Proposal for the Modernisation of the Securitisation Law

Giuseppe Cafiero, Director, July 2021

On 21 May 2021, the draft bill of law n° 7825 (the "Draft Bill") aiming at modernising the amended law of 22 March 2004 on securitisation (the "Law") was submitted to the Luxembourg parliament. The legislative process still has to continue before the final text is adopted, so the Draft Bill may be subject to some adjustments before the final vote. The Draft Bill has been referred to the *Commission des Finances et du Budget*, but is not yet on the agenda of the next work session of this Commission, so that it seems very unlikely that it will be reviewed before the opening of the next parliamentary session starting on 15th September 2021.

A Welcome Initiative

The success of the Law, which provides for one of the most competitive legal frameworks for securitisation transactions in Europe, is well proven. However, some aspects of the Law needed to be developed, which is the main purpose of the Draft Bill. We refer here to the attached table which lists the new elements of the Draft Bill.

In practice, the most relevant points of the Draft Bill can be summarised as follows:

1. **Possibility for a securitisation undertaking to be financed through any form of borrowing** (such borrowing being currently strictly limited to a transitional period or on an ancillary way). In accordance with the comments of the Draft Bill, the concept of borrowing, regardless of its accounting treatment, includes any form of indebtedness, which creates a reimbursement obligation for the securitisation undertaking, including indebtedness where the amount repayable depends on the performance of the underlying assets or of the financial position of the issuer. Such borrowings may, for example, take the form of particpating loans or funders contracts.

This would be a major innovation of the Law, respectively of the concept of a "*securitisation transaction*" in the sense that securitisation is commonly regarded as the transaction by which assets/risks are "*transformed*" into securities issued in the financial markets. It would be welcomed, as this would provide the necessary legal certainty for the financing of securitisation transactions by issuing "hybrid" instruments usually governed by foreign law and having both the characteristics of a loan and of financial instruments.

2. **Clear definition of continuous issues of financial instruments offered to the public**, inspired by the positions taken by the Commission de Surveillance du Secteur Financier (the "**CSSF**"), for which the prior authorisation of the CSSF is required for the concerned undertaking. A double condition must be met to consider that an issue of financial instruments is offered to the public on a continuous basis:

- "**continuous**" issuance, i.e. **more than three issues** of financial instruments offered to the public in a financial year (i.e. four or more issues);
- issuance to the "**public**", i.e., cumulatively, an issue:
  - intended for non-professional customers;
  - with denominations of less than EUR 100,000; and
  - which is not distributed in the form of a private placement.

It is to be noted that, in practice, the majority of the current securitisation undertakings will continue to benefit from the exemption of such authorisation, as only a limited number of securitisation undertakings meet all these conditions in practice.

3. Ability for securitisation undertakings, not financed by the issuance of financial instruments to the public, to **actively manage** themselves or through a third party (i.e. external manager) a risk portfolio consisting of debt securities, financial instruments of debts or claims. Here again, this would be a major improvement of the Law as this activity is currently prohibited for securitisation undertakings.

For example, in practice, the undertaking would be allowed to delegate to a specialised manager the management of collateralised loan obligations (CLOs), which generally results in a continuous activity of acquisition and transfer of claims.

4. Possibility for the securitisation undertaking to grant security or pledge over its assets not only to its investors, **but also to any third parties**, provided that the security/guarantee relates to a securitisation transaction.

To the extent that the Draft Bill intends to allow indirect securitisation, in particular through a company wholly owned by the securitisation undertaking, the Draft Bill would benefit from clarifying whether the securitisation undertaking may grant security or pledge over its assets to also cover the liabilities of its wholly owned subisidiaries (or of a company under its control). To the extent that the securitisation transaction as a whole would include the concerned company in its scope, such security/guarantee would seem to be allowed.

5. **Securitisation of tangible/property assets**: although securitisation of such assets has always been explicitly permitted by the Law, in practice structuring such transactions has always been a challenging task for market players.

Now, not only do the Draft Bill and the related commentaries reaffirm the possibility of securitising such assets, but they also provide for a pragmatic solution:

- the acquisition can be made directly or indirectly through a company owned by the securitisation undertaking;
- the method of transferring ownership of the underlying assets should be used as a tool for refinancing the asset concerned and as a means of making a physical asset liquid;
- all operational risks related to the asset whose ownership is transferred to the securitisation undertaking must be assumed by the user of the asset;
- the direct or indirect acquisition of an asset should not be understood as the possibility of developing a commercial or entrepreneurial activity, which is strictly prohibited for a securitisation undertaking.

To illustrate, **real estate leaseback** is a typical example of a transaction that satisfies the above conditions:

- the owner of a property for professional use suffers from a cash flow needs;
- the owner transfers the legal ownership of the property to the securitisation undertaking in return for payment of a price agreed between the parties, financed, for example, by the issue of financial instruments to the undertaking's investors;
- the original owner retains full use of the asset, which is made available to him by the securitisation undertaking under, for example, a lease agreement with a purchase option;
- the initial owner retains all the risks associated with the operation/management of the property;
- the original owner pays a regular rent to the securitisation undertaking;
- the securitisation undertaking pays back to the investors any amount due under the financial instruments issued.

Some Outstanding Key Points

Although the Draft Bill reveals the intention of the legislator to offer new possibilities to carry out securitisation transactions under clear conditions combining flexibility and legal certainty, it could have been a good opportunrity, within the framework of the proposed modernisation of the Law, to address other outstanding issues which, in practice, may be of crucial importance in the structuring of securitisation transactions.

1. Loan origination by a securitisation undertaking

While in some respects the Draft Bill aims at following certain recommendations of the CSSF (ref. public offering), it seems regrettable that the legislator did not take the opportunity to clarify the rather controversial position in practice of whether or not a securitisation undertaking can grant loans and, assuming that it is legally possible, to clarify the conditions under which such activity is permitted (we refer here to the parliamentary work of the Law as well as to the CSSF FAQ of 2013 and the CSSF activity report of 2007).

Moreover, the question is highly relevant as:

- the Draft Bill provides that the securitisation undertaking may be financed by borrowing. Assuming that the granting of loans is a permitted activity for the securitisation undertaking, then the open question would then arise to what extent the financing of a securitisation undertaking by borrowing for the purpose of granting loans still constitutes a securitisation transaction under the Law. If so, what would be the difference with a classic financing operation through a simple holding company (soparfi) for example; and
- the Draft Bill explicitly provides for indirect securitisation through a company owned by the securitisation undertaking so that in practice it cannot be excluded that the securitisation undertaking may finance its subsidiary with debt rather than with capital.

2. Issuance of financial instruments as fiduciary contracts (fiduciary notes)

As a reminder, pursuant to the amended law of 27 July 2003 on trust and fiduciary contracts, securitisation

undertakings are allowed to act as trustees in fiduciary contracts.

As the spectrum of financing means of a securitisation undertaking has been broaden under the Draft Bill, it would have seemed appropriate to provide a legal clarification on the possibility for securitisation undertaings to issue financial instruments on a fiduciary basis.

In conclusion, although the Draft Bill, as it stands, seems to be unanimously supported by practitioners, particularly since it offers a great deal of flexibility, certain grey areas of the Law and of the Draft Bill could be clarified in order to provide a greater legal security for securitisation transactions subject to the Law.

	Current regime under the Law	Regime under the Draft Bill
Use of borrowing	Not contemplated. However, the CSSF admits a strictly limited recourse for a transitional period or in an accessory way.	Use of any form of indebtedness that creates a reimbursement obligation for the securitisation undertaking to make.
Types of entity	Public limited company, partnership limited by shares, limited liability company or cooperative company organised as a public limited company.	General partnership, limited partnership, special partnership, simplified joint stock company, public limited company, partnership limited by shares, limited liability company or cooperative company organised as a public limited company.
Constitution of securities or guarantees	For investors only.	Granted to any third party, as long as it relates to a securitisation transaction.
CSSF approval in the event of public offers	No legal definition (only CSSF guidelines).	Legal definition: at least four issues of financial instruments in the same financial year to non-professional customers, with denominations of less than EUR 100,000, which are not distributed on a private placement basis.
Active management	Prohibited.	Allowed except in cases where financing instruments are issued to the public. Activity can be carried out internally or by a third party.
Registration and publication of the annual accounts in the RCS	Only for securitisation companies.	Required for companies and securitisation funds.

For further information, do not hesitate to contact:

Michel Bulach, Partner & Head of the Banking and Finance Practice Group
T: +352 40 49 60 228
E : michel.bulach@wildgen.lu

Giuseppe Cafiero, Director
T : +352 40 49 60 281
E : giuseppe.cafiero@wildgen.lu

www.wildgen.lu

wildgen
LUXEMBOURG LAW FIRM

wildgen
LUXEMBOURG LAW FIRM

SINCE 1923

www.wildgen.lu

Luxembourg Office

69, Bd de la Pétrusse
L-2320 Luxembourg
Luxembourg

T: (+352) 40 49 60 1
E: luxembourg@wildgen.lu

London Office

33, St James's Square
London SW1Y 4JS
United Kingdom

T: (+44) 20 3875 0182
E: london@wildgen.lu

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