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Securitisation 2023

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Luxembourg: Trends & Developments

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Trends and Developments

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Introduction

The EU Commission has recognised that securitisations are an important component of well-functioning financial markets since they contribute to diversifying financial institutions' funding sources and releasing regulatory capital that can be reallocated to support further lending. Furthermore, securitisations provide financial institutions and other market participants with additional investment opportunities, thus allowing portfolio diversification and facilitating the flow of funding to businesses and individuals both within member states and on a cross-border basis throughout the EU.

Important institutions in the ESG sector such as the European Investment Fund in Luxembourg are making good use of securitisation techniques to fulfil their mandate and to balance the allocation of risk assumed by them and the provision of direct or indirect funding to banks, corporates or investment funds within the EU.

Since the adoption of the Luxembourg Law of 22 March 2004 on securitisation undertakings in 2004, as amended from time to time (the "Former Securitisation Law") which was last amended by the new law dated 25 February 2022, applicable as of 8 March 2022 (the "New Securitisation Law", together with the Former Securitisation Law referred to as the "Securitisation Law"), Luxembourg has been a very active market for the setting up of securitisation vehicles and the structuring of securitisation transactions, and has become one of the major hubs for securitisation transactions in Europe.

The Securitisation Law is very flexible and allows any type of securitisation transaction, with private placement or offer to the public, true sale or synthetic, tranched or untranched. Securitisation vehicles may be regulated or unregulated and can create compartments to ring-fence the assets and liabilities of a securitisation transaction from those of other transactions of the same securitisation vehicle. Of more than circa 1,500 securitisation vehicles (more than 6,000 compartments) active in Luxembourg as of today, only 29 are regulated.

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 (the "EU Securitisation Regulation") is further mitigating the negative perception caused by the 2008 financial crisis. In accordance with the EU Securitisation Regulation, a securitisation vehicle can issue senior and junior tranches of notes, each having a different risk profile triggering risk retention requirements and reporting obligations towards the regulator in Luxembourg.

Synthetic Securitisation of Loan Portfolios

In a synthetic securitisation transaction, the originator is seeking credit protection via the use of credit derivatives in respect of the assets to be transferred but without selling that asset to the securitisation vehicle. A true sale of the assets is, in general, not possible due to the regulatory framework applicable to the originators, which

are often regulated financial institutions such as banks.

Generally, the originator, as protection buyer, transfers the credit risk in respect of a portfolio of loans to the securitisation vehicle as protection seller. While the credit risk in respect of the portfolio's assets is transferred, the legal ownership of that portfolio remains with the originator. Credit risk can be transferred via a multitude of derivative instruments embedded, for instance, in credit-linked notes, whereby the originator issues credit-linked notes to the securitisation vehicle, which assumes the risk of a default in respect of the underlying risk. Further, the risk can also be transferred by way of a credit default swap or other complex credit derivative transactions.

In addition, the securitisation vehicle can enter into a collateral agreement with the originator and guarantee any failure to pay of the originator in connection with a portfolio of reference obligations. The originator will pay a fee to the securitisation vehicle for entering into the collateral agreement and to provide credit protection. Typically, the securitisation vehicle will provide a cash deposit to the originator funded by the issue proceeds derived from the issue of securities by the securitisation vehicle to investors, which ultimately will bear the risk of the underlying loan portfolio. The main purpose of the collateral agreement is to achieve a better regulatory capital treatment for the originator.

Even though the Securitisation Law clarifies that transactions qualifying as securitisations under the Securitisation Law do not qualify as activities that are subject to the legal framework applying to the insurance sector, there have been discussions in the Luxembourg legal literature (as well as Belgian and French legal literature, to which Luxembourg courts tend to turn) as to whether the provision of credit protection by the use of credit derivatives or a guarantee could be recharacterised as an insurance contract. Without going into the details of the main difference between an insurance contract and a credit derivative or a guarantee, there are strong arguments in support of the proposition that these instruments would not be considered as insurance contracts under Luxembourg law.

This position was further strengthened by the adoption of the Luxembourg Law on professional payment guarantees dated 10 July 2020 (the "Professional Guarantee Law"), which introduced a special regime for personal securities (*sûretés personnelles*) providing for a payment obligation and granted in a professional context.

The professional guarantee (the "Professional Guarantee") is defined as an arrangement by which the guarantor undertakes towards a beneficiary to pay, at the request of the beneficiary or of an agreed third party, a sum determined in accordance with the specific terms in relation to one or more claims or the risks associated with them. The Professional Guarantee may be granted by any person, including an individual, in a professional context.

As stated above, there were discussions as to whether the granting of a guarantee in the context of a synthetic securitisation, in which credit risk of loss is transferred by using such an instrument, could constitute an insurance contract and hence a regulated insurance activity carried out by a securitisation vehicle. With the adoption of the Professional Guarantee Law, there are now further arguments, strengthening the view that such a guarantee will not qualify as an insurance contract under Luxembourg law.

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Provision of Loans
The granting of loans as a business is heavily regulated in Luxembourg in accordance with the Law of 5 April 1993 on the financial sector, as amended (the "Financial Sector Law"). Professional lenders must either hold a banking licence or hold a licence as a professional of the financial sector carrying out lending operations. The main difference between a licensed bank and a licensed professional carrying out lending operations is that the latter is not allowed to take deposits or other repayable funds from the public; ie, its lending activity is financed by its own funds and borrowing from affiliates and banks.

The capital requirements imposed on banks following the financial crisis in 2008 have been, in part, considered as having contributed to the reduction of the lending activities of certain EU banks. The reduction of bank lending has led to a gap in available bank funding for the EU economy. Therefore, the EU has aimed at fostering lending solutions to spur growth within the EU. One of the tools to pursue this goal was the promotion of a label of "high-quality securitisation" under the EU Securitisation Regulation, also for the purpose of achieving a Capital Markets Union (CMU) so that securitisation is recognised again as a tool to diversify the sources of financing for the real economy.

Undertakings qualifying under the Securitisation Law are expressly excluded from the scope of the Financial Sector Law, similar to alternative investment funds qualifying under Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (AIFMD).

Securitisation vehicles can therefore, in principle, act as first lenders but are not permitted to arrange loans. This means that securitisation undertakings may, in principle, act as lenders and provide loans to corporate borrowers provided they do not carry out a credit activity on their own account and do not raise funds from the public. Further, the loan agreement must not have been negotiated by, or on behalf of, the securitisation vehicle. The latter is in line with the general idea of passive management, save for the active management of securitised assets in certain types of transactions as now allowed under the New Securitisation Law, of the assets allocated to a securitisation vehicle and that a securitisation vehicle should not itself create the risk pertaining to a loan origination, such as the identification and screening of the borrowers, the credit risk assessment and the negotiation of the loan agreement.

The documentation relating to a securitisation vehicle acting as first lender must therefore either clearly define the assets on which the service and the repayment of the loans granted by the securitisation vehicle will depend, or clearly describe the borrower(s) and/or the criteria according to which the borrowers will be selected, so that the investors are adequately informed of the risks, including the credit risks and the profitability of their investment at the time securities are issued by the securitisation vehicle.

According to a guidance note of the European Central Bank, which is relevant to assess the qualification of a securitisation under the Alternative Investment Fund Managers Directive (AIFMD), securitisation transactions may consist of the "adhesion by the purchaser to a set of predetermined terms that are identical or essentially similar to those on offer to other investors", such

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as participation in a loan syndication, unless the vehicle has underwriting responsibilities.

Tokenisation of Securities

Luxembourg has taken important steps to promote the digitalisation of the capital markets and introduced a "digital" security alongside the existing framework applicable to bearer, registered and dematerialised securities. The Luxembourg Law of 1 March 2019 (the "Blockchain Law I") established that a security token held via digital ledger technology such as blockchain qualifies as a security and satisfies the criteria of being a transferable and negotiable instrument. Similarly to securities cleared via clearing systems, the Blockchain Law I recognises that transfers of securities are perfected by registration in the relevant account held on a blockchain.

Further, the Luxembourg Law of 22 January 2021 (the "Blockchain Law II") brings additional improvements of the fintech legal framework in Luxembourg and bridges a gap regarding the regulation of dematerialised securities in Luxembourg. The Blockchain Law II allows investment firms and credit institutions to hold and manage securities issuance accounts via secured electronic registration systems, eg, DLT and databases.

With these legislative initiatives, Luxembourg contributes to enabling financial market participants to take full advantage of the opportunities offered by new technologies and at the same time provides for legal certainty in this evolving sector.

The New Securitisation Law

The New Securitisation Law broadens the means of financing securitisation transactions, including now also the possibility to finance through loans on an exclusive basis or to issue financial instruments (covering, unlike the previously used term "securities", amongst others, a broader field of instruments).

Further, the New Securitisation Law now explicitly allows active management of the securitised assets in certain types of transactions, as long as the transactions are not financed by way of offering financial instruments to the public. Luxembourg securitisation vehicles may now securitise a pool of risks consisting of debt securities, financial debt instruments or receivables which are actively managed, either by the undertaking itself, or by a third party. In practice, the new legal framework allows for securitisation of actively managed CDOs (Collateralised Debt Obligations) and CLOs (Collateralised Loan Obligations) in private placements.

Previously, the possibility of a securitisation vehicle to provide collateral to other parties was limited to securing the claims of direct creditors and investors. The New Securitisation Law has now also widened the scope of possible collateral arrangements by allowing a securitisation vehicle to grant collateral in favour of all parties involved in a securitisation transaction.

The Securitisation Law distinguishes between securitisation companies and securitisation funds, which qualify as securitisation vehicles and are eligible to carry out securitisation transactions within the meaning of the Securitisation Law.

Under the Former Securitisation Law, it was only possible to set up securitisation companies as a public limited company (*société anonyme*), a corporate partnership limited by shares (*société en commandite par actions*), a private limited liability company (*société à responsabilité limitée*) or a co-operative company organised as

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a public limited company (*société cooperative organisée comme une société anonyme*). The New Securitisation Law has added the possibility to use partnership structures for securitisation structures. Currently, an unlimited company (*société en nom collectif*), a common limited partnership (*société en commandite simple*), a special limited partnership (*société en commandite spéciale*), and a simplified joint stock company (*société par actions simplifiée*) can also be used as a securitisation vehicle.

Securitisation funds are not within the scope of the AIFMD and consist of one or several co-ownerships, or one or several fiduciary estates. Securitisation funds do not have legal personality and are managed by a management company. In accordance with the New Securitisation Law, while previously only the management companies of securitisation funds needed to be registered with the Luxembourg Trade and Companies Register, securitisation funds will also need to be registered.

Conclusion

The Securitisation Law, together with the EU Securitisation Regulation, provides a comprehensive toolkit for the European securitisation market and ensures that the regulatory framework enables securitisation to play its part in the European Capital Markets Union. Securitisation vehicles can effectively assume the risks pertaining to synthetic securitisation transactions and help to free up regulatory capital of institutional lenders, resulting in additional lending capacities of these entities to the real economy. The Professional Guarantee is perfectly fit to support sophisticated structuring of these transactions and to allocate the senior and/or junior risk pertaining to the underlying loan portfolios. Under certain circumstances, securitisation vehicles may, via the private placement of securities to institutional investors, be used as funding vehicles for small and medium-sized enterprises in distress. The possibility to digitalise securities under Luxembourg law may be useful for the diversification of the investor base using securitisation structures and the broadening of funding capacities. In particular with the New Securitisation Law, Luxembourg has increased the flexibility and legal certainty of the securitisation framework by updating the national legal regime to match the needs of the securitisation market, while at the same time focusing on investor protection.

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