firms. On the other hand, any entity pursuing the respective activity can act as originator or original lender. The Securitisation Special Purpose Entity (“SSPE”) is not restricted in legal form or jurisdiction (except if STS compliance is intended, in which case it must be established within the EU).

This also means that a non-EU or non-regulated originator could be caught by the Regulation. Similarly, a non-EU SSPE that meets above mentioned credit risk and tranching criteria would trigger further obligations for the EU institutional investor and the SSPE itself. For example, US agency MBS are not per se out of scope of the Regulation but only if they do not meet the definition (which, for example, is usually the case for the so called pass-through securities).

All these actors must meet one or more of the requirements prescribed by the Regulation relating to (i) due-diligence (for institutional investors), (ii) risk retention (for originators, sponsors, or original lender) and (iii) transparency (for originators, sponsors, and SSPEs).

Furthermore, the Regulation defines criteria for the credit granting process at origination and initiates the creation of a “securitisation repository” collecting EU securitisation related data.

Key requirements from the Regulation

(i) Due-diligence

Prior to holding a securitisation position, institutional investors have to verify certain elements of the transaction, e.g.:

- the existence of a well-defined credit-granting process of the originator (except if EU credit institutions or investment firms);
- the compliance of originator/sponsor/original lender with risk retention requirements;
- the regular provision of required information by originator/sponsor/SSPE.

Institutional investors also have to carry out a due-diligence assessment, which enables them to assess the risks characteristics and structural features. They have to establish written procedures (initially and on an ongoing basis) in order to monitor the above-mentioned compliance and the performance of the securitisation position. No Level 2 regulation will be produced on due diligence. Yet, non-compliance could lead to significant sanctions.

(ii) Risk retention

In order to align their interests with those of the investors either originator, sponsor, or original lender shall retain a material net economic interest in the securitisation on an ongoing basis. Risk retention must also meet the following additional requirements:

- the material net economic interest shall be not less than 5% of the ongoing nominal value of the tranches sold or exposures securitised and shall not be subject to any credit-risk mitigation or hedging;
- only one of the parties must retain the material net economic interest (i.e., no split between the involved parties) and, if no agreement reached between the parties, the originator shall fulfil the risk retention obligation.

The Regulation introduces a conclusive catalogue of possibilities to meet the risk retention requirement and solely exempts exposures that are fully, unconditionally, and irrevocably guaranteed by public authorities. This catalogue closely resembles that published by EBA in the form of a Regulatory Technical Standard under the old regulation, specifying several aspects on the risk retention requirements.

The requirement for risk retention is similar to the ones under the Dodd-Frank Act in the United States but different in the details. Thus, a securitisation valid for US risk retention is not necessarily EU Regulation compliant while sponsors have developed dual-compliant securitisations.

(iii) Transparency

Originator, sponsor, and SSPE have to provide detailed quantitative and qualitative, static and dynamic information on the securitisation. This includes, amongst others, to:

- provide the (potential) investors on a regular basis with sufficient information, e.g. on the underlying exposure and documentation;
- designate who among themselves will provide the required information;
- make this information available via the securitisation repository to provide the investors with a single and supervised source of the data necessary for performing their due diligence (except for private securitisations).

The ESMA has published technical and implementing standard (Level 2 regulation) on transparency requirements which introduces many, very detailed reporting templates that have to be used. Public securitisations (i.e. securities listed on EU-regulated market) need to complete more templates than a private securitisation and has to report to a securitisation repository. Nevertheless, also private securitisations need to report under the predefined templates even if the investor would not require it. In December 2018, these standards were rejected by the EU commission which announced to not endorse them in the present form and instructed ESMA to redraft them. The final version is expected to be available in Q3 2019.

(iv) Ban on re-securitisations

As mentioned above, the Regulation states that the underlying exposures used in a securitisation shall not include any securitisation positions. Certain exceptions may be granted by the competent authority, e.g. when wind-up issues or NPL are part of the transaction.

(v) Criteria for credit granting

In order to avoid “credit origination to securitise” (equalling pre-crisis “originate-to-distribute”-models), the originators, sponsors, and original lenders shall apply the same sound and well-defined criteria for credit-granting which they apply to non-securitised exposures.

5.1.2 Specific framework for STS securitisations

With the specific framework of the Regulation, the European Union wants to establish a more risk-sensitive prudential framework for STS securitisations. Banks and insurers investing in STS securitisations will benefit from lower capital requirements.

In order to be considered as STS, an EU securitisation must fulfil numerous criteria relating to simplicity, transparency and standardisation. Those criteria are further interpreted by guidelines published by EBA.

This does neither mean that an STS securitisation position is free of risks, nor does it indicate anything about the credit quality underlying the securitisation. Nevertheless, it indicates that a prudent and diligent investor will be able to properly analyse the risks involved in the securitisation.

Securitisation securities issued before 1 January 2019 may use the STS designation, if the STS requirements are complied with at the time of issuance and of notification as STS. This will be nearly impossible to achieve by most existing transactions, because the contractual provisions required by some STS standards were not included at the time of origination. Time will show whether there will be transaction documentations adapted in order to fulfill the STS criteria.

Requirements for STS in addition to those applicable to all EU securitisations

As mentioned above, an STS securitisation must fulfil numerous criteria relating to simplicity, transparency, and standardisation. The figure below illustrates a selection of these criteria:

Figure 33: STS criteria

Simplicity	Transparency	Standardisation
<div>Portfolio and cashflows</div> <ul style="list-style-type: none">• True sale only• No active management (eligibility criteria)• Homogeneous asset type• No re-securitisation• No defaulted exposures• Cashflows not substantially dependent on sale of asset• At least one payment made• ...	<div>Investor data availability</div> <ul style="list-style-type: none">• Historical (≥5yrs) default and loss performance data• Sample of exposure independently verified• Liability cash flow model linked to exposure• Originator and sponsor responsible for transparency (incl. STS notification and quarterly investor reporting)• ...	<div>Structural elements</div> <ul style="list-style-type: none">• Risk retention satisfied by originator, sponsor original lender• Interest and currency risk mitigated• Roles and responsibilities of transaction parties, esp. servicer, clearly described• Remedies and actions in case of delinquency/default of debtors or conflicts of investors predefined• ...

In addition to fulfilling the STS criteria, further conditions must be met, for example:

- Originator, sponsor, and SSPE (i.e. the securitisation vehicle) must be established in the European Union, e.g. in Luxembourg;
- All STS securitisations must be published in a list on the official website of the ESMA;
- Originators and sponsors shall jointly notify ESMA of a new STS securitisation. This notification shall include an explanation by the originator, the sponsor, and the SSPE on how each of the STS criteria has been complied with or a statement that the compliance with the STS criteria was confirmed by an authorised third party, like the STS Verification International GmbH, Frankfurt.

Upon communication by the SSPE to ESMA, the instrument will be listed in a centralised web data repository listing all STS securitisations. This website is accessible to all investors.

Third party verification

Originator, sponsor, and SSPE may use the service of an authorised third party to verify whether a securitisation complies with the STS criteria. However, the use of such service shall under no circumstances affect the liability of the originator, sponsor, or SSPE in respect of their legal obligations under the Regulation nor the due-diligence obligations imposed on institutional investors. Third parties undertaking to offer this kind of verification undergo a tough licensing process and are supervised by ESMA. Currently, STS Verification International GmbH, Prime Collateralised Securities (PCS) UK Limited, Dutch Securitisation Association (DSA) are approved third party verification agents or intend to obtain such approval, with others to follow.

Competent authorities and sanctions

As securitisation involves several parties, it is important to clarify which supervisory authority will be responsible for the supervision of each party and action in the securitisation process. The Regulation attributes some powers directly to competent authorities, while it confers the power to assign other supervision duties to the Member States (for Luxembourg, the CSSF and the CAA are the designated competent authorities). ESMA is tasked with the role of assuring consistent implementation, deciding in some instances when competent authorities cannot agree and monitoring the securitisation markets for the commission. As each securitisation can involve parties from different sectors (banking, insurance, asset management) and different countries, competent supervisory authorities will have to communicate and collaborate in order to find common approaches on securitisation matters in order to avoid escalations, which may prolong processes in some cases.

The Regulation also contains provisions regarding sanctions for malpractice. Sanctions are imposed in case of wrongdoing by any party involved in the securitisation process, as this is considered essential for the functioning and the credibility of the system.

In particular, if a competent supervisory authority ascertains that a securitisation previously considered STS does no longer fulfil requirements, the product will be removed from the website listing STS products and a financial sanction will be imposed on the originator (minimum EUR 5 million, or up to 10% of the annual turnover of the offender at individual or group consolidated level). The originator may also be banned temporarily from issuing STS products.

Member States also have the possibility to introduce criminal charges but they are not obliged to do so.

5.1.3 Impact on Luxembourg

According to the securitisation definition in the Luxembourg Securitisation Law, not all Luxembourg securitisation transactions meet the definition of a securitisation as per the Regulation, and therefore the Regulation may not apply to all Luxembourg securitisations. On the other hand, vehicles performing securitisation under the EU definition may not have opted for the Luxembourg Securitisation Law.

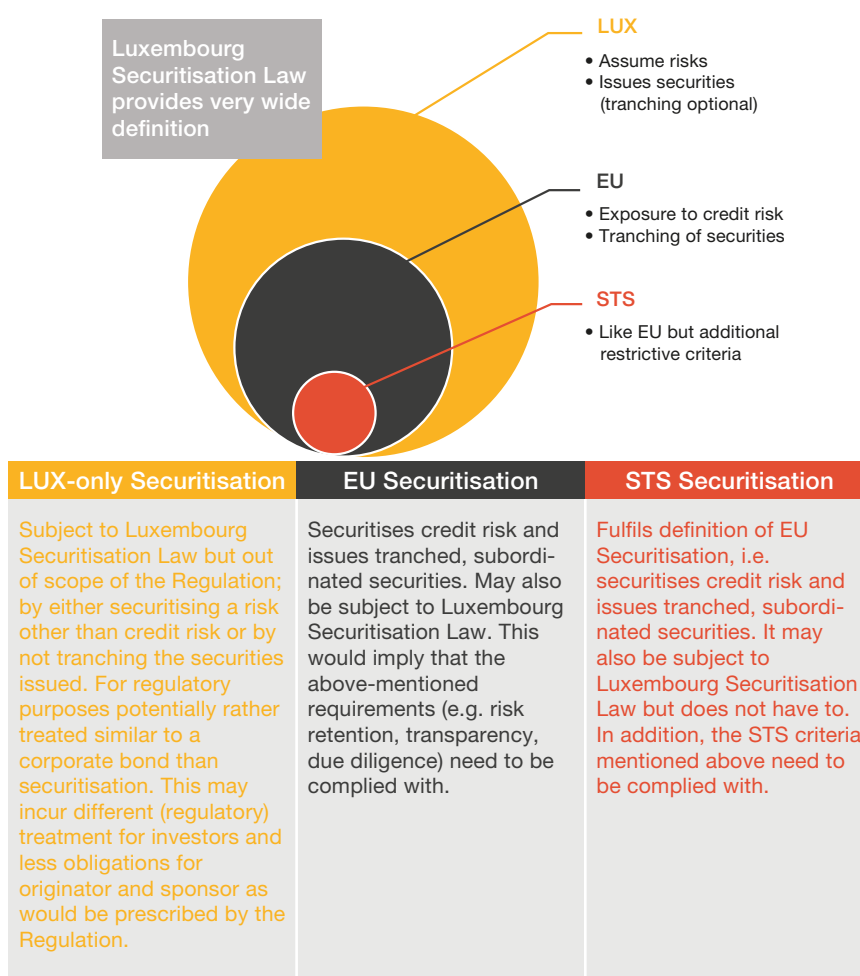
The Regulation does not per se apply to all Luxembourg Securitisations because of the broader scope in the Luxembourg Securitisation Law, which is neither restricted to credit risk nor prescribing tranching, as the Regulation does.

A Luxembourg securitisation vehicle may acquire or assume any risk (and not only credit risk) and issue securities linked to this risk, while tranching is not mandatory. It also allows synthetic risk transfer, which would currently not be allowed for STS securitisations. Contrary to the general rule of the Regulation, securities issued by Luxembourg securitisation vehicles may also be sold to retail clients, while this implies supervision by the CSSF if certain conditions are met.

Thus, a Luxembourg securitisation vehicle may be structured in three possible ways (see Figure 34 below).

As such, Luxembourg remains a very flexible and attractive environment, providing legal certainty and an interesting product toolbox. In addition, Luxembourg Securitisation Law allows for the creation of compartments or sub-funds under one legal entity.

Figure 34: Impact of EU Securitisation Regulation on Luxembourg



5.2 Capital requirements for banks (CRR)

Basel III is the name widely used for the Capital Requirements Directive (“CRD IV”) and the Capital Requirements Regulation (“CRR”). This framework has been transposed into EU Directive 2013/36/EU and EU Regulation 575/2013. Luxembourg has implemented the framework by transposing the Directive into the Law of 5 April 1993 on the financial sector, whereas the regulation is directly fully applicable and does not need any transposition. The term “amended CRD IV” is further used in this chapter and commonly refers to both EU Directive 2013/36/EU and EU Regulation 575/2013, as well as its amendment with regards to securitisation by EU Regulation 2017/2401.

The amended CRD IV framework covers the minimum capital requirements and the methodology for calculating the capital adequacy, operational requirements, and disclosure by credit institutions. Furthermore, the framework contains ratios, such as the Liquidity Coverage Ratio, the Net Stable Funding Ratio, and the Leverage Ratio. Additionally, risk management and supervision are also being covered. The amendment of the CRD IV framework in relation to the treatment of securitisation exposures has been implemented through EU Regulation 2017/2401 published on 28 December 2017 in the Official Journal of the European Union. The Regulation entered into force on 17 January 2018 and became applicable to securitisation transactions as from 1 January 2019; certain grandfathering rules apply. Regulation 2017/2401 is one part of a regulatory update of the EU securitisation framework, which addresses several shortcomings of the CRD IV framework, as for example, a reliance on external ratings, excessively low risk weights for highly-rated securitisation tranches and high risk weights for low-rated tranches, as well as insufficient

risk sensitivity, the other part being EU Regulation 2017/2402 defining securitisation and establishing due-diligence, risk-retention, and transparency requirements as well as creating a specific framework for STS securitisation (please refer to section 5.1).

Overview of the amended CRD IV framework related to securitisation

Minimum capital requirements for securitisation positions

This area is the most important with regard 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 by credit institutions when calculating their capital requirements of securitisation transactions.

There are two cornerstones in relation to the regulatory approach described in this area, namely:

a) The “economic substance approach”

The overall amended CRD IV 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 amended CRD IV established the “economic substance” approach, it seems, at least implicitly, to consider risk transfer and funding as drivers of a securitisation transaction only and does not take into account other transaction drivers and their impact on the originator’s activities.

b) A broad focus on “securitisation 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: “traditional securitisation” and “synthetic securitisation” as described in Section 2 of EU Regulation 2017/2401.

A traditional securitisation transaction (similar to a True Sale securitisation) 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.

The difference regarding a synthetic securitisation is that credit risk from the underlying exposures is transferred, in whole or in part, through the use of credit derivatives or guarantees that serve to hedge the credit risk of the portfolio.

Operational requirements

There are detailed operational requirements that an originating credit institution 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 aforementioned requirements aim to ensure that exposures are transferred and that there are no mechanisms allowing these exposures to be returned to the originating credit institution, whereas the latter 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; thus it can be highly subjective.



Treatment of capital exposures

The treatment of capital exposures for a credit institution is defined on the exposure rather than the role played by the credit institution. Credit institutions are required to hold capital against all of their securitisation exposures, including those arising from:

- the provision of credit risk mitigating a securitisation transaction;
- investments in ABS;
- retaining a subordinated tranche;
- extending a liquidity facility;
- granting a credit enhancement and providing of implicit support to a securitisation; and
- repurchased securitisation exposures.

In summary, contrary to the prior version of the CRD IV framework where a credit institution can calculate the capital requirements for credit risk arising from securitisation exposures based upon two approaches - the standardised approach, and the Internal Ratings Based (“IRB”) approach - the amended CRD IV framework implements a hierarchy of three approaches (it is still compulsory to use the very same approach as selected by the credit institution for treating the underlying portfolio of assets) in the following order:

a) Securitisation Internal Ratings Based Approach – “SEC-IRBA”

Under the SEC-IRBA a Simplified Supervisory Formula Approach (“SSFA”) has been implemented. Key input factor of the formula is the IRB capital charge of the underlying pool which is determined by multiplying the risk-weighted exposure amounts that would be calculated (including the amount of expected and unexpected losses associated with all underlying exposures) as if the underlying exposures had not been securitised by 8% divided by the exposure

value of the underlying exposures. Furthermore, the approach includes the determination of tranche maturity and tranche thickness, which is a range between the threshold at which losses would start to be allocated to the relevant securitisation position (attachment point), and at which losses would result in a complete loss of principal (detachment point). The key input factor should be available for at least 95% of the securitised exposures. The formula also introduces a new supervisory parameter (p) which depends on tranche thickness and the calculation of the Loss Given Default (“LGD”).

The calculation of the risk-weighted exposure is subject to a minimum floor risk weight of 15%. For STS securitisations, the risk weight floor for senior securitisation positions is 10%. The maximum risk weight remains 1,250%.

Where the institution has permission to apply the IRB approach, it “is able to calculate regulatory capital requirements in relation to the underlying exposures as if these had not been securitised”.

SEC-IRBA is not permissible for a re-securitisation position.

Before credit institutions (the same applies via Solvency II for insurance companies) become exposed to the risks of securitisation exposure, they shall be able to demonstrate having a comprehensive and thorough understanding of their investments in securitised positions and having implemented formal policies and appropriate procedures.

Furthermore, credit institutions (also applicable for insurance companies through Solvency II) shall be exposed to the credit risk of securitisation exposure only if the originator, sponsor, or original lender has explicitly disclosed that it will retain, on an ongoing basis, a material net economic interest not less than 5%.



b) Securitisation Standardised Approach – “SEC-SA”

Where the SEC-IRBA may not be used because sufficient information on the underlying exposures is not available or competent authorities have precluded the use because securitisations have highly risky/complex features, the SEC-SA shall be used. Under this method the standardised approach, as described below, is used to calculate the capital requirements in relation to the underlying exposures of a securitisation “as if they had not been securitised”. SEC-SA may be used for a resecuritisation position with a risk weight floor of 100%. For securitisation positions, the range of risk weights is the same as under the SEC-IRBA. The supervisory parameter (p) is less complex as neither LGD, nor tranche thickness is included in its calculation.

c) Securitisation External Ratings Based Approach – “SEC-ERBA”

In the third method in the hierarchy, the capital requirements are calculated by applying a risk weight to a securitisation tranche based on its external rating. The standardised approach consists of calculating a risk-weighted asset amount of the exposure based on an existing table in the framework. Mapping the eligible rating agencies’ external ratings to credit-quality classes provided by the CRD IV is part of the responsibility of the EBA. The amended framework provides a separate mapping table for short-term and long-term positions, which means risk weights are determined based on a look-up table similar to the prior framework.

When the exposure is an asset, it is easily quantifiable, as it is generally 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” by applying Credit Conversion Factors.

Disclosure requirements for securitisation

As securitisation exposures form part of the risk-weighted assets, credit institutions have to disclose inter alia information regarding:

- a description of the institution’s objectives in relation to securitisation activity;
- the nature of other risks, including liquidity risk inherent in securitised assets;
- the type of risks in terms of seniority of underlying securitisation positions and in terms of assets underlying the securitisation positions assumed and retained with re-securitisation activity;
- the different roles played by the institution in the securitisation process;
- a description of the processes in place to monitor changes in the credit and market risk of securitisation exposures;
- a description of the institution’s policy governing the use of hedging and unfunded protection to mitigate the risks of retained securitisation exposures;
- the approaches to calculating risk-weighted exposure amounts that the institution follows for its securitisation activities;
- the types of vehicles that the institution, as sponsor, uses to securitise third-party exposures, as well as a list of the entities that the institution manages or advises and that invest in either the securitisation positions that the institution has securitised or in vehicles that the institution sponsors;
- a summary of the institution’s accounting policies for securitisation activities;
- the names of the External Credit Assessment Institutions used for securitisations and the types of exposure; and
- the total amount of outstanding exposures securitised by the institution.

Conclusion and outlook

The EU Regulation 2017/2401 became applicable to securitisation transactions as from 1 January 2019.

The regulation sets out additional criteria for differentiating the capital treatment of STS securitisations from that of other securitisation transactions. The additional criteria, for example, exclude transactions in which the standardised risk weights for the underlying assets exceed certain levels. This ensures that securitisations with higher-risk underlying exposures do not qualify for the same capital treatment as STS-compliant transactions. Compliance with the expanded set of STS criteria should provide additional confidence in the performance of the transactions, and, thereby, warrant a modest reduction in minimum capital requirements for STS securitisations.

Expectations of sponsors/originators are to offer a product creating trust and being less stigmatised than a non-STS securitisation.

It remains to be seen how well institutions with securitisation exposures can adapt to the new hierarchy of approaches, especially concerning the availability of necessary data/input parameters for the capital requirements calculation under the SEC-IRBA and SEC-SA.

The BCBS has issued the standard “Capital treatment for simple, transparent, and comparable short-term securitisations” on 14 May 2018 setting out additional criteria for preferential capital for credit institutions acting as Sponsor or Investor in an ABCP program, as short-term securitisations had been scoped out explicitly in the published criteria for identifying simple, transparent, and comparable securitisations. The risk weights to be applied under the SEC-ERBA are consistent with the published standard for tranches of term securitisations with short-term credit ratings. The standard also gives guidance which parameters to use when applying the SEC-IRBA.

The EBA has issued a Consultation Paper on 28 August 2018 (Draft Implementing Technical Standards amending Commission Implementing Regulation (EU) 680/2014 on supervisory reporting of institutions) with regard to securitisations to specify how the changes of the new securitisation framework can be implemented in the corresponding reporting templates. The new templates include for example the replacement of previous approaches by SEC-IRBA, SEC-SA, and SEC-ERBA, implementation of new credit quality steps, possible deductions from the exposure value of securitisation positions, as well as differentiated capital treatment for STS and certain SME securitisations.

5.3 Capital requirements for (re-)insurance companies

Since the Solvency II Directive and its delegated acts entered into force in 2016, Luxembourg securitisation vehicles have become even more attractive for insurers and re-insurers. All insurers and re-insurers have to apply the Solvency II requirements which includes the solvency capital requirements as well.

Equity-type investments – especially in the alternative sector – could be less attractive compared to debt products with the same underlying, as these could lead to a lower amount of solvency capital at the insurers' level depending on their design and features. Therefore, the use of securitisation vehicles instead of mere fund structures could be an even more attractive choice and should definitely be considered more often.

For debt instruments, e.g. securities issued by a securitisation vehicle, the question of a good external rating becomes a significant factor in determining the stress factor of an investment, and thus ultimately the amount of the solvency capital.

In a first step, it has to be elaborated whether the entity has to be considered as a “securitisation” vehicle under Solvency II or not. Although the securitisation vehicle will be established under the Luxembourg Securitisation Law, we are satisfied that the securitisation vehicle is not a “securitisation” for the purposes of Solvency II, for the reasons set out below.

Solvency II takes its definition of a securitisation from the Regulation (EUR) 2017/2401:

“Securitisation” means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics:

- a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures;
- b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.
- c) the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013 (“Specialised lending”).

A securitisation vehicle set up according to the Luxembourg Securitisation Law can be structured without tranches. Hence, it would be possible to avoid the above characteristic and therefore the securitisation vehicle should not be considered a “securitisation” under Solvency II and no “look through” should apply.

In setting up a securitisation the Articles 84 and 164 of the Commission Delegated Regulation have to be considered particularly to let the insurance investors benefit from lower solvency capital requirements:

Art. 84 Sec. 1 of the Commission Delegated Regulation states:

“The Solvency Capital Requirement shall be calculated on the basis of each of the underlying assets of collective investment undertakings and other investments packaged as funds (look-through approach).”

Although there is no regulatory or other official guidance, we believe that the Luxembourg securitisation vehicles can be structured in a way that it does not meet this definition.

To enable the securitisation vehicle’s securities to be considered as debt instruments without any “look-through” obligation, the entity necessarily needs to be none of the following:

- a) a “collective investment undertaking”;
- b) an “other investment packaged as a fund”; or
- c) a “securitisation”.

A “collective investment undertaking” is defined to be either a UCITS or an AIF. While the securitisation vehicle will clearly not constitute a UCITS, it could amount to an AIF. The definition of an AIF can in theory be met by a Luxembourg securitisation vehicle; however under Article 2(3)(g) of the AIFMD, a “securitisation special purpose entity” will not be considered as an AIF. We understand that the securitisation vehicle will be established in such a way that it meets the requisite criteria and therefore will not be an AIF and will accordingly be exempt from the scope of the AIFMD.

Although there is no guidance on the meaning of “other investment packaged as a fund”, a securitisation vehicle that is not a UCITS “fund”, or an AIF “fund”, or a “fund” cannot be in any regulatory sense an “investment” (or any other structure) packaged as a fund.

In considering the issue of a debt instrument, the requirements of Art. 84 Sec. 2 of the Commission Delegated Regulation have further to be taken into account:

“The look-through approach referred to in paragraph 1 shall also apply to the following:

- a) indirect exposures to market risk other than collective investment undertakings and investments packaged as funds;
- b) indirect exposures to underwriting risk;
- c) indirect exposures to counterparty risk.”

Art. 164 of the Commission Delegated Regulation names the sub-modules of the market risk module:

- a) the interest rate risk sub-module;
- b) the equity risk sub-module;
- c) the property risk sub-module;
- d) the spread risk sub-module;
- e) the currency risk sub-module;
- f) the market risk concentrations sub-module.

In structuring the debt instrument, the reflection whether the instrument has an “indirect exposure to market risk” or whether it does not is important. Any link of the above-mentioned sub-modules of the market risk of the underlying portfolio to the debt instrument, leading to an “indirect exposure to market risk”, would consequently lead to a “look-through” requirement. To enable the securitisation vehicle’s securities to be considered as debt instruments without any “look-through” obligation, a set-up without direct link, 1:1 relationship of the market risk of the underlying portfolio and the debt instrument creating an indirect market risk exposure for the buyer of the debt instrument has to be created.

However, due to the ambiguity of Solvency II in general, and of Article 84 Sec. 1 in particular, especially the expression “investment packaged as a fund”, we highly recommend to give the securitisation vehicle “substance”. The Board should take appropriate management and investment decisions on behalf of the securitisation vehicle. The Board can be advised by an external service provider pursuant to a service support agreement, together with discretionary investment management agreements with a limited number of managers. The latter may also be responsible for ensuring that the securitisation vehicle has the required resources to carry out its business and to implement its investment objectives and policy.

In conclusion, we believe that a Luxembourg securitisation vehicle has become even more attractive to European insurers under Solvency II. Properly structured and with a good external rating, it ultimately leads to a lower amount of underlying required capital at the insurers’ level.



5.4 Packaged Retail and Insurance-based Investment Products (PRIIPs) regulation

General

Since 1 January 2018, the Packaged Retail and Insurance-based Investment Products (“PRIIPs”) regulation entered in force in the European Union. The Regulation requires that all “packaged” financial products sold to retail investors have a Key Information Document (“KID”).

Very limited flexibility is allowed to manufacturers for drawing up the KID as the template, the form, the narratives, and the other contents have been defined in the appendices of the RTS published in March 2017.

Information disclosed in the KID are:

- product and manufacturer’s names, code, supervisory authority;
- a comprehension alert in case of complex product;
- the investment objectives and the means to achieve it;
- the intended retail investors (or “target market”);
- the recommended holding period or product’s maturity;
- a risk indicator from 1 to 7 combining market and credit risk;
- future performance under different market conditions;
- the breakdown of the costs including transaction costs;
- the impact of the costs on the product’s future performance;
- the process to lodge a complaint;
- some explanations in case of default of the manufacturer.

Finally, the KID shall be translated in one of the official languages of the country where the PRIIP is distributed.

In the context of securitisation

Firstly, by “packaged”, the EU Regulator means financial products “where the amount repayable to the retail investor is subject to fluctuation because of exposure to reference values, or subject to the performance of one or more assets which are not directly purchased by the retail investor.[...] Financial instruments issued by special purpose vehicles that conform to the definition of PRIIPs should also fall within the scope of this Regulation²⁰.”

Secondly, by “retail” investors, PRIIPs refer to the definition under Market in Financial Instruments Directive (“MiFID”). Briefly, all non-professional investors including well-informed, semi-professional, or high net worth individuals are considered as “retail” investors by the PRIIPs Regulation.

In this context, we could see two situations where securitisation vehicles could be impacted by PRIIPs and we will distinguish the situation between direct (requirement to prepare a KID) and indirect impact (requirement to provide information).

1) Direct impact

If securities issued by securitisation vehicles are sold directly to non-professional investors in Europe, a full PRIIPs KID will be required. The KID will need to be finalised and provided to the investors before the transaction. It will also require publication on a website and monitoring. Indeed, any material changes in the KID should trigger immediate update and publication of the document.

2) Indirect impact

When a PRIIP (e.g. an investment fund) invests in securitisation vehicles, they will require cost information to draw the KID. Indeed, where the investments of a PRIIP (i.e. the fund) are not producing a KID, it will be necessary to obtain KID equivalent information for the direct investments (i.e. the securitisation vehicle). All the cost paid by the vehicle during the past year will have to be provided to the fund.

As stated above, a different situation can occur in the specific case of securitisation vehicles, therefore an assessment of potential impact of PRIIPs regime will have to be performed before selling the securities issued by the securitisation vehicles.

²⁰ Article 6 of EU Regulation 1286/2014.

5.5 AIFMD

The Alternative Investment Fund Managers Directive 2011/61/EU provides a harmonised regulatory and supervisory framework within the EU, as well as a single EU market for managers of AIF. It sets rules regarding the marketing of AIF and the substance and organisation of their managers. In Luxembourg, the AIFMD was transposed into the national Law of 12 July 2013 on alternative investment fund managers (the “AIFM Law”).

As the AIFM Law does not generally apply to “securitisation special purpose vehicles”, the question was raised as to whether Luxembourg securitisation vehicles fall within the scope of the AIFM Law and thus qualify as an AIF. The response of the CSSF has clarified this question in their Q&A on securitisations.

The issue was that the AIFM Law refers to entities whose sole purpose is to carry out a securitisation within the meaning of Article 1 (2) of Regulation (EC) No 1075/2013 of the ECB of 18 October 2013 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions, replacing Regulation (EC) No 24/2009 (ECB/2008/30). Compared to the Luxembourg Securitisation Law, this EC regulation provides a much narrower definition of securitisation.

The CSSF has published three criteria to define whether a securitisation vehicle is qualified as an AIF or not:

- 1 Securitisation vehicles falling within the definition of “securitisation special purpose entities” (*structures de*

titrisation ad hoc) within the meaning of the AIFM Law may not be considered as AIFs within the meaning of the AIFM Law, as Article 2(2)(g) of the AIFM Law provides that securitisation special purpose entities are excluded from its scope.

Securitisation special purpose entities are defined as entities whose sole object is to carry out one or more securitisation transactions within the meaning of the aforementioned ECB regulation. The latter defines “securitisation” as “a transaction or scheme whereby an asset or pool of assets is transferred to an entity that is separate from the originator and is created for or serves the purpose of the securitisation and/or the credit risk of an asset, or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitisation, and:

(a) in case of transfer of credit risk, the transfer is achieved by:

- the economic transfer of the assets being securitised to an entity separate from the originator created for or serving the purpose of the securitisation. This is accomplished by the transfer of ownership of the securitised assets from the originator or through sub-participation, or
- the use of credit derivatives, guarantees or any similar mechanism;

and

(b) where such securities, securitisation fund units, debt instruments and/or financial derivatives are issued, they do not represent the originator's payment obligations."

- 2 Whether or not they fall within the definition of securitisation special-purpose entities pursuant to the AIFM Law, securitisation vehicles that issue only debt instruments shall not qualify as AIFs. It seems that it was not the EU lawmakers' intention to qualify undertakings issuing debt instruments as AIFs.
- 3 Whether or not they fall within the definition of securitisation special-purpose entities pursuant to the AIFM Law, securitisation undertakings that are not managed in accordance with a defined investment policy pursuant to Article 4 (1)(a) of the AIFMD shall not qualify as AIFs. Subject to criteria set out in the ESMA guidelines, securitisation undertakings that issue structured products offering synthetic exposure to assets (equities, commodities or indices thereof), as well as acquire underlying assets and/or enter into swaps with the sole purpose of hedging the payment obligations arising from the issued structured products, shall not be considered to be managed in accordance with a defined investment policy.

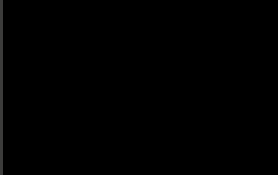
It should be noted that securitisation undertakings are required to carry out a self-assessment to determine whether they qualify as an AIF.

Consequently, Luxembourg securitisation vehicles which

- a) securitise credit risk, or
- b) issue only debt instruments, or
- c) are not managed in accordance with a defined investment policy

do not qualify as AIF.

Therefore, the vast majority of securitisation vehicles established in Luxembourg are outside the scope of the AIFM Law. In particular, the majority of the authorised Luxembourg securitisation companies established as platforms issuing structured products through many compartments do not fall within the scope of the AIFM Law. For a securitisation fund issuing only immaterial number of fund units and the residual funding via debt, in our view, it is legitimate not to consider the securitisation fund as an AIF. It is the responsibility of the securitisation fund's management company to decide whether the securitisation fund is an AIF or not.



6

Other aspects

6.1 Anti-Money Laundering obligations

The increasingly tighter regulatory requirements regarding the fight against money laundering and the financing of terrorism have become one of the recurring themes in the regulatory framework for financial centres and financial institutions in recent years. Also in 2019, with the upcoming visit of the FATF (“Financial Action Task Force”) in Luxembourg, this trend shows no sign of stopping, and risks to regulation and reputation continue to represent major concerns for a rising number of company board members.

More and more sanctions and fines are imposed for non-respect of anti-money laundering and anti-terrorist financing duties by national supervisory authorities as well as by judges. In order to regain reputation and trust, governments, regulators, and financial players worldwide have launched important initiatives to control financial systems more efficiently.

In recent years, regulations combating money laundering and the financing of terrorism – as well as preventing the financial sector from being used for such purposes – have been enlarged. In Luxembourg, this is seen with (a) the Law of 12 November 2004, modified in February 2018 to transpose the 4th EU AML Directive, (b) the CSSF Regulation N° 12-02 of 14 December 2012, (c) the CSSF/FIU Circular 17/650 issued in 2017 and addressing the tax crimes as primary offences, and (d) finally the Law of 13 January 2019 introducing the national central register of beneficial owners (so-called “RBE”). Comprehensive guidelines for the establishment of an appropriate risk-based approach, as suggested by the European authorities, were also introduced in the national regulation in June 2018 (CSSF Circular 17/661). These regulations consistently integrate 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, auditors, casinos, attorneys-at-law, estate agents, tax and financial advisors, persons selling high value goods, and providers of gambling services, including via distance communication means.

Securitisation vehicles are in scope, but only in cases where they also carry out service providers’ activities with regard to companies and trusts. All the other types of securitisation vehicles are excluded from the scope of the modified Law of 12 November 2004. In practice, Luxembourg securitisation vehicles usually do not carry out such service-provider activities, but in contrary use other service providers themselves, providing services to the securitisation vehicles.

Nevertheless, many service providers of securitisation vehicles, like domiciliation agents, paying agents, auditors etc., must comply with the AML regulations and identify the securitisation vehicles’ beneficial owners as well as analyse business connections and investigate the sources of funds. For example, in accordance with the Law of 31 May 1999, companies who have their registered offices at third-party addresses must conclude a domiciliation contract with a domiciliation agent. CSSF Circular 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 transactions and checking the names of the persons identified against blacklists.

Who are the beneficial owners of a securitisation vehicle?

Or, to put it another way, who are the natural persons who directly or indirectly own or control a securitisation vehicle? The current legislation does not provide a clear answer to this question but requires financial-sector professionals to perform and document their own analysis of the securitisation vehicle's beneficial ownership and to define the risk associated to all parties involved in the transaction.

The Law of 12 November 2004, as amended, states that the beneficial owner is a natural person "who ultimately owns or controls" the entity. Two criteria are mentioned to define the ownership and control indicators: an indicative shareholding threshold of 25% or the control via a "sufficient percentage of the shares or voting rights or ownership interest". Where no natural person could be identified using these criteria, and after having exhausted all possible means to determine them, provided there are no grounds for suspicion it is not possible to identify a beneficial owner, the beneficial owner will be "any natural person who holds the position of senior dirigeant (manager)".

Usually, securitisation vehicles are only capitalised with the required minimum capital, which is brought in by foundations, like charitable trusts or Dutch "Stichtings". Obviously, these entities are not the beneficial owners of the securitisation vehicle's assets or cash flows.

The beneficial owners of a securitisation transaction are mainly the investors providing 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. In some other cases, the originator of the securitisation transaction might also be considered as the beneficial owner as he will indirectly control and benefit from the transaction. Finally, following the definition

of beneficial owner, the board members – being senior managers – might be considered as the beneficial owners of the vehicle.

The paying agent is usually responsible for transferring 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 Luxembourg-equivalent countries.

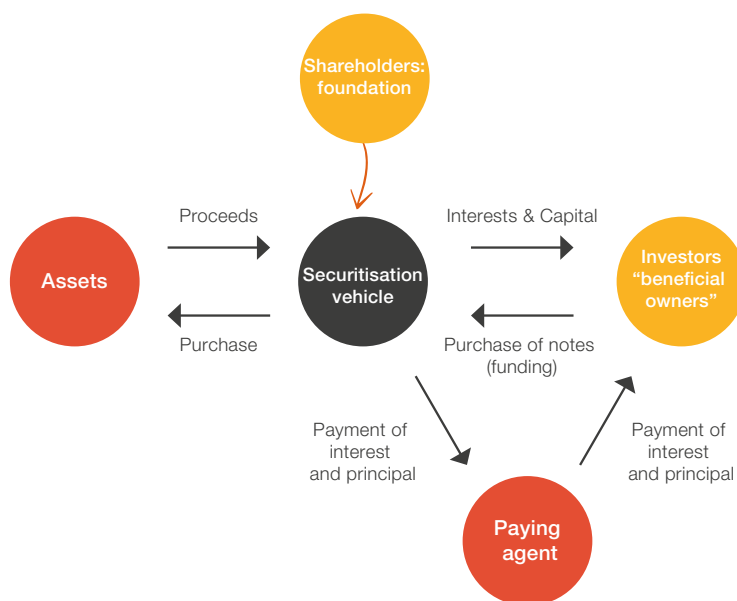
Securitisation can be a complex set-up involving several participants: arranger, originator, securitisation vehicle, custodian, paying agent, etc. The analysis of the role and the risk associated to each participant must be properly documented and kept up-to-date on a regular basis in order to ensure that the requirements to know the beneficial owner, if any, can be met by the service providers involved. Consequently, typical Luxembourg service providers will at least identify the beneficial owner.

Additionally, the 4th EU AML Directive requires more transparency on the beneficial ownership of legal persons and arrangements. Today, corporate and legal entities already need to hold accurate and up-to-date information on their beneficial owners. With the 4th EU AML Directive, the transparency in the identification of the beneficial owners increased as a national central register of beneficial owners, the RBE, was created in Luxembourg via the Law of 13 January 2019. All corporate and other legal entities including the securitisation vehicles incorporated in Luxembourg are required to upload information on their beneficial owners in this national central register. The filing is to be done electronically via the website of the LBR ("Luxembourg Business Register") and can be done in French, German, or Luxembourgish. Typically

service providers such as the domiciliation agents of the securitisation vehicle will have to provide the required information to the RBE. The entities, their beneficial owners or representatives have up to 6 months after the entry into force of the Law to be compliant (i.e. 1 September 2019). It is the responsibility of the affected entities themselves, their beneficial owners, or any of their representatives to register the beneficial owners of the entities and provide required information: first and last names, nationalities, date and place of birth, country of residence, address, identification number, nature and extent of the beneficial interests held.

The above listed information in the RBE is accessible to anyone without specific conditions (e.g. legitimate interest or prior authorisation by a competent organ), except the address and identification number which are only available to national authorities.

Figure 35: Cash flow of a typical securitisation transaction



6.2 Distribution and listing

6.2.1 Listing in Luxembourg



The Luxembourg Stock Exchange (“LuxSE”) operates two markets for listing of securities issued by securitisation vehicles: (1) the EU-regulated market, the “Bourse de Luxembourg” market, and (2) the exchange-regulated market “Euro MTF”.

For issuers who are looking for a sound regulatory framework but do not require a European passport as defined in the Prospectus Directive²¹, the exchange-regulated market Euro MTF often meets their financing needs. This market is outside the scope of the Prospectus Directive and the Transparency Law²², both leading to specific disclosure requirements for the issuing entity. There are no restrictions on the type of securities to be listed on both markets. However, issuers will need to comply with different requirements according to the chosen market.

Official listing requirements are applicable to both markets. For issuers looking for visibility and for whom admission to trading is not prerequisite, the LuxSE offers the possibility to admit securities to its official list without admission to trading. These securities will be displayed on the LuxSE Securities Official List (“LuxSE SOL”), a dedicated section of the entire LuxSE’s official list.

Furthermore, disclosures required in the annual accounts will differ. Entities having securities listed on an EU-regulated market will always have to publish a management report and a corporate governance statement. While consolidated accounts (normally not the case for securitisation vehicles) would have to be drawn up under IFRS, stand-alone accounts can still be published under local GAAP²³. Nevertheless, they should be accompanied by a cash flow statement.

Figure 36: Common features of Bourse de Luxembourg and Euro MTF markets

Same trading platform (UTP from Euronext)		Identical listing & maintenance fees for both markets	No restriction to market access (any type of investors, any size)
 Listing on the Bourse de Luxembourg	Prospectus must meet the Law of 10 July 2005, as amended (Prospectus Law) implementing the Prospectus directive; Prospectus regulation as from July 2019;	 Listing on the Euro MTF	Compliance with European prospectus and transparency regulations not required;
	The Law of 11 January 2008 on Transparency obligations and the Law of 23 July 2016 on Audit transposing the transparency and audit directives respectively;		Admission to trading and reporting requirements according to the Rules & Regulation of the stock exchange only;
	The CSSF is in charge of prospectus approval;		Financial reporting in line with IFRS or local GAAP;
	Financial Statements of the issuer must comply with IFRS accounting standards or equivalent (for non-EU issuer); and		The Luxembourg Stock Exchange is solely in charge of prospectus approval; and
	Listing on this market grants eligibility for/access to the European Passport for the admission to trading of the securities in other EU member states.		No European passporting for the documentation.

²¹ Directive 2004/109/EC, as amended and superseded by Prospectus Regulation 2017/1129.

²² Luxembourg Transparency Law of 11 January 2008, as amended.

²³ Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC.

6.2.2 Prospectus disclosure obligations

Once a securitisation transaction has been structured, questions regarding the distribution of the securities issued may arise. 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 and how many countries the securities should be sold, and whether or not a listing on a regulated market is demanded).

The requirements governing the publication of a prospectus when securities (debt and equity securities) are offered to the public or admitted to trading, are laid down in the Prospectus Directive and transposed into Luxembourg legislation by the Law of 10 July 2005 on the prospectus of securities ("Prospectus Law"), both having been amended from time to time.

The Prospectus Directive responds to the following main objectives:

- defining and harmonising the 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;
- improving the quality of information provided to investors by companies wishing to raise capital in the EU;
- lowering the cost of capital;
- setting out the conditions to be met by issuers when offering securities to the public in the EU;
- specifying minimum disclosure requirements for different products and according the type of targeted investors;
- ensuring that interested parties have access to prospectuses.

The Prospectus Law differentiates three different prospectus regimes: a "public offer of securities" and/or an "admission of the securities to trading on an EU-regulated market", and "private placements". Before having a deeper look at the regimes, "public offering" should be further defined. Under the Prospectus Law, any communication to persons in any form and by any means presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities will constitute a "public offer" and, consequently, require a prospectus to be published. The same applies to securities admitted to listing on an EU-regulated market as well as placements of securities through one financial intermediary.

However, according to Article 5 (2), the obligation to publish a prospectus does not have to be met for the following distribution forms, which should be considered as "private placements":

- offers to qualified investors only; and/or
- offers to less than 150 individuals or legal entities per EU or EEA Member State other than qualified investors; and/or
- offers to investors who subscribe at least EUR 100,000 per investor; and/or
- offers where each security has a nominal value of at least EUR 100,000; and/or
- offers where the total nominal amount issued is less than EUR 100,000 calculated over a period of 12 months.

24 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

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 Prospectus Law only states that all material information should be provided to them. However, it does not explicitly 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 entity 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. The Prospectus Law distinguishes three regimes:

- i The first regime applies to “public offers” of securities within the scope of the Prospectus Directive and offering to the public or admission to trading on an EU-regulated market by corporate issuers, which, in Luxembourg, is the Bourse de Luxembourg market segment of the LuxSE. In this case, the CSSF is the competent authority to ensure that the provisions of the Prospectus Law are enforced, i.e. that the prospectuses and any related supplement to them are approved where Luxembourg is the issuer’s home Member State. The filings of documents and notices are also within the supervision 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”) as home Member State authority.

The prospectus must include all the necessary information on the particular nature of the issuer and the securities offered to the public, according to the Commission Regulation (EC) No 809/2004 as regard to the information contained in prospectuses, format incorporation by reference and publication of such

prospectuses. This enables investors to make informed assessments of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, as well as of the rights attaching to such securities. The information shall be provided in a format that is 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 (securities issued with a minimum denomination of EUR 100,000 deemed to be issued to “sophisticated” or “professional investors”). In the case of a simplified prospectus, which is described below, a summary is not required.

- ii The second regime applies to “offering of securities and admissions to trading outside the scope of the Prospectus Directive.” In case of public offering of these securities, simplified prospectuses have to be drawn up (however with the same private placement exceptions as above described). These securities mainly include: (a) securities issued by EU Member States, their regional or local authorities or related entities; (b) “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 (c) 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 approving of simplified prospectuses and any related supplement to the prospectuses. Simplified prospectuses, however, do not benefit from the European passport.

In case of trading on a Luxembourg regulated market, the LuxSE is the competent authority for approving of simplified prospectuses, as well as admitting these securities for trading on an EU-regulated market that it operates. The simplified prospectus must also include all information necessary to enable investors to make an informed assessment of their investments, e.g. annual financial statements and the corporate structure details.

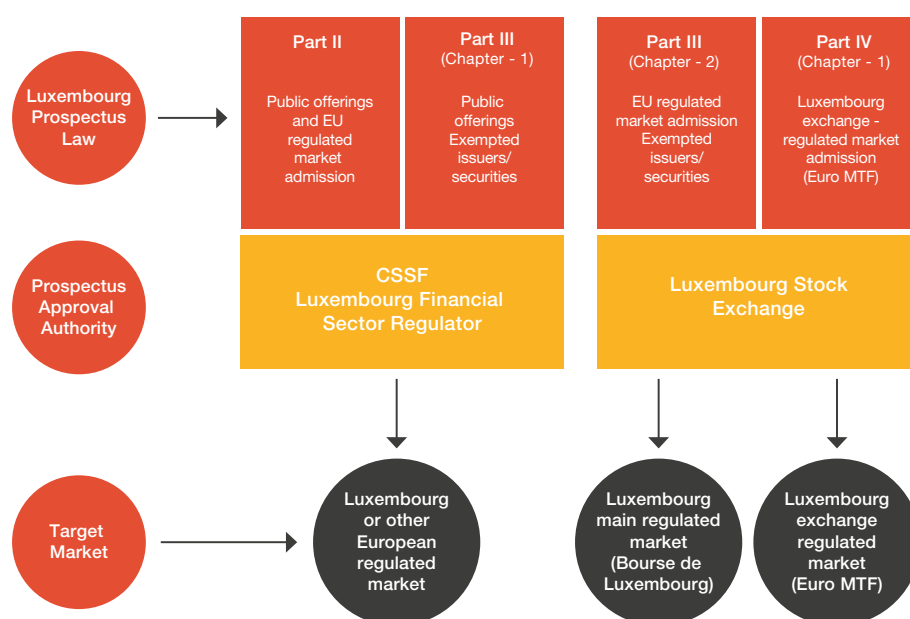
- iii The third regime deals with admitting securities for trading on a market not set out on the list of EU-regulated markets published by the EC. For admission to the Euro MTF market, the LuxSE is the competent authority and its Rules and Regulations apply. However, they may not be more restrictive than those applicable on an EU-regulated market. For example, an issuer would have to provide a documentation containing the characteristics of the notes (maturity, rank of subordination, interests/ coupons, description of the activity of the issuer etc.).

Regulation (EU) 2017/1129 of 14 June 2017 significantly simplifies the above rules in order to coordinate and harmonise regulations in each EU countries.

The new Regulation will supersede the Prospective Directive and national transposition laws and will be directly applicable in the EU Member States in full as from 21 July 2019, although a few provisions have become effective earlier.

The purpose of this Regulation is mainly to simplify the prospectus' format and content in order to make it easier and cheaper for smaller companies to access capital while maintaining a strong level of investor protection and also offering new possibilities for companies to diversify their financing. The old regime provides for a number of exemptions from the obligation to publish a prospectus for public offers which remain largely the same but have been extended. In addition, some of the existing exemptions of preparing a prospectus for admission of securities to trading on an EU-regulated market have been partly revised or extended.

Figure 37: Prospectus Law requirements



6.3 Responsibilities and liabilities of the Board of Directors

The Luxembourg Securitisation Law does not define specific duties or responsibilities for the members of the Board of Directors (or Board of Managers for an SARL) of the securitisation companies or management companies of securitisation funds. Therefore, their responsibilities are governed by general rules, mostly defined by commercial company law, commercial and civil law and, of course, the statutes of the relevant companies.

The core responsibility of directors is to take any action necessary or useful to realise corporate objectives, within the powers vested by law and by the individual company's Articles of incorporation. In addition, the company will be represented relating to 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. Some tasks may also be delegated to other transaction parties, e.g. the paying agent. Regarding transaction management, the directors usually approve and sign all transaction documents. Thus, they need to understand the structure, the expected cash flows, and the underlying transaction documents in order to ensure that the securitisation vehicle's operations comply with the transaction documents. To ensure this, they liaise closely with the arranger, trustees, and lawyers involved. The Board of Directors is also responsible for the proper preparation of the annual accounts and any other reporting obligations (BCL, CSSF, interim accounts). In particular, this comprises an appropriate assessment of the valuation of the underlying assets. To prepare the company's annual accounts, the directors need to have a broad knowledge

of the different accounting principles used, like IFRS and LuxGAAP, but sometimes also US GAAP or UK GAAP.

As such, the directors are exposed to several liabilities. They are jointly liable for all damages adversely affecting the company and third parties resulting from breaching the commercial company law or the statutes. In addition, directors are liable for all possible avoidable administrative mistakes and/or failures made by management.

Of course, the Board of Directors can delegate certain tasks like accounting, asset servicing or valuation to third parties. However, the responsibility always remains with the directors.

Similarly, the independent auditor cannot limit his work to the level of the legal entity but needs to look beyond in cases where third party information is used to prepare significant elements of the company's annual accounts. Specifically, the International Standards on Auditing ("ISA") lay out the auditor's responsibilities for audits of annual accounts for which information provided by so-called "service organisations" (ISA 402) and "management's experts" (ISA 500) is used.

Therefore, both the auditor and the Board of Directors have a genuine interest and duty to gain sufficient understanding of and familiarity with the information obtained from third parties. This may include obtaining controls reports on the third party's processes (often so-called ISAE 3402 reports), procedure manuals, internal audit reports, on-site visits etc. Furthermore, plausibility checks on the appropriateness of the information received should be made, e.g. back-testing and variation analysis of third-party valuations.

6.4 Audit committee

Under the EU Audit legislation, each Public Interest Entity²⁵ shall establish an audit committee. Based on the Article 52 (5c) of the Law of 23 July 2016 concerning the audit profession, any PIE whose sole business is to act as an issuer of asset backed securities²⁶ are exempted from the requirement to establish an audit committee. However, if the exemption is used, the securitisation vehicle shall explain to the public the reasons why it considers that it is not appropriate for it to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee. The law does not describe in detail where or to whom the securitisation vehicle shall make this disclosure. We recommend appropriate disclosure in the management report or in the corporate governance statement. Alternatively, the disclosure to the public can be made through other means such as publication in the RCSL or through the website of the securitisation vehicle. Such disclosure shall not be done through the notes to the annual accounts.

Below is a summary of the measures that relate to the role and responsibilities of audit committees of EU public interest entities:

- inform the Board of Directors of the PIE about the outcome of the statutory audit and explain its contribution to the integrity of the financial statements;
- monitor the financial reporting process;
- monitor the effectiveness of the internal quality control and risk management systems;
- monitor the process of the audit of statutory financial statements, mainly covering the findings and conclusions;
- oversee the statutory auditor's compliance with additional reporting requirements in the audit report and the report to the audit committee;
- pre-approve permissible non-audit services ("NAS") following an assessment of the threats to independence and the safeguards that the statutory auditor will apply to mitigate or eliminate those threats;
- being responsible for the procedure for the selection of the statutory auditor or audit firm.

²⁵ For definition of PIE, see section 3.4.2.2.

²⁶ Asset backed securities as defined in point 5 of Article 2 of Commission Regulation (EC) No 809/2004 means securities which: (a) represent an interest in assets, including any rights intended to assure servicing, or the receipt or timeliness of receipts by holders of assets of amounts payable there under; or (b) are secured by assets and the terms of which provide for payments which relate to payments or reasonable projections of payments calculated by reference to identified or identifiable assets.



6.5 Islamic Finance

One application for Luxembourg securitisation vehicles is their use within Islamic Finance transactions.

Luxembourg is active in Islamic Finance since 1978: since then, Islamic banks and insurance companies have been incorporated in Luxembourg, the BCL became member of the Islamic Financial Services Board and the Luxembourg Stock exchange was the first European stock exchange to list Sukuk (often referred to as Islamic bonds). Most leading financial players in Luxembourg have now specialised teams in Islamic Finance.

Islamic Finance products follow the characteristics of being asset-based or asset-backed. As such, an asset-backed security or securitisation vehicle seems to be the natural fit for structuring Islamic Finance transactions. However, Islamic Finance does not allow for investments into interest-bearing (“*riba*”) products, speculation, or investments in certain activities. Furthermore, the security issued shall also not be interest-bearing but based on a participation of business risk.

The former depends on the type of asset acquired (they need to be Shariah-compliant) while the latter is usually resolved by giving ownership rights to investors and/or the issuance of Sukuk. Since the Luxembourg Securitisation Law is not restrictive on the type of assumed assets and risks, it is easily possible to securitise “real” assets other than interest-bearing assets. Furthermore, the

Securitisation Law provides high flexibility with regard to the type of securities issued which may be an equity instrument or Sukuk.

Sukuk are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions (“AAOIFI”) as: “certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs, and services or (in the ownership of) the assets of particular projects or special investment activities”, i.e. a kind of asset-backed security. However, they do not simply represent a securitisation vehicle’s debt obligation but ownerships in stakes in well-defined assets. Their value directly depends on the market value of the underlying assets including a participation in potential losses. The link to the securitised assets is thus more direct than for a classic securitisation transaction.

As such, Islamic Finance under the Luxembourg Securitisation Law can be a powerful financing and investment tool, not only for Muslim investors but also for the non-Muslim world. Furthermore, Islamic Finance is often associated to a more sustainable way of financing, especially after the financial crisis – and as such, it represents an interesting symbiosis with securitisation.



6.6 Securitisation and the Luxembourg toolbox

As mentioned in section 1.3, in the Luxembourg market, some securitisation transactions are not carried out through securitisation vehicles (company or fund) under the Law of 22 March 2004 but through or in combination with other types of vehicles. The main ones are the following:

- Undertaking for Collective Investment (“UCIs”) Part II;
- Specialised Investment Fund (“SIF”);
- Société d’Investissement en Capital à Risque (“SICAR”);
- Reserved Alternative Investment Fund (“RAIF”).

The possibility to use other types of structures (instead of or in combination with a securitisation vehicle) provides Luxembourg with a fertile environment for product development and gives managers the option to choose between a fund type product and products outside the fund regimes or to combine both.

The following schedule summarises the main characteristics of some of the other types of structures used in Luxembourg.

	Securitisation vehicle	UCI Part II	SIF	SICAR	RAIF
Background	<p>Highly flexible, mainly unregulated alternative investment vehicle transforming assets or risks into transferable securities</p> <p>Governed by the Law of 22 March 2004 ("Securitisation Law")</p>	<p>The classic regulated alternative investment fund publicly distributed in Luxembourg</p> <p>Governed by «Part II» of the Law of 17 December 2010 ("Fund Law")</p>	<p>Regulated and flexible multipurpose investment fund regime for institutional investors</p> <p>Governed by Law of 13 February 2007 ("SIF Law"), split in two sections (general provisions and those applicable to AIFs only)</p>	<p>Private and venture capital investment vehicle exclusively dedicated to investments in risk capital</p> <p>Governed by the Law of 15 June 2004 ("SICAR Law"), split in two sections (general provisions and those applicable to AIFs only)</p>	<p>Very flexible, multipurpose alternative investment fund that can be marketed quickly and is not (directly) supervised by the CSSF</p> <p>Governed by the Law of 23 July 2016 ("RAIF Law")</p> <p>Replicates many features of Luxembourg SIF and SICAR regimes without requiring CSSF approval before its launch (short time-to-market)</p>
Legal form	<p>Securitisation Company, in the form of SA, Sarl, SCA or SCopSA</p> <p>Securitisation Fund, in the form of FCP or as fiduciary estate and managed by a management company</p> <p>Segregated sub-funds/ compartments possible</p>	<p>Fonds Commun de Placement (FCP)</p> <p>Société d'Investissement à Capital Variable (SICAV), in the form of a SA</p> <p>Société d'Investissement à Capital Fixe (SICAF), in the form of SA, Sarl, SCA, SCS or SCSp</p> <p>Segregated sub-funds/ compartments possible</p>	<p>FCP</p> <p>SICAV/SICAF, in the form of SA, Sarl, SCA, SCS, SCSp or SCopSA</p> <p>Segregated sub-funds/ compartments possible</p>	<p>Partnership (SCS or SCSp) or corporation (SA, Sarl, SCA or SCopSA)</p> <p>Segregated sub-funds/ compartments possible</p>	<p>FCP</p> <p>SICAV/SICAF, in the form of SA, Sarl, SCA, SCS, SCSp or SCopSA</p> <p>Segregated sub-funds/ compartments possible</p>
Minimum capital requirements	<p>Securitisation Company: depending on legal form (SA/SCA: EUR 30k, Sarl: EUR 12k, SCopSA: none)</p> <p>Securitisation Fund: none (but for management company depending on legal form)</p>	<p>EUR 1.25 million to be reached within six months of authorisation</p>	<p>EUR 1.25 million to be reached within twelve months of authorisation</p>	<p>EUR 1.0 million to be reached within twelve months of authorisation</p>	<p>EUR 1.25 million to be reached within twelve months after set-up</p>
Supervision	<p>No supervision by CSSF (except if continuously issuing securities to the public)</p> <p>Luxembourg Securitisation Vehicles do normally not qualify as AIF (see CSSF FAQ)</p>	<p>Supervised by the CSSF</p> <p>Qualify as AIF as per Law of 12 July 2013 ("AIFM Law") and require an authorised Alternative Investment Fund Manager (AIFM)</p>	<p>Supervised by the CSSF</p> <p>Most SIFs qualify as AIF and require an authorised AIFM</p>	<p>Supervised by the CSSF</p> <p>Some SICARs qualify as AIFs and require an authorised AIFM</p>	<p>RAIF itself not supervised by CSSF but has to be managed by an authorised AIFM</p> <p>All RAIF qualify as AIFs and require an external authorised AIFM</p>
Investment restrictions	<p>No restriction of eligible investments (risks linked to all kind of assets)</p> <p>No risk diversification requirement</p> <p>No restriction of investor types</p>	<p>No restriction of eligible investments (but prior approval of investment objective and strategy by CSSF)</p> <p>Some risk diversification required (max. 20% of NAV per investment)</p> <p>No restriction of investor types</p>	<p>No restriction of eligible investments</p> <p>Some risk diversification required (max. 30% of NAV per investment)</p> <p>Well-informed investors only, i.e. institutional, professional investors or high-net-worth individuals</p>	<p>Investments restricted to risk capital only</p> <p>No risk diversification requirement</p> <p>Well-informed investors only</p>	<p>No restriction of eligible investments</p> <p>Some risk diversification required similar to SIF, except if exclusively invested in risk capital (no diversification required)</p> <p>Well-informed investors only</p>

	Securitisation vehicle	UCI Part II	SIF	SICAR	RAIF
Valuation of assets	Securitisation Company: at (i) cost less impairment, (ii) lower of cost or market, or (iii) fair value option Securitisation Fund: at realisable value estimated in good faith (if not provided for differently in management regulations/constitutive documents)	At realisable value estimated in good faith (if not provided for differently in management regulations/constitutive documents)	At fair value (if not provided for differently in management regulations/constitutive documents)	At fair value (to be determined according to rules in constitutive documents)	At fair value (if not provided for differently in management regulations/constitutive documents)
Tax status	Securitisation Companies: fully taxable while exempt from net wealth tax (except for minimum net wealth tax). In addition, distributions to investors/creditors are fully tax deductible, i.e. reducing the tax base Securitisation Fund: tax-exempt from direct taxes (income and net wealth tax) Not subject to subscription tax Subject to VAT but exemption on management services	Tax-exempt from direct taxes (income and net wealth tax) Subscription tax (<i>taxe d'abonnement</i>) of 0.01% or 0.05% of NAV p.a. Subject to VAT but exemption on management services	Tax-exempt from direct taxes (income and net wealth tax) Subscription tax of 0.01% of NAV p.a. Subject to VAT but exemption on management services	Partnerships are Luxembourg tax transparent, i.e. no taxation at the level of the Luxembourg partnership Corporate legal forms in general fully taxable while exempt from net wealth tax (except for minimum net wealth tax). In addition, tax exemption for income (including interest) from investments in risk bearing capital. All other income is subject to income tax. Not subject to subscription tax Subject to VAT but exemption on management services	Tax-exempt from direct taxes (income and net wealth tax) like a SIF as long as not invested exclusively in risk capital. In that case, taxation like SICAR and subject to the minimum net wealth tax. Subscription tax of 0.01% of NAV p.a.; exempt if taxed like SICAR Subject to VAT but exemption on management services
Treaty status	Securitisation Company: may have access to several Luxembourg DTT Securitisation Fund: generally have no access to DTT	FCP generally have no access to DTT SICAVs and SICAFs may have access to several Luxembourg DTT	FCP generally have no access to DTT SICAVs and SICAFs may have access to several Luxembourg DTT	Partnerships generally have no access to DTT SICARs in corporate form may have access to several Luxembourg DTT	RAIFs under SICAR tax regime and in corporate form may have access to several Luxembourg DTT FCP and partnerships generally have no access to DTT SICAVs and SICAFs (non-SICAR regime) may have access to several Luxembourg DTT
Withholding tax	Distributions from an SV are not subject to Luxembourg WHT	Distributions from a UCI Part II are not subject to Luxembourg WHT	Distributions from a SIF are not subject to Luxembourg WHT	Distributions from a SICAR are not subject to Luxembourg WHT	Distributions from a RAIF are not subject to Luxembourg WHT

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Glossary

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 him/herself. Thus, it is no longer possible to clearly identify the cash flow collected on behalf of the SV. 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 dwellings, 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 with multiple originators. Conduits are mostly used in cases 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)	If there are predefined credit events that indicate credit default by a reference obligor, a 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 compensation to the other.
Credit enhancement	General term for measures taken by the originator in a securitisation structure to enhance the securitised instrument's security, credit or rating. These measures include 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 a note.
Credit enhancer	A party who 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 their payment obligations or the cash flow produced by the pool of assets is less than the amount(s) contractually required because of defaults by the underlying obligors.
Default	A failure by one party to a contractual agreement to live up to their 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 SV to serve as cash collateral.
Derecognition	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 SV. 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 corporate restructuring.
Excess spread	The excess of the proceeds inherent in the SV's asset portfolio, 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 be fully paid back. However, the expected maturity is not the legal final maturity, as the transaction's rating is not based on repayment by the expected maturity.
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	When the risks in the SV's asset portfolio 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	The securitisation of receivables which only arise in future periods.
Guaranteed investment contract	A contract in which a particular rate of return on investments is guaranteed.
Issuer	Within the framework of securitisations, the issuer is the SV 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 Baa3 or higher.
Junior bonds	Bonds that rank below senior bonds.
Legal final maturity	The final maturity by which a security must be repaid to avoid the contractual obligation defaulting. Typically, in securitisation transactions, the legal maturity is set at a few months after the expected maturity, to allow for delinquent assets to pay off and to avoid contractual default which can lead to the 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 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 the originator of the SV to meet the short-term funding gaps and pay off its securities. Liquidity facilities can sometimes be substantial and the only way to redeem securities – for example, in the 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 in priority below senior bonds, but above junior bonds.
Mortgage-Backed Securities (MBS)	Securities backed by cash flow resulting from mortgage loans. MBSs can be divided into residential mortgage-backed securities and commercial mortgage-backed securities.
Non-petition undertaking	A 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 may, for example, have 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 security's issuance to prospective investors.
Originator	The entity assigning assets in a securitisation transaction.
Originator advance	A liquidity facility provided by an originator to a securitisation transaction, whereby the originator pays the expected collections of one or more months 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 SV owned by a charitable trust or a "Stichting". Such a company is often used to avoid consolidating the SV with any other entity.
Over-collateralisation	A type of credit enhancement in a securitisation transaction where the originator transfers additional collateral to the SV to serve as security in the event of delinquencies, etc.
Pass through	A special payment method whereby the payments made by the SV to the investors take place in the same time periods and are subject to the same fluctuations as the receivables. This means that the cash flow collected every month is 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 whereby the payments made by the SV to the investors take place according to a predetermined pattern and maturity, and do not reflect the payback behaviour of the receivables. During the intervening periods, the SV reinvests the receivables, mainly in passive and predefined investments.
Pfandbrief	A German traditional secondary market mortgage product whereby 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 SV can pass through the prepaid amounts to investors, thus resulting in earlier payment of principal than expected and reduced income over time. Alternatively, if the SV reinvests the prepayments, the reinvestment's rate of return will be lower than that 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 protection seller is 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 SV 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 type 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 Securitisation 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 SV have high or the highest claim against the SV.
Sequential payment structure	A payment structure whereby the cash flow collected by the SV is paid in sequence to the various classes. This means the cash flow is first used for the full payment to the investors of the most senior class, and then for the full payment of the second class, and so on.
Servicer	The entity that collects principal and interest payments from obligors and administers the portfolio after the transaction has closed. It is very common in securitisation transactions for the originators to act as servicers, although this is not always the case. See also “backup servicer”.
Special Purpose Vehicle (SPV)	<p>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. Therefore, the investors have acquired nothing but the specific assets. The vehicle holds no other assets and has no other obligations.</p> <p>In the context of this brochure, we rather use the term “Securitisation vehicle” (SV) to illustrate that we discuss a SPV involved in a securitisation transaction.</p>
Structural credit enhancement	A type of credit enhancement. It involves creating senior and junior securities, thereby enhancing the credit rating of the senior securities.
Subordination	The technique of subordinating the payment rights of investors and creditors 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 SV, 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	An entity that is not subject to tax itself in principle. 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 a bank letter of credit.
Tranche	A piece, fragment or slice of a deal or structured financing. The risks distributed on different tranches concerning losses, sequential payment of the cash flow, etc. are different. This is 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 Securitisation 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 who commits to purchasing all or part of a securities issuance at a specified price.

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How we can help

We consider one of our roles to be a key driver in promoting a better understanding of the securitisation and structured-finance industry, emphasising both the benefits and the potential pitfalls, as well as developing ideas for the future direction of the industry.

To meet this challenge, PwC Luxembourg is part of the Global Structured Finance Group (SFG), which is composed of experts and professionals with extensive knowledge of securitisation and structured finance in all the main jurisdictions around the world. Many PwC professionals across Europe, the US and Asia provide clients with advice, in-depth market insight and pre-eminent transaction support in securitisation and structured-finance deals.

We provide services in the following areas:

Audit services

Our global presence allows us to provide all audit services for special purpose entities used for securitisations and structured finance transactions.

Tax strategies and structuring

We can provide tax advice in connection with all aspects of your securitisation, from deal structuring to implementation and monitoring. Through our network of securitisation tax specialists within PwC's global network, we are able to deliver quality tax advice in all major territories. We ensure our clients get answers with respect to tax opinions and tax advice relating to securitisations quickly.

Accounting and regulatory advice

We provide advice on the accounting treatment of securitisation and structured finance structures under IFRS & LuxGAAP and other accounting frameworks. We can help you comply with applicable regulations through regulatory advice and guidance on the latest developments in accounting and regulatory rules and their impact on structures.

Education & training

Provided through PwC's Academy, we run tailored training courses to educate and train clients new to the securitisation and structured-finance market.



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Should you have any questions, please do not hesitate to contact us:

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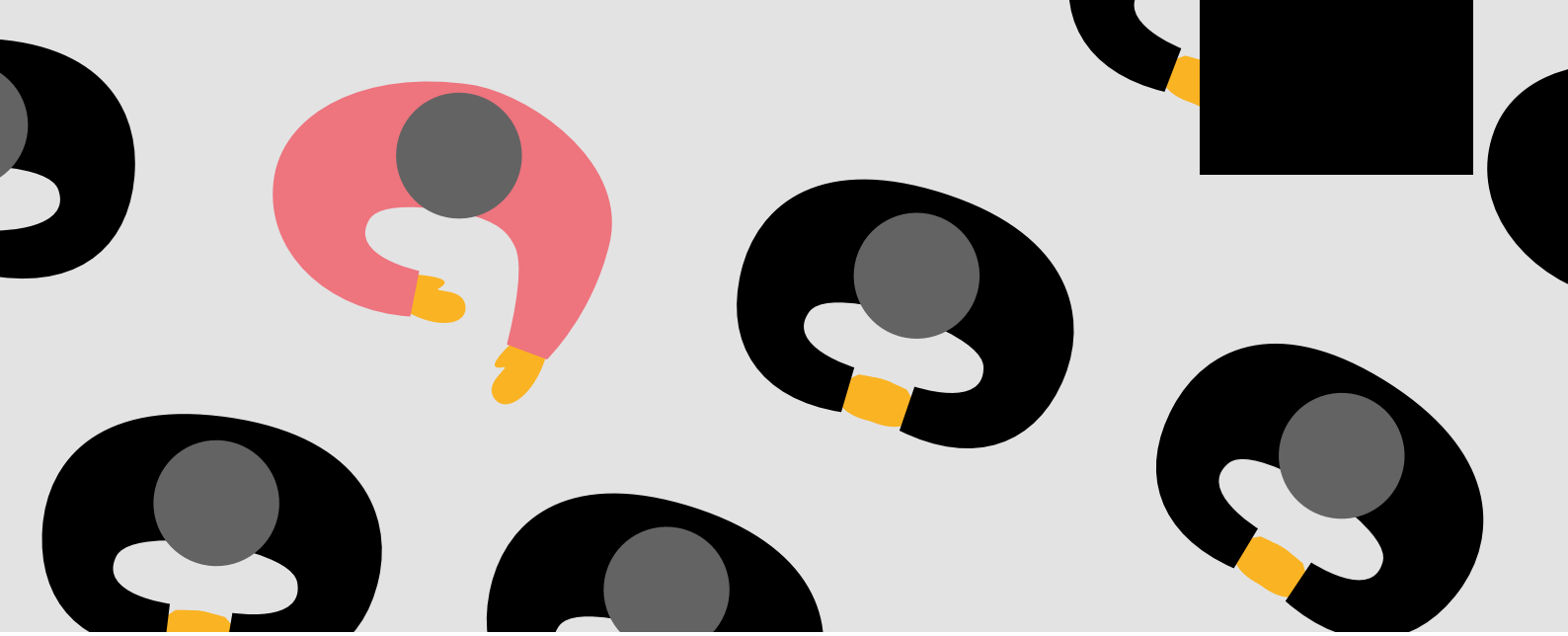
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PwC Luxembourg (www.pwc.lu) is the largest professional services firm in Luxembourg with 2,870 people employed from 76 different countries. PwC Luxembourg provides audit, tax and advisory services including management consulting, transaction, financing and regulatory advice. The firm provides advice to a wide variety of clients from local and middle market entrepreneurs to large multinational companies operating from Luxembourg and the Greater Region. The firm helps its clients create the value they are looking for by contributing to the smooth operation of the capital markets and providing advice through an industry-focused approach.

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 158 countries with over 250,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com and www.pwc.lu.

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