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Securitisation in Luxembourg

Alex Schmitt and Laurent Lazard
Bonn Schmitt Steichen

Securitisation may be described as the process of converting receivables or other assets that are not readily marketable into securities that can be placed and traded on the capital markets. The issued securities are backed or collateralised by the pool of assets or claims, which are transferred to a separate entity, known as a special purpose vehicle (SPV), which is usually the issuer of the securities. Virtually every asset capable of generating cash flow can be securitised.

While conventional securitisations (ie, repackagings) require the transfer of assets, which may sometimes be difficult for legal, regulatory or tax reasons, synthetic securitisation allows the maintenance of the securitised assets on the balance sheet while transferring the credit risk to the investors by means of a credit derivative (eg, a credit default swap). Synthetic securitisations are increasingly in demand as many banks wish to pursue credit risk management but are not necessarily interested in true sale funding.

By segregating the credit risk of the originator of the securitised assets from that of the SPV, securitisation can result in an improved balance sheet for the originator, whereby financial ratios are improved and, as the case may be, capital adequacy requirements can be met. In addition, securitisation is a unique tool allowing the raising of cheaper or longer-term finance.

Securitisations are also attractive for investors because they can be customised to create the level of exposure that fits into their specific risk appetite and regulatory constraints.

A flexible and non-intrusive framework

The Securitisation Law of March 22 2004 has been designed to meet the expectations of the market by creating a dedicated yet flexible legal environment

in which the market can pick and choose the features that it wants to apply to each individual structure.

The law provides for added flexibility in structuring a securitisation - for example, through the use of independent compartments and tranching, or through the wide contractual freedom that is left to the arrangers and investors in the design of the management regulations, the insertion of a security trustee or a collection agent in the management structure and the definition of their powers.

The law is purely enabling. It does not purport to affect existing securitisations based on a special purpose company, but contains an opt-in provision. Existing securitisations and repackagings may still be used under the same conditions, provided there is no continuous issuance of securities to the public. If such a special purpose company engages in the continuous issuance of securities to the public, opt-in is advisable (otherwise the company will be subject to regulation as a credit institution under the EU Banking Directive, which entails much more stringent consequences).

Additional tax benefits

The tax environment retains all its traditionally attractive features, namely:

- moderate tax pressure;
- no thin capitalisation or debt/equity ratio for the Luxembourg SPV; and
- an extended network of treaties to avoid double taxation if the company structure is chosen.

These features remain available to securitisation structures that the arrangers choose to set up under the law. In addition, those structures will enjoy further tax advantages such as:

- the exemption of management fees from value added tax;
- a wealth tax exemption;
- a fixed capital contribution duty (maximum €1,250); and
- an investment fund-type income tax exemption, if the fund structure is chosen.

No added regulatory supervision

No regulatory burden is associated with these new opportunities. The law draws a clear line between those vehicles that engage in the continuous issuance of securities to the public and other vehicles.

Only those vehicles that continuously issue securities to the public are subject to prior authorisation and supervision by the *Commission de Surveillance du Secteur Financier* (CSSF), the financial sector regulator. Regulation of securitisation in Luxembourg is therefore kept to a minimum.

In all other cases, including a one-off issuance of securities to the public and the continuous issuance of securities not available to the public, the vehicle may enjoy the law's benefits to their fullest extent without any authorisation or supervision by the CSSF.

Securitisable risks

The law has a broad scope. Almost any predictable stream of income or risk may be securitised. Securitisation is envisaged as the transfer of a risk rather than the mere transfer of a monetary claim or asset. The securitisable risk may be attached to assets of any nature or obligations or activities of third parties regardless of the way in which the vehicle bears such risk (eg, true sale, guarantee, swap or any form of contractual obligation). Conventional securitisations and more recent forms of securitisation (eg, synthetic or whole business securitisations) fall squarely under the law. It also leaves ample room for the design of new products in this area.

Claims premised on an existing or future contract may also be assigned as long as they may be sufficiently identified at the time they arise or at any other time defined by the parties.

There is no risk diversification requirement regardless of whether the vehicle is subject to CSSF authorisation.

Topping up of new assets is organised by the law. The law requires no homogeneity of risk profile between new assets and previous assets.

Related provisions

Formalities for the enforceability of assignment of receivables are less stringent. The assignment of receivables is valid and enforceable regarding third parties by the mere agreement between the assignor and the assignee.

The law also clarifies the enforceability of assignment against third parties other than the assigned debtor (as this situation is not foreseen in the Rome Convention) and states that the enforceability of the assignment against third parties is governed by the law of the state where the assignor is situated.

Expanded ring-fencing opportunities

Luxembourg securitisation vehicles are insulated from bankruptcy and regulatory risks to the greatest extent possible at several levels.

At vehicle level, the rights of investors and creditors are limited to the assets of the securitisation vehicle. This means that the assets and liabilities of the securitisation vehicle are fully separate from those of the other participants in the securitisation transaction (eg, arranger, trustee) - hence the desired bankruptcy remoteness. This limited recourse is a boilerplate provision in securitisation transactions but, in the absence of any express legal rule and court precedents on this matter, previously its enforceability could not be guaranteed. It is now anchored in the law.

The law also enables the creation of multiple independent compartments within the same securitisation vehicle. The assets of a compartment are available exclusively to satisfy the claims of the investors who funded them and the creditors whose claims arose in connection with these assets. The law recognises and confirms the validity of the limited recourse provisions for multi-issuing vehicles. This recognition was awaited by securitisation professionals, especially rating agencies. It plays a major role in confirming the interest and the attraction of Luxembourg for securitisation matters.

The law also confirms the possibility for a securitisation vehicle to issue several tranches of securities corresponding to different collateral and providing for different value, yield and redemption conditions.

Clarification of some legal uncertainties

Subordination provisions between the securitisation vehicle and its creditors, whereby the latter establish a ranking of their respective claims, and 'no petition' provisions, whereby the creditors agree not to petition for the bankruptcy of the securitisation vehicle, are commonly found in securitisation transaction documents. Previously there was some doubt as to their validity and enforceability. The law expressly confirms the effectiveness of such clauses.

The law also validates the true sale character of a transfer of receivables where such receivables, subsequent to their assignment to the securitisation vehicle, are transferred to a third party or even the initial assignor (which is often the case when credit enhancement is obtained by an over-collateralisation). The law excludes the re-characterisation of such transactions (eg, as secured indebtedness of the initial assignor).

Finally, the law clarifies an issue that frequently arises in case of synthetic securitisations when the securitisation vehicle guarantees a risk under derivative instruments, especially credit derivatives (eg, credit default swaps), which bear some resemblance to insurance contracts that can be entered into only by licensed insurance companies. Such transactions are excluded from the realm of insurance law, thus removing the risk of a re-characterisation of derivatives as insurance agreements.

Securitisation vehicles

The law proposes two forms of securitisation vehicles. One is a special purpose company, the other a securitisation fund managed by a management company.

The special purpose company may be set up exactly as before the law, with the difference that such company may now elect to place itself under the law.

Both the securitisation companies and securitisation funds may be subdivided into autonomous compartments.

In addition, a securitisation transaction need not be carried out by one and the same vehicle; the law also allows a dissociation of the acquisition and issuing functions, which can be performed by different entities.

It is therefore possible to reach outstanding levels of customisation in the design of securitisation structures, depending on the characteristics of each project and on the desired risk allocation pattern.

Securitisation companies

Conditions

It is easy to qualify as a securitisation company under the law, to the extent that such a company does not continuously issue securities to the public. The company must perform the securitisation in whole or in part and it must subject itself to the law by an explicit reference inserted in its articles.

The law does not mandate any other conditions. Indeed, it allows for great flexibility in drafting the articles of incorporation, which may include the management regulations.

The articles may also allow the board of directors to create separate compartments, each comprising a distinct portion of the company's assets.

Incorporation requirements

Securitisation companies must be stock companies (ie, *sociétés anonymes, sociétés à responsabilité limitée, sociétés en commandite par actions, sociétés coopératives organisées comme une société anonyme*).

They usually take the form of *sociétés anonymes* (public limited liability companies), which may have only one shareholder at the time of incorporation and at all times thereafter. Shareholders can be resident or non-resident, corporate entities or individuals, or even nominees or trustees holding the shares for the benefit of a third party.

The required number of directors is one if the company has only one shareholder, or three if there are two or more shareholders. Directors need not be shareholders and they can be corporate or individual and resident or non-resident (although there should be some resident directors for tax reasons).

The accounts of a securitisation company must be reviewed by an independent auditor.

Securitisation companies are not required to rent their own offices or to hire staff. However, they will need a registered office within Luxembourg, which is usually provided by specialised domiciliation agents, together with ancillary services such as bookkeeping, filing and reporting or providing directors.

Tax

The distinctive feature of the securitisation company versus the securitisation fund is that the former has full legal and tax personality. It remains subject to regular corporate income tax; however, this does not result in a significant tax liability because only a minimal profit margin needs to be realised by the company.

Consequently, the securitisation company is fully entitled to tax-treaty benefits, which can sometimes be an essential feature of the securitisation structure. Luxembourg has a comprehensive and expanding network of double tax treaties covering all major European and American trading partners. A securitisation structure can be adapted to take advantage of particular treaty provisions, such as exemptions of interest on government bonds.

By the Savings Law of June 21 2005 Luxembourg implemented the EU Taxation of Savings Income Directive. Under the Savings Law, Luxembourg levies a withholding tax on payments of interest or other similar income paid by a Luxembourg paying agent to or for an individual resident in another EU member state, unless such individual agrees to an exchange of information regarding the interest or similar income it received between the Luxembourg tax authorities and the relevant EU member state. The rate of the withholding tax is equal to:

- 15 per cent from July 1 2005;
- 20 per cent from July 1 2008; and
- 35 per cent from July 1 2011.

Under the Law of December 23 2005, Luxembourg introduced a withholding tax of 10 per cent for interest payments made by a Luxembourg paying agent to individuals resident in Luxembourg.

Securitisation companies are exempt from net-worth tax. Like securitisation funds, they bear a fixed capital contribution duty (maximum €1,250) instead of the regular 1 per cent duty) and their management by an external management company is not subject to value added tax.

Shares and bonds issued by securitisation companies are exempt from any duty. No stamp duty is levied on the trading of shares and bonds on the Luxembourg Stock Exchange.

Securitisation funds

The securitisation vehicle may also take the form of a securitisation fund, managed by a management company. Although the fund has no legal personality, the liabilities of the participants are limited by law to the amount of their participation. Securitisation funds are of an exclusively contractual nature.

The fund can be structured through a Luxembourg law fiduciary agreement, under which its assets will be held by a fiduciary. Alternatively, simple co-ownership of the fund's assets by the investors is also possible.

The fund is not liable for the debts of the investors or the management company. The creditors of the investors and the management company cannot enforce their rights on the assets of the fund.

Each fund has a set of management regulations. In the event the fund has compartments, it is possible to specify a different set of management regulations for each compartment.

The fund has to be managed by a management company, acting in the exclusive interest of the fund and the investors. The management company can also hold the securitised assets as fiduciary.

Tax

Unlike companies, securitisation funds fall under the tax regime applicable to investment funds. This results in securitisation funds being exempt from all direct taxes. The only difference from investment funds is that securitisation funds are not even subject to subscription tax.

The management fees for Luxembourg securitisation funds are exempt from value added tax.

In short, this means that securitisation funds bear absolutely no Luxembourg tax other than the fixed capital contribution duty (maximum €1,250) and the withholding tax under specific conditions. In fact, tax consequences arise exclusively in the hands of the beneficiaries of distributions by the fund.

Trustee based in Luxembourg

The law creates a legal framework for trustees based in Luxembourg.

A trustee may be included in a securitisation structure at the investors' request or pursuant to the articles of incorporation or management regulations of the vehicle.

The powers of the trustee are defined by the investors or by the securitisation vehicle, depending on the issues raised.

The trustee can act in the name and on behalf of the investors – the representative function - or in its name and on its behalf but in the interest of the investors – the fiduciary function. The investors can transfer on a fiduciary basis the ownership of the assets and rights they hold and any security in relation thereto to the trustee. In its capacity as fiduciary, the trustee can receive payments that are owed to the investors with discharging effect and enforce the security granted to the investors.

To further protect the investors, the law provides that the securitisation vehicle can assign contracts concluded with third parties to the trustee (eg, security agreements, underlying contracts and swaps). The parties are free to define the circumstances and conditions under which such assignment will take place. It is therefore possible to provide for an extremely wide intervention of the trustee in the management of the vehicle, including the ability to seek a court order replacing the administrative organs of the securitisation company or the management company based on sufficiently serious grounds.

Luxembourg trustees are subject to CSSF authorisation and supervision.

Regulatory oversight

Only those securitisation vehicles that engage in the continuous issuance of securities to the public are subject to prior authorisation and regulation by the CSSF. The law does not define the concept of 'continuous issuance'. What is certain, however, is that one-off issuances of securities to the public can be carried out without CSSF approval.

The authorisation regime established by the law relies on basic financial sector regulation principles, but in a less stringent form.

In a special purpose company structure, the authorisation requirement applies to the securitisation company itself. In a fund structure, the authorisation requirement extends to both the fund and its management company.

Prior authorisation by the CSSF is subject to the approval of:

- the articles of incorporation (for a company) or management regulations (for a fund) of the vehicle, and the articles of incorporation of the management company (for a fund); and
- the directors and reference shareholders of the special purpose company or management company (the 'fit and proper' test).

The special purpose company and the management company must demonstrate that they have sufficient organisation and are financially sound.

Regulated vehicles are not subject to specific disclosure requirements.