POSITION PAPER

UPDATED PERSPECTIVES ON THE EU SECURITISATION REGULATION

RECENT AMENDMENTS, PRACTICAL EXAMPLES AND EMERGING POLICY TRENDS IN THE CONTEXT OF GREEN FINANCE

WORKING GROUP | SECURITISATION

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LUX CMA
Luxembourg Capital Markets Association

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ABSTRACT

The **LuxCMA**, which was constituted on 1 March 2019, has set up specific working groups dealing with securitisation questions, in particular the rules and regulations currently affecting the Luxembourg securitisation market. This updated position paper has been prepared by the Securitisation Working Group and addresses certain specific issues raised by the Regulation (EU) 2017/2402 of 12 December 2017, hereafter referred to as the **EU Securitisation Regulation**, which is applicable from 1 January 2019 to securitisation transactions carried out on or after that date and is closely linked to market practice.[1]

We have decided to update our 2021 paper for three reasons:

(i) the EU Securitisation Regulation has been amended in some parts since we published our paper making it necessary to amending the respective chapters;

(ii) we wanted to add a selection of practical examples to the paper and provide an indicative analysis as to whether such structure might be subject to the EU Securitisation Regulation; and

(iii) in recent months, securitisation became more prominent on the agendas of policy makers emphasising its important role as efficient tool to finance upcoming (green) transformation in the European Union.[2]

The definition of "securitisation" set out in Article 2(1) of the EU Securitisation Regulation lays down a general framework for securitisation and creates a specific framework for simple, transparent and standardised (**STS**) securitisation. The topic of this paper will be the application of the EU Securitisation Regulation with a specific focus on tranching, risk retention and contamination, while the STS framework will not be addressed explicitly in this paper.

We will discuss the four main criteria that a securitisation transaction should meet to fall under the scope of the EU Securitisation Regulation. Furthermore, we will analyse what "tranching" means in practice and will conclude that the assessment of such criteria should be made from the perspective of the securitisation undertaking and not from the investor's point of view. Consequently, tranching will also arise in a scenario in which one single investor holds all securities with different tranches, notably given the fact the securitisation undertaking cannot control any subsequent transfers of the securities by the initial investor.

Accordingly, the application of the EU Securitisation Regulation is limited by, among other things, the requirement that the securitised credit risk be divided into tranches, which need to be a contractually established segment of credit risk, hence subordinated to each other.

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[1] All statements are explicitly not intended to give any advice to readers, especially no legal or financial advice.

[2] For example, the final report of the Noyer Group, launched by French Finance Minister Bruno Le Maire in April 2024, to develop proposals for revitalising the Capital Markets Union..

Conversely, if the subordination does not determine the distribution of losses, the transaction is not covered by this definition and will consequently not fall under the EU Securitisation Regulation. Furthermore, investors and external parties might enter arrangements which would de facto have the economic effect of creating a subordination between tranches. Examples are e.g., external credit enhancements, the granting of guarantees, the entry into credit default swaps, subordination agreements, agreements among lenders, and many more. For a structure which was not originally set up as a tranched securitisation transaction, it does not seem to be reasonable to impose the resulting obligations on the securitisation undertaking / the originator / the sponsor or original lender, if the tranching / subordination arrangements result from actions outside their direct control and they did not intend this.

Where a securitisation transaction falls under the EU Securitisation Regulation, we address the subject of "contamination": each compartment created under the Luxembourg Law of 22 March 2004 on securitisation, as amended (the "**Securitisation Law**") represents a separate, legally ring-fenced part of the securitisation undertaking that is clearly segregated from the assets and liabilities of other compartments. Applying the concept of segregation consequently means the EU Securitisation Regulation applies only to those compartments which concurrently meet the four aspects required to fall under the EU Securitisation Regulation.

For each transaction, the originator, the sponsor, and the original lender should agree on the risk retainer. If no agreement is achieved, the EU Securitisation Regulation states that the originator will bear the risk retention. The entity qualifying as originator is often the risk retainer in practice.

Because of its importance and the issues that usually arise with the determination of who the originator is, we dedicate a specific subsection to this topic. Regarding the valuation of the risk to be retained, the rules under Article 6 of the EU Securitisation Regulation specify that such interest will be measured at the origination and determined by the then current notional value of the assets.

Furthermore, as soon as a securitisation transaction falls under the EU Securitisation Regulation, several due diligence requirements for institutional investors and substantial transparency requirements for originators, sponsors and Securitisation Special Purpose Entitlies ("**SSPE**"s) arise, which we will address in detail in this paper.

The terms and acronyms used in this **Publication** are defined in the "**GLOSSARY**" at the end.

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1 INTRODUCTION

1.1 Strategic approach

In the aftermath of the 2008 global financial crisis, the perception of securitisation underwent a significant shift within the European Union (EU). Initially viewed with scepticism due to its negatively perceived role in the crisis, securitisation has since been recognised as a key element for economic recovery and growth in particular with regard to the European Green Deal and the funding of the green and digital transformation of the European economy. This shift in sentiment was driven by the realisation that, when properly regulated, securitisation could enhance financial stability by improving liquidity and diversifying risk. In this respect, there has lately been political consensus on the pivotal role of securitisation as a tool for financing the European economy. The High Level Forum on the Capital Markets Union identified the development of the securitisation market as a top priority. More recently, in March 2024, the ECB's Governing Council confirmed such a priority and highlighted that the EU securitisation market can play a role in transferring risks away from banks to enable them to provide more financing to the real economy, while creating opportunities for capital markets investors. In its statement of 11 March 2024, the Eurogroup also underlined the importance of reviving securitisation in Europe. Finally, the Noyer Group report on "Developing European Capital Markets to Finance the Future" confirmed the significant importance of securitisation for the internal market by weighting on the ability of securitisation to diversify risk and removing assets from the banks' balance sheet. In this respect, the Noyer Group report emphasises to revitalise the European securitisation market while correcting applicable capital requirements for banks and insurance companies and simplifying of certain disclosure requirements.

On a related note, the importance of securitisation has also been identified in the context of financing assets needed for the low-carbon transition. Securitisation offers a pathway to mobilise the vast amounts of private capital required for the green transition, enabling the scaling up of renewable energy projects, energy efficiency initiatives, and other sustainable infrastructure developments. By providing investors with access to diversified, risk-adjusted returns, securitisation can accelerate the flow of capital towards green investments, driving the EU's transition to a low-carbon economy and supporting the achievement of its climate goals. Indeed in its Sustainable Finance Strategy, the German government already highlighted the sustainable securitisation of exposures as a potential instrument to support the European Green Deal. Further, in Luxembourg, the Luxembourg Green Exchange, the world's first and leading platform dedicated exclusively to sustainable finance, which now lists around 3,600 securities, has helped to cement Luxembourg's position as a leading centre for green, social and sustainable bonds as well as for securitisation and structured financial instruments. Finally, The Regulation on

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European Green Bonds (EUGBS) seems to have also identified the "green" benefits of securitisation, as it contains a separate section detailing the first ever dedicated legal framework for "green" securitisations. Specifically, the EUGBS is modified in part for green securitisation bonds to cater for the special structural features of securitisations.

Hence, the LuxCMA working group on securitisation aims also to monitor from a strategic point of view the political developments surrounding the EU legislation on securitisation.

1.2 The securitisation market in Luxembourg

Since the enactment of the Securitisation Law, Luxembourg has proven to be one of the prime locations to set-up the special purpose entities for securitisation transactions in Europe and has become a hub for the setup of securitisation structures. Indeed, based on statistics of the European Central Bank ("**ECB**") for the Euro area, a very large number of vehicles pursuing securitisation activities[3] have been registered in Luxembourg (as of 31 December 2023: 1,512 vehicles or 29% compared to 32% in Ireland and 19% in Italy).

The Luxembourg securitisation market continues to show a positive trend with overall around 2,900 vehicles (companies and funds) created under the Securitisation Law of which around 1,495 were active as of December 2023.[4]

The number of securitisation undertakings itself is however not a representative measure of the extent of securitisation transactions carried out in Luxembourg. With the specificity of the Securitisation Law allowing for the creation of compartments (a ring-fenced sub-division of the securitisation undertaking's estate) it is possible easily, quickly, and cost-effectively to operate multiple securitisation transactions within one legal entity. We estimate that around 6,000-8,000 transactions are executed among the currently active securitisation undertakings. While looking at the compartment structures one must discuss the robustness of the segregation operated on the basis of the Securitisation Law. A dedicated chapter in this paper will treat the question of cross-contamination amongst different compartments and the impact the EU Securitisation Regulation, might have.

Although many other new rules and regulations might affect securitisation transactions (e.g., **ATAD 1**) this paper focuses on the EU Securitisation Regulation, which aims to achieve standardisation and harmonisation of the European securitisation market as well as to create a framework for high quality securitisations. The STS is a sub-category of the securitisation transactions falling within the scope of the EU Securitisation Regulation. Amongst other topics, the EU Securitisation Regulation has introduced and clarified rules on risk retention, tranching and reporting. The EU Securitisation Regulation not only

[3] So-called financial vehicle corporations or FVC, which defines "securitisation" slightly different than the EU Securitisation Regulation (see below)

[4] Source: PwC Securitisation in Luxembourg: A comprehensive guide - May 2024 (slightly different definition of securitisation than FVC)

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creates obligations for issuers and their related parties but also sets out due-diligence requirements for institutional investors. Tranching and risk retention being of major concern for issuers, this paper will contain dedicated sections on these topics.

2 OVERVIEW OF SECURITISATION TRANSACTIONS: VOLUMES, DESCRIPTION OF SPECIFICITIES[5]

The identification of an EU Securitisation transaction is based on a case-by-case analysis and the securitisation transactions falling within the EU Securitisation Regulation are subjected to the notification obligations under Article 7 of the EU Securitisation Regulation. Nevertheless, there are no statistics available on how many EU Securitisations were created. Therefore, we concentrate here on the trends regarding STS transactions.

In total, 708 securitisations with STS status were notified to the **ESMA** and active as of 31 December 2023. Around 37% are public transactions (2022: 34%), with 63% the majority are private deals. Almost all the transactions (87%) are set-up as true-sale or traditional securitisation, with the remainder (13%) being synthetic STS securitisations (which is only authorised under the Regulation since 2021).

With regards to the asset classes of the STS transactions, about 28% are linked to auto loans/leases, 31% relate to trade receivables, 14% residential mortgages, 12% SME loans and 10% to consumer loans. The remaining 5% have not specified the asset class. This is a similar picture compared to prior years. Considering Luxembourg, one must note that not all securitisation vehicles under Luxembourg Securitisation Law qualify as Securitisation Special Purpose Entity ("SSPE") involved in securitisation (as defined in the EU Securitisation Regulation) with the main criteria of such being (i) the securitisation of a credit risk, (ii) tranching (iii) the payments being dependent on the performance of the underlying exposure(s) and (iv) the absence of specialised lending (further details are provided below). The Luxembourg definition of securitisation under the Luxembourg Securitisation Law is much wider and includes the securitisation of risks other than credit risk as well as fully equity financed or non-tranched debt structures.

Even though Luxembourg structures mainly invest in loans (38%) and debt securities (35%), a significant portion is also invested in equity and funds (11%), which in their majority would most likely not qualify as subject to the EU Securitisation Regulation.

[5] This section emphasises that the securitisation market in Luxembourg has a critical size and the impact of ATAD should be considered by authorities.

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Based on our observations and our Market Survey 2024 performed with PwC Luxembourg, the Luxembourg securitisation market's main asset classes are trade receivables and repackage transactions, followed by real estate and mortgages as well as lease receivables. Another important transaction type observed in Luxembourg is structured products.

Another speciality of Luxembourg securitisation and investor protection is that undertakings issuing financial instruments to the public on a continuous basis need to be directly supervised by the **CSSF**. As of 31 December 2023, only 28 undertakings (or 2% of all securitisation vehicles) are supervised but represent around 7% of the total assets and around 26% of the series issued (as an approximation to the number of compartments)[6]. In nearly all cases, the supervised securitisation undertakings have created several compartments and most of such undertakings issue certificates as investment products for retail investors (so-called "structured products", paying according to performance of an index or similar underlying synthetically received via a total return swap) and thus also would not fall under the EU Securitisation definition.

Although STS is quite a challenging product, one must note that it is now part of the overall securitisation market and is receiving an increasing degree of attention. From a Luxembourg perspective, many existing securitisation structures do not fall into the ambit of the EU Securitisation Regulation. Luxembourg nevertheless remains an interesting jurisdiction for the corporate structure of those vehicles and the admission to trading of the tranches issued.

[6] Source: PwC research based on ECB and CSSF data.

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3 PURPOSE AND SCOPE OF THE EU SECURITISATION REGULATION

The EU Securitisation Regulation lays down a general framework for securitisation. It defines securitisation and establishes due-diligence, risk-retention and transparency requirements for parties involved in securitisations, criteria for credit granting, requirements for selling securitised products to retail clients, a ban on re-securitisation, requirements for SSPEs as well as conditions and procedures for securitisation repositories.

It also creates a specific framework for STS securitisation.

3.1 ENTITIES COVERED BY THE EU SECURITISATION REGULATION

The EU Securitisation Regulation applies to:

- SSPEs;
- Originators;
- Original lenders;
- Sponsors (i.e. EU or non-EU credit institutions or investment firms other than an originator); and
- Institutional investors, e.g.:
  - insurance undertakings;
  - re-insurance undertakings;
  - **AIFMs** that manage and/or market AIFs in the EU;
  - management company of **UCITS**;
  - self-managed UCITS;
  - credit institutions; and
  - investment firms.

Section 5.1 contains more detail on the roles of Sponsor, Original lender and Originator.

3.2 ACTIVITIES COVERED BY THE EU SECURITISATION REGULATION

"*Securitisation*" is defined in Article 2(1) of the EU Securitisation Regulation and refers to transactions or schemes where:

- credit risk associated with an exposure or a pool of exposures is tranched;
- the tranches are subordinated to one another and the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;
- the payments in the transaction or scheme are dependent upon the performance of an exposure or pool of exposures; and

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- the transaction or scheme does not create specialised lending exposures[7].

Consequently, the application of the EU Securitisation Regulation is limited by, among other things, the requirement that the securitised credit risk be divided into tranches, which are contractually subordinated to each other.

CONCEPT OF EU SECURITISATION

Regulatory Definition:

"Securitisation" means a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

Credit risk	+	Tranching	+	No specialised lending
Payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures		The subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme		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

Unlike the Securitisation Law, the EU Securitisation Regulation is only applicable to the transactions involving credit risk (as opposed to market risk) and the exposures to physical assets are normally excluded from its scope under the specialised lending exception.

Furthermore, the existence of tranched debt alone is not sufficient to satisfy the criteria of a securitisation under the EU Securitisation Regulation, even in the presence of credit risk carrying assets. It is indeed necessary that, in addition, the "dependency test" is met. A transaction is thus only regarded as securitisation within the meaning of the EU Securitisation Regulation where the credit risk of the investors is dependent on the performance of the underlying assets during the life of the transaction. If the investors have a recourse against other assets or entities (for instance, in case of a third-party guarantee or a security interest), the dependency test may not be satisfied and the transaction in question may not constitute a securitisation within the meaning of the EU Securitisation Regulation.

In addition, it is worth noting that the EU Securitisation Regulation, while explicitly governing issuances involving tranched credit risk of an exposure, does not contain any

[7] Within the meaning of 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.

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obligation to structure a transaction as a securitisation falling within its scope. This means that a securitisation undertaking having issued securities where the securitised risk is not tranched, the securitised assets do not carry credit risk or the dependency test is not met would fall outside the scope of the EU Securitisation Regulation and would only be governed (if incorporated under Luxembourg law and provided that the securitisation undertaking opted to be subject to it) by the Securitisation Law. Hence, for example, when a securitisation undertaking issues financial instruments which all have the same risk characteristics, the transaction would not constitute a securitisation transaction within the meaning of the EU Securitisation Regulation, while still falling under the scope of the Securitisation Law.

4 ELEMENTS DETERMINING THE QUALIFICATION AS EU SECURITISATION OF A TRANSACTION

4.1 CREDIT RISK

4.1.1 Definition of the term "credit risk"

Although the scope of the EU Securitisation Regulation is explicitly limited to securitisations that create exposures to credit risk, the EU Securitisation Regulation does not define credit risk – possibly because the legislator thought the term self-explanatory. Related legal frameworks, such as the Capital Requirements Regulation ("**CRR**"), the Regulatory Technical Standards ("**RTS**") or regulatory guidance also fail to provide a concise definition of credit risk.

A definition has, however, been provided by the Bank of International Settlements, whose standards served as primary inspiration for the EU Securitisation Regulation. In its publication on "Principles for the Management of Credit Risk", it defines credit risk as "*the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms*". In other terms, credit risk is counterparty risk. The RTS on reporting templates provide a non-limitative number of examples of assets deemed to bear credit risk, including loans backed by residential and commercial real estate, corporate loans, auto loans, credit card, lease and trade receivables.

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4.1.2 Excluded transaction types

i. Non-credit risk exposures

As the scope of the EU Securitisation Regulation is limited to credit risk transactions, transactions of risks other than credit risk are not covered by the EU Securitisation Regulation. By way of illustration, the following qualify as non-credit risk transactions:

- real estate or private equity investment funds that aim at generating revenue by selling assets for a price higher than the purchase price create exposure to market risk;
- special purpose vehicles within the meaning of the Solvency II framework investing in insurance policies speculate on the non-occurrence of the coverage trigger (e.g., the occurrence of death in the context of life insurance policies or a fire in the context of fire insurance policies) which in most cases are non-credit risk related. However, an insurance policy providing coverage against credit risk (e.g., credit or rental loss insurances) nonetheless constitutes a credit risk exposure;
- counterparty risk in a total return swap transferring the risk of an equity pool to the SSPE.

In most cases, however, the distinction by risk-type is not always clear-cut and investors are exposed to a multitude of risks, of which credit risk may be only one component. For instance, the value of a pool of exchange traded corporate bonds fluctuates according to the rules of offer and demand, thereby creating a market risk exposure. On the other hand, life insurance linked securities entail a risk that policy holders may default on insurance premium payments (i.e., credit risk). In a synthetic transaction one would also always have the counterparty risk of the swap counterparty while the performance rather depends on an underlying pool of equities.

Most market participants would agree, however, that a pool of corporate bonds satisfies the credit risk criteria under the EU Securitisation Regulation, while life-insurance linked securities do not. Similarly, the main risk determining the repayment of investors in the described synthetic transaction would be the market risk of the equity pool, and normally not the counterparty risk of the swap counterparty (which in addition is often further reduced in the case of a funded transaction). Thus, where an asset class displays a multitude of risks, only the primary, predominant risk-type is retained to assess whether the credit risk criteria under the EU Securitisation Regulation is met.

In this regard, future flow or forward flow transactions deserve particular consideration with regards to the credit risk criteria. In the context of future flow transactions, the

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originator sells all present and future trade receivables generated by its operational business (or part thereof) to a special purpose vehicle against payment of a purchase price corresponding to the proceeds of a third-party financing extended to such special purpose vehicle. The contractual terms provide that cash generated by the receivables, which serve as the collateral of the investors, is reverted back to the originator after each periodical debt service to the investors. Although the transferred receivables, by their very nature, constitute credit risk exposures, the fact that these are usually very short-lived (often less than 30 days to maturity) requires the collateral pool to be constantly renewed, failing which the transaction defaults. The credit risk exposure is in most instances only ancillary to the main risk, being the risk that the originator fails to generate sufficient future receivables to service the third-party financing (i.e., business risk). Whether the component of credit risk or business risk ultimately dominates needs to be assessed on a case-by-case basis, taking into account the diversification of debtors, the level of overcollateralization and the term of the receivables.

ii. Specialised lending exposures

The definition of "securitisation" in the EU Securitisation Regulation expressly excludes specialised lending exposures within the meaning of article 147(8) of the CRR. This exemption targets transactions in which a special purpose vehicle is created for the financing and operation of a physical asset that generates the income used to repay the vehicle's liabilities.[8] It is also required that the lender has a substantial degree of control over the asset and the income generated thereby. Typical forms of specialised lending include aircraft and nautical vessel leaseback transactions, as well as certain project finance transactions, for instance toll road financings in which toll revenues are used to pay off the lenders. We provide further detail on this exemption in section 7.

4.1.3 Transaction types requiring a case-by-case analysis

i. Loan originating vehicles

A question that has caused a lot of debate in the market concerns loan origination vehicles and whether these structures would be captured by the scope of the EU Securitisation Regulation. While there is no doubt that they create credit risk exposures, it has been questioned whether such structures, which directly originate the credit risk instead of acquiring it from third parties, are covered by the scope of the EU Securitisation

[8] Please refer to the **EBA** Regulatory Technical Standards on specialised lending exposures.

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Regulation. After all, the definition of "SSPE" requires that the "SSPE" is set-up "*to isolate the obligations of the SSPE from those of the originator*", which is a criterion that loan originating structures do not meet. Parallels have been drawn to the interpretation given by the European Central Bank ("ECB") in the context of the statistical reporting of securitisation vehicles under Regulation (EU) No 1075/2013 of the European Central Bank of 18 October 2013 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions, according to which loan originating structure would not satisfy the "transfer of risk" criterion, thereby falling outside the scope of the ECB Regulation 1075/2013.

Advocates for an exclusion of loan origination vehicles from the scope of the EU Securitisation Regulation may find further support in the recent amendment to the EU Securitisation Regulation, which introduces a seemingly binary distinction between "traditional securitisations" and "synthetic securitisations". Both securitisation types have in common that they are characterised by risk transfer (as opposed to risk origination).

An interpretation favouring an exclusion of loan origination vehicles from the scope of the EU Securitisation Regulation remains, however, in strong opposition to the position taken by the European Banking Authority ("EBA"). The EBA stated with respect to loan origination vehicles that they are captured by the definition of "securitisation", as the EU Securitisation Regulation "*does not require an exposure to be first created or purchased by one party and transferred to another party afterwards*". The EBA does not see such statement as contradicting the terms of the EU Securitisation Regulation, notably the risk transfer requirement enshrined in the definition of "SSPE". In this respect, the EBA issued guidance suggesting that the definition of "SSPE" is irrelevant for the determination of the scope of the EU Securitisation Regulation and that the vehicles performing securitisation transactions within the scope of the EU Securitisation Regulation do not necessarily qualify as an SSPE.[9] The Financial Conduct Authority ("FCA") in UK seems to have confirmed this approach in its notification template.

Against the background of the above it becomes apparent that the debate on whether loan origination structures are captured by the scope of the EU Securitisation Regulation has not been settled yet but regulators seem to consider that loan origination structures do fall under the EU Securitisation Regulation in any event. The entity that will bear the risk retention may need to be carefully analysed though.

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[9] Opinion of the European Banking Authority on matters relating to other financial intermediaries and regulatory perimeter issues – November 2017

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ii. Indirect credit risk exposures

The assessment of the credit risk criteria may be less obvious where the SSPE is only indirectly exposed to credit risk. For example, when it acts as investor in limited partnership units of a debt fund.

At first glance, it securitises an equity holding. However, the performance of the limited partnership units and therefore indirectly the financial instruments issued by the SSPE are fully dependent on the underlying exposures. This structure type is further analysed in our "Examples" part in section 8.

In any case, a detailed analysis of the structure of the debt fund and the limited partnership units would be required to assess whether the payments to the investors are indeed dependent on the performance of the underlying exposures. Should the fund contain other, dominant features (e.g., certain derivatives), this may no longer be the case.

Conclusion on credit risk

The "credit risk" criteria for meeting the definition of "securitisation" in the EU Securitisation Regulation may seem clear-cut. Indeed, it is clearly easier to assess than the "tranching" definition discussed in the next chapter. Nevertheless, an analysis of each individual structure may be required.

4.2 TRANCHING

4.2.1 Definition of the term "tranche"

For the purposes of the EU Securitisation Regulation, a "tranche" means "*a contractually established segment of the credit risk associated with an exposure or a pool of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments*" (Article 2(6) of the EU Securitisation Regulation).

This also means that a transaction or scheme where there is subordination of tranches, but where the subordination does not determine the distribution of losses (i.e., the subordinated tranches are not loss-absorbing), is not covered by the definition or therefore by the EU Securitisation Regulation.

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Tranching can be generally described as a technique whereby the credit risk which is associated with an exposure or a pool of exposures is split into different segments that have different risk features.

Tranching usually takes the form of an issuance by a securitisation undertaking of different classes of securities or other debt instruments, in which the return/yield of each class is dependent on the risk associated therewith.

The aim of such structure is to accommodate the needs of various investors having different risk profiles.

The subordination of the tranches is used to allocate the return (or losses) incurred by the underlying portfolio between investors so that the claims under the senior tranches are satisfied in priority over the claims under the subordinated tranches.

This technique enhances the credit quality of the senior tranches. The terms and conditions of the subordinated tranches typically contain a clause whereby the instruments holders waive their right to be paid until the payment obligations which have arisen under more senior tranches have all been satisfied.

In particular, this means that the most senior and least risky tranche receives investment returns (generated by the securitised asset pool) ahead of any other tranches and is last to incur losses.

On account of this lower risk profile, the expected return relating to such senior tranche is lower than for the tranches with higher risk (i.e., mezzanine or junior tranches). Given that each tranche has a different level of risk associated with it, certain investors might only be eligible to invest in specific tranches or build investment portfolios with specific risk and return characteristics, provided their investments are accompanied by other senior, mezzanine and junior tranches.

The range of investors in senior tranche instruments usually includes insurance companies, pension funds and other institutional investors who are reluctant to take higher than average risks. Junior instruments are typically unrated and offer the highest yield/risk return as they must absorb the first losses generated by the relevant asset pool. Therefore, investors in junior tranche instruments are often hedge funds, debt funds and other investors who look for much higher risk returns.

In most instances a predetermined waterfall schedule (also commonly referred to as the "waterfall"), setting out in detail the manner in which interest and principal generated by the asset pool is to be distributed by the securitisation undertaking, is included in the relevant issuance documentation, e.g., the terms and conditions, prospectus or private placement memorandum.

In a typical waterfall structure, the holders of senior tranches are the first to receive cash payments after all relevant payment obligations to tax authorities and service providers,

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such as auditors, custodian banks, corporate services providers and other agents or trustees, have been fulfilled. Subsequently, holders of mezzanine tranche securities receive the residual cash flow. The remaining "excess spread" is then used to meet the payment obligations vis-à-vis the investors in the junior tranche. Conversely, the junior tranche constitutes the first segment to absorb losses in the event that the securitised asset pool underperforms and does not generate sufficient cash flow in order to service all segments.

Although the above mechanism seems relatively straightforward and clear, there are a number of different situations where questions arise as to whether the definition of "*tranche*" as set out in Article 2(6) of the EU Securitisation Regulation is met. Unfortunately, there is no official guidance on the matter and this chapter seeks to provide answers to the most common issues based on the existing market practice.

4.2.2 Share capital as a tranche

The EU Securitisation Regulation explicitly refers to tranching as being a *contractually* established segment of credit risk. The EU Securitisation Regulation states that securitisation transactions should not be structured in such a way so as to avoid the application of the retention requirement and that requirement should be applicable in all situations where the economic substance of a securitisation is applicable, whatever legal structures or instruments are used.[10]

Thus, the mere fact that financing was provided in the form of the equity and not debt cannot be in itself taken as a guarantee that the EU Securitisation Regulation would not apply. Instead, the economic substance and purpose of the overall transaction should be analysed on a case-by-case basis. Notably, it needs to be assessed whether the vehicle has been specifically set up for the structuring of a dedicated securitisation transaction. Overreliance on the legal form of the financing might expose the securitisation undertaking to the risk of supervisory authorities regarding such structures as an inadmissible attempt to avoid compliance with the EU Securitisation Regulation.

Even more attention should be paid in scenarios where the securitisation undertaking has issued several classes of shares with different rankings and payment priorities or in relation to preference shares and other equity instruments having debt-like features. For the avoidance of doubt, the mere existence of equity and debt funding for the purpose of financing an entity does not constitute tranching in accordance with the EU Securitisation Regulation.

[10] As per Recital (10) of the EU Securitisation Regulation.

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Article 64(1) of the Securitisation Law, as most recently amended, provides statutory subordination rules with regard to the financial instruments issued by a Luxembourg securitisation undertaking.

4.2.3 Multi-compartment structures

Furthermore, the question arises whether the EU Securitisation Regulation would have to be applied on an entity or a compartment-by-compartment basis when assessing tranching. The former would imply that any applicable obligations set out in the EU Securitisation Regulation would not only apply to the relevant compartments having issued different tranches of financial instruments, but also to all other compartments that have not issued financial instruments with different rankings.

Given that each compartment created under the Securitisation Law represents a separate, legally ring-fenced part of the securitisation entity that is clearly segregated from the assets and liabilities of any other compartments, it seems more in line with this concept of segregation to apply the EU Securitisation Regulation only to those compartments which do in fact engage in securitisation transactions as defined under the EU Securitisation Regulation and issue different classes of financial instruments with different rankings. Consequently, tranching would only occur and the EU Securitisation Regulation would only apply in respect of compartments having issued different classes of financial instruments with different rankings and would have to be applied only on a compartment-by-compartment basis, without having regard to the financial instruments issued by other compartments.

Every rule or requirement under the EU Securitisation Regulation is imposed on “securitisations”, calling, for an application and an analysis on a transaction-by-transaction basis. This should exclude a risk of contamination, either between transactions of a same SSPE, between transactions of a same compartment within an SSPE or between compartments within one SSPE.

This interpretation should apply for all requirements of the EU Securitisation Regulation, i.e., risk retention and transparency obligations, for initial notifications to be performed and for the initial information to be provided to the competent authority but also for the ongoing information to be shared. Only a said transaction should be caught by the application of the EU Securitisation Regulation and the constraints imposed by the EU Securitisation Regulation apply only to such operation, not to the entire compartment or SSPE.

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4.2.4 Instruments other than securities

Although the recitals of the EU Securitisation Regulation refer to "securities", the definition of "*securitisation*" does not contain any specific restrictions with regard to the form of instruments to be issued by the securitisation undertaking. This implies that other forms of financing, notably the use of senior and/or subordinated loans or other debt instruments, would usually also result in tranching and fall within the scope of the EU Securitisation Regulation. A case-by-case analysis of the legal terms and transaction structuring may however be needed.

4.2.5 Intra-investor arrangements

There may be questions whether any arrangements made between investors which would de facto have the effect of subordinated tranches (e.g., by way of granting guarantees, the entry into credit default swaps, subordination agreements, agreements among lenders, etc.) might fall within the scope of the EU Securitisation Regulation in a situation where the securitisation had not been originally set up as a tranched securitisation transaction by the initiators.

Article 2(6) of the EU Securitisation Regulation is explicit on the fact that the analysis of the tranching should not take account of credit protection provided by third parties directly to the investors. Hence, any credit enhancement techniques involving third parties should not result in a subordination leading to tranching.

Given that the EU Securitisation Regulation contains a series of obligations relating, among others, to the securitisation, originator, sponsor or original lender, it does not seem to be reasonable to impose such obligations on them if the tranching/subordination arrangements arise out of actions beyond their control and which they had not intended to implement.

In addition, investors which did not enter into any such arrangements might hesitate to invest in an initially non-tranched securitisation if, by the action of other investors (on which they do not have any influence), the application of the EU Securitisation Regulation could be triggered at a later stage. Such an interpretation would also create concerns in relation to any obligations (in particular due diligence obligations) which institutional investors are to comply with prior to their participation in the securitisation transaction. Indeed, it would be impossible for the investors to comply with such requirements if securities issued by a securitisation undertaking would by virtue of intra-investor arrangements be de facto tranched after the issuance by the securitisation undertaking. Therefore, it seems more in line with the spirit of the EU Securitisation Regulation to conclude that only contractual forms of subordination initiated by the securitisation undertaking qualify as tranching. This position is supported by Article 2(6) of the EU Securitisation Regulation which sets out the

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definition of "tranching" and pursuant to which credit protection provided by third parties directly to the holders of positions in the segment or in other segments should not be taken into account (as opposed to guarantees received by the SSPE to reduce the asset default risk).

4.2.6 Structural subordination

Structural subordination where the borrowing/investment occurs at different levels of a corporate structure and is therefore dependent on different corporate entities could not qualify as tranching either. The reason for this is that, while there would be an effect of subordination, such subordination would be caused by the corporate structure rather than by a contract.

4.2.7 Pari passu instruments with different rates of return

There are certain transactions in which the securitisation undertaking issues different classes of instruments that are *pari passu*, but some of them are entitled to higher rates of return. For instance, the collateral manager and/or its affiliates may subscribe for debt instruments with carried interest or performance return features and, once certain financial performance hurdles have been reached, additional interest may become payable on such carried interest debt at the expense of the interest payable on the other classes of debt. There should be no credit risk tranching within the meaning of the EU Securitisation Regulation in situations where the repayment of principal under all the classes of debt occurs on a *pro rata* basis, the risk of a credit loss in respect of principal repayments is borne *pro rata* by the holders of all classes of debt securities, and the additional interest payment on the carried interest instruments does not constitute economically a form of credit enhancement.

4.2.8 Single investor

For the assessment of whether or not certain instruments are tranched, the number of subscribers for such instruments should not be the deciding factor.

The analysis should be made from the perspective of the securitisation undertaking and not from the investor's point of view. Consequently, tranching will also arise in a scenario in which one single investor holds all instruments with different tranches, notably given the fact the securitisation undertaking cannot control any subsequent sales of the instruments by the initial investor.

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4.2.9 Different payment components

The question may arise if, in the presence of one single class of instruments where each instrument contains different payment components (e.g., in the form of fixed rate interest and variable rate interest payable in a certain sequence and in accordance with certain priority mechanisms), tranching could occur within the meaning of the EU Securitisation Regulation.

Such question needs to be assessed from the securitisation undertaking's perspective. This means that at least two different positions in two different segments need to have been contractually established and to differ in respect to their risk of credit loss.

In other words, in a scenario in which two different segments exist, one segment should be more exposed to the credit risk than the other one. This, however, would not be the case in a context where the different credit risk segments exist within the same instrument and all instruments are ranking *pari passu* and structured in the same manner. Thus, any default situation would have the same impact on all investors. The fact that, according to the established priority of payments, only certain payments under the same instrument would be affected should not be sufficient in order for the instruments to qualify as tranched instrument, given that all investors would suffer the same losses and would therefore not have different credit risk.

4.2.10 Distribution of losses during the ongoing life of the transaction

One might argue that despite the reference to "*an exposure or pool of exposures*" set out in Article 2(1)b) of the EU Securitisation Regulation, single repackaging structures (i.e., transactions which involve securities that are only backed by one single asset) could not be capable of constituting a securitisation under the EU Securitisation Regulation.

The issue is that in this type of situation, a default of that asset would equally affect all tranches, leading to a default on all tranches at the same time. However, in such a context, a distribution of losses during the ongoing life of the transaction might strictly speaking never be achieved, given that such distribution would only be determined at one single point in time (i.e., the time when the default arises) after the end of the transaction and not during its life.

On the other hand, the definition of "tranche" explicitly refers to credit risk associated with both an exposure or a pool of exposures. This implies that the European legislator intended the EU Securitisation Regulation to also cover such single asset repackaging structures. Furthermore, even in a single asset structure, the default might only be partial. A partial default might arise in a situation in which, instead of a total payment default, the underlying assets collapse only partially and the funds of the securitisation undertaking might not be sufficient to pay all obligations under its issued instruments during a particular

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period of time. In such case, there would still be a different distribution of losses during the life of the transaction which would not automatically lead to the end of the securitisation.

4.2.11 *Time tranched securitisations*

Time-tranched securitisations (i.e., securitisation with several classes of securities that are *pari passu* but have different maturity dates) should not per se be subject to the EU Securitisation Regulation (provided the payments prior to the earliest maturity date are made to all investors pro rata), but need to be assessed on a case-by-case basis. While an earlier maturity date reduces the risk of loss of the holder of the relevant financial instrument, an event of default occurring before the earliest of the maturity dates would nevertheless affect all investors.

4.2.12 *Synthetic securitisations*

Tranching can also be present in a synthetic securitisation, for example where the risk is transferred by means of a guarantee. In the "Joint Committee Q&As relating to the Securitisation Regulation (EU) 2017/2402", the three European Supervisory Authorities (i.e. EBA, ESMA and EIOPA), considered a scenario, where (A) a manufacturer sells its products to a group of off takers, (B) a bank provides financing directly to such off-takers keeping the loans in its lending book and (C) the manufacturer provides 15% first risk guarantee to the bank achieving a partial transfer of the credit risk (the first 15% of losses on the pool being reimbursed by the manufacturer to the bank and losses above the 15% being borne by the bank). The Joint Committee responded unambiguously that the described transaction constitutes a synthetic securitisation where the credit risk is tranched.

4.2.13 *Guarantee of the first loss piece*

In a scenario, where an originator guarantees to the issuer the first loss piece of the underlying assets of a uni-tranche note structure, one could argue that the granting of the guarantee constitutes a “position in the segment” of the “credit risk associated with an exposure or a pool of exposures” and could therefore qualify as an economic tranching within the meaning of the Securitisation Regulation.

However, we take the view that the originator “guarantee” is not a credit protection within the meaning of Art. 2 (6) of the Securitisation Regulation, since it does not apply “directly to the holder of the positions”, i.e., the noteholder. These measures taken by the originator

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only alter the credit risk intrinsic to the exposure pool, but they do not constitute subordinated positions in segments of credit risk. The same applies for the residual credit enhancement policy often received from insurance companies for trade receivables securitisations.

Therefore, we would conclude that, generally speaking, such set-up may not per se result in the transaction falling in the scope of the Securitisation Regulation. Nevertheless, a case-by-case analysis would be required since slight changes in the structure or the wider context may lead to a different conclusion.

Conclusion on tranching

A transaction will not qualify as securitisation for the purposes of the EU Securitisation Regulation unless there is a tranching of credit risk. That being said, some transactions which might appear at first sight as being tranched securitisations and that might, at least economically speaking, produce the effect of tranching, might not always fall under the scope of the EU Securitisation Regulation.

The definition of "securitisation" excludes from its scope those transactions where there is subordination of tranches, but where the subordinated tranches are not loss-absorbing and the subordination does not determine the distribution of losses on an ongoing basis.

Repackaging transactions (involving the issuance of only one class of instruments) are not securitisations caught by the EU Securitisation Regulation.

To meet the definition set out in Article 2(6) of the EU Securitisation Regulation, the economic substance of a transaction should be analysed, whatever legal structures or instruments are used. While securitisation transactions where the effect of tranching only arises by operation of law rather than contract (e.g., investors in debt instruments receiving payments before shareholders of the securitisation undertaking) may not always qualify as securitisation under the EU Securitisation Regulation, the specific context should always be assessed on a case-by-case basis.

The definition of securitisation under the EU Securitisation Regulation does not require that the issuance of securities by an SSPE and the transactions covered by loans or other instruments would still be captured.

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(continued)

Structural subordination, where the borrowing/investment occurs at different levels of a corporate structure and is therefore dependent on different corporate entities, could not qualify as tranching either.

Furthermore, in order to fall within the scope of the EU Securitisation Regulation, tranching must occur at the level of the securitisation undertaking and not at the investor level. For this reason, certain forms of arrangements made by the investors in the securitisation transaction (without the involvement of the securitisation undertaking) should not be considered as giving rise to a securitisation under the EU Securitisation Regulation.

Transactions involving issuances of pari passu classes of instruments with different rates of return (e.g., debt instruments with a higher carried interest at the expense of the interest payable on the other classes of debt instruments) or a single class of instruments with different components (e.g., fixed and variable interest) should not per se result in tranching.

Furthermore, the number of the investors is not relevant when assessing the tranching and transaction involving instruments with different ranking would not be exempted from the scope of the EU Securitisation Regulation merely due to the fact that such instruments are held by the same investor.

The definition of "securitisation" excludes from its scope those transactions where there is subordination of tranches, but where the subordinated tranches are not loss-absorbing, and the subordination does not determine the distribution of losses on an ongoing basis. Also, a transaction that is only time-tranched and not credit tranched during its life, would not per se qualify as securitisation under the EU Securitisation Regulation.

Finally, given the explicit reference to credit risk associated with an exposure or pool of exposures, the securitisation of a single type of asset should, depending on the idiosyncrasies of the case, also constitute a securitisation within the meaning of the EU Securitisation Regulation, provided all other conditions are met.

5 REQUIREMENTS FOR SECURITISATIONS WHICH ARE SUBJECT TO THE EU SECURITISATION REGULATION

APPLICABLE RULES

CRITERIA

Risk Retention

Due Diligence

Transparency Reporting

5.1 RISK RETENTION (ARTICLE 6)

5.1.1 Background

In the lead-up to the financial crisis, original lenders realised that, rather than holding their originated credits to maturity, they could securitise them (thereby removing such assets from their balance sheets) and gain access to liquidity that they could, once more, employ in new credit granting. This marked the transition from the “originate-to-hold” model to the “originate-to-distribute” model.

By being able to remove these exposures from their balance sheets, original lenders also woke up to the fact that they could relax their credit granting criteria (by lending to riskier borrowers), thereby increasing the number of outstanding loans on their balance sheets and, consequently, the number of riskier securitised exposures marketed to investors.

As these exposures were often bundled with a series of other, less risky asset classes to create complex products, investors were frequently unaware of the real risk profile of the investments they were subscribing.

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In the above context of product complexity and market opacity, the interests of original lenders, originators and sponsors involved in securitisation became ever more misaligned with those of investors.

Risk retention therefore arose in the preparation of the EU Securitisation Regulation as one of the means to ensure the alignment between the interests of originators, sponsors and original lenders, on the one hand, with those of investors, on the other hand[11]. Recital (10) of the EU Securitisation Regulation establishes such alignment as one of the main objectives of the regime created by the EU Securitisation Regulation, by providing that "*the originator, sponsor or original lender should retain a significant interest in the underlying exposures of the securitisation*".

The risk retention requirement was therefore laid down in Article 6 of the EU Securitisation Regulation and applies to all securitisation transactions within the scope of the EU Securitisation Regulation, irrespective of whether the STS stamp is envisaged.

On 6 April 2021, the EU Securitisation Regulation was amended pursuant the **EU Securitisation Regulation Amendments**, which introduced a new retention framework for securitisations of Non-Performing Exposures ("NPEs") and allowed a servicer of an **NPE Securitisation**

securitisation to act as the risk retainer, provided that it meets certain conditions.

Furthermore, the Commission Delegated Regulation (EU) 2023/2175 of 7 July 2023 ("**2023 RTS**") on risk retention lays down regulatory technical standards specifying in greater detail the risk retention requirements for originators, sponsors, original lenders, and servicers.

The new RTS on risk retention (which does not significantly deviate from the regime existing under CRR) contains rules strengthening the retention obligation as to, among others, (i) retainers of risk, (ii) synthetic or contingent forms of retention, (iii) each form of admissible retention under Article 6(3) of the EU Securitisation Regulation, (iv) measurement of the level of retention, (v) prohibition of hedging or selling the retained interest, (vi) retention on a consolidated basis and (vii) initial disclosure of the level of the commitment to maintain a material net economic interest.

5.1.2 The risk retention obligation: overview

Article 6 of the EU Securitisation Regulation directly requires the EU-established originator, sponsor, original lender or in case of NPEs, the servicer of a securitisation to

[11] One other means to ensure the alignment of interests pertains to the criteria for credit-generation of securitised exposures (Article 9 of the EU Securitisation Regulation).

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retain, on an ongoing basis, a material net economic interest in the securitisation of not less than 5% using one of the specified retention options as further specified in Section 4.1.3. (Including, a first loss tranche, a vertical slice, randomly selected exposures or seller's share).

Article 6 of the EU Securitisation Regulation also specifies that the material net economic interest must be measured at the origination and determined by the notional value of the assets (and not by the real market value at which those assets were acquired by the SSPE). The EU Securitisation Regulation Amendments introduced a separate regime for the calculation of the amount of the risk retention in respect of NPE securitisations. The 5% material net economic interest is to be calculated on the basis of the discounted value of the exposures transferred to the SSPE, i.e. deducting the Non-Refundable Purchase Price Discount ("NRPPD"), defined as "*the difference between the outstanding balance of the exposure or exposures in the underlying pool and the price at which those exposures are sold by the originator to the SSPE, where neither the originator nor the original lender are reimbursed for that difference*". It is explicit that, for the purpose of the risk retention calculation, the NRPPD can be established on a per exposure basis, or portfolio basis and that the NRPPD includes purchase price discounts in the first sale to third party investors where the issuance is initially subscribed by the originator.

In addition, in order to ensure that the retainer has sufficient "skin in the game" to satisfy the purpose of the legal requirement, the EU Securitisation Regulation is clear in stipulating that the material net economic interest (i) shall not be split amongst the possible different types of retainers and (ii) shall not be subject to any credit-risk mitigation or hedging.

The EU Securitisation Regulation then specifies who should retain risk and how risk must be retained.

5.1.3 How to retain

Article 6(3) of the EU Securitisation Regulation specifies that there are only five ways in which the risk-retention obligation may be satisfied:

1. by retention of at least 5% of the nominal value of each tranche sold or transferred to investors (the so-called "vertical" retention model);
2. in the case of revolving securitisations or securitisations of revolving exposures, by retention of the originator's interest of not less than 5% of the nominal value of each of the securitised exposures;
3. by retention of randomly selected exposures, equivalent to not less than 5% of the nominal value of the securitised exposures, where such non-securitised exposures

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would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is not less than 100 at origination;

4. by retention of the first loss tranche and, where such retention does not amount to 5% of the nominal value of the securitised exposures, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total not less than 5% of the nominal value of the securitised exposures; or

5. the retention of a first loss exposure of not less than 5% of every securitised exposure in the securitisation (the so-called "horizontal" retention model).

5.1.4 The retainer

Article 6 of the EU Securitisation Regulation states that either the originator, the sponsor, the original lender or servicer (as all these terms are defined in the EU Securitisation Regulation) should retain the 5% net economic interest in the securitisation.

For the avoidance of doubt, only one of these types of entities must retain the risk.

The principle is that, within the context of a specific transaction, the originator, the sponsor, the original lender and the servicer should aim to reach an agreement as to whom will be the risk retainer. In order to avoid that, absent the parties reaching an agreement, no entity would bear the burden, the EU Securitisation Regulation further states that, failing such an agreement, the originator will bear the risk retention weight.

To comply with the risk retention obligation, it is therefore essential that the risk retainer falls within one of the four categories:

1. **Sponsor**: generally speaking, this category is reserved to credit institutions and to investment firms, other than the originator, that establish and manage (or delegate the management of) an asset-backed commercial paper programme or other securitisations (Article 2(5) of the EU Securitisation Regulation);
2. **Original lender**: this category refers to the entities which conclude the original agreements which created the obligations of the debtor giving rise to the securitised exposures (Article 2(20) of the EU Securitisation Regulation); and
3. **Originator**: this category refers to either an entity which (Article 2(3) of the EU Securitisation Regulation):

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a. was involved in the original agreement which created the obligations of the debtor giving rise to the securitised exposures (in which case, the originator will likely correspond to the original lender); or

b. purchases a third party's exposures on its own account and then securitises them.

4. **Servicer of a NPE securitisation**: this category refers to an entity that manages a pool of purchased receivables or the underlying credit exposures on a day-to-day basis in the case of traditional (i.e., non-synthetic) NPE securitisation. A "NPE securitisation" is a securitisation backed by a pool of non-performing exposures that meet the **Conditions** set out in Article 47a(3) of Regulation (EU) No 575/2013 (refer to the Glossary section for a full definition of these conditions) and the nominal value of which makes up not less than 90 % of the pool's nominal value at the time of origination and at a later time where assets are added to or removed from the underlying pool due to replenishment, restructuring or any other relevant reason.

   The EU Securitisation Regulation Amendments require the servicer to be able to demonstrate that it has expertise in servicing exposures of a similar nature to those securitised and has well-documented and adequate policies, procedures and risk-management controls relating to the servicing of exposures. This means that on a NPE securitisation, the special asset servicer, rather than the original lender, originator or sponsor, may be a permitted retention holder, provided it has sufficient expertise (this is similar to requirements for servicers in STS securitisations).

In practice, the entity qualifying as originator will, more often than not, be selected as the risk retainer. Because of its importance and the issues that usually arise with the determination of who the originator is, a specific subsection is dedicated to this entity.

5.1.5 *The originator*

The notion of an originator could, generally speaking, overlap with that of an original lender, the former being an entity which either (i) itself or through related entities, directly or indirectly, was involved (but not necessarily concluded as an original lender) in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposures being securitised (the so-called "limb (a) originator") or (ii) an entity which "*purchases a third party's exposures on its own account and then securitises them*" (the so-called "limb (b) originator").

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Under the pre-EU Securitisation Regulation risk retention regime pursuant to the CRR (please see section ***Structural subordination***), the EBA expressed the view that an entity wishing to qualify as a limb (b) originator should be "*of real substance*" and hold "*actual economic capital on its assets for a minimum period of time*".

In the same manner, the EU Securitisation Regulation now provides that, for the purposes of the risk retention obligation, an entity shall not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures (Article 6(1)). The **(2023) RTS on risk retention**[12] set out a test for determining whether or not an entity has met this requirement. Accordingly, an entity will not be considered to have been established or to operate for the sole purpose of securitising exposure where all of the below applies:

1. the entity has a strategy and the capacity to meet payment obligations consistent with a broader business model that involves material support from capital, assets, fees or other sources of income by virtue of which the entity does not rely on the exposures to be securitised, on any interests retained or proposed to be retained in accordance with Article 6 of the EU Securitisation Regulation, or on any corresponding income from such exposures and interests, as its sole or predominant source of revenue; and
2. the members of the management body have the necessary experience to enable the entity to pursue the established business strategy, as well as an adequate corporate governance arrangement.

5.2 DUE-DILIGENCE REQUIREMENTS FOR INSTITUTIONAL INVESTORS (ARTICLE 5)

5.2.1 Verification requirements of institutional investors

Prior to holding a securitisation position, an institutional investor shall verify that*:*

1. where the originator or original lender established in the EU is not a credit institution or an investment firm or is established in a third country (irrespective of its regulatory status), the originator or original lender grants all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply these criteria and processes in accordance with Article 9, i.e., *inter alia*, to ensure that

12 See below on their application.

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credit-granting is based on a thorough assessment of the obligor's creditworthiness, or, in case of non-performing exposures, sound standards apply in the selection and pricing of the exposures.;

2. if established in the EU, originator, sponsor or original lender maintains on an ongoing basis a material net economic interest in accordance with Article 6 and the risk retention is disclosed to the institutional investor in accordance with Article 7 , or, if established in a third country, such entity maintains on an ongoing basis a material net economic interest of not less than 5%(determined in accordance with Article 6) and discloses risk retention to the institutional investors;

3. the originator, sponsor or SSPE has made available the information required by Article 7, in accordance with frequency and modalities provided for in that Article.

In the case of fully supported Asset-backed commercial paper ("**ABCP**") transactions, the requirement specified in paragraph 1 above shall apply to the sponsor.

5.2.2 Due diligence requirements of institutional investors

Prior to holding a securitisation position, an institutional investor shall carry out a due-diligence assessment which shall consider at least all of the following:

1. the risk characteristics of the individual securitisation position and of the underlying exposures;

2. all the structural features of the securitisation that can materially impact the performance of the securitisation position, including contractual priorities of payment, payment related triggers, credit and liquidity enhancements, market value triggers and the definitions of default;

3. with regard to a securitisation notified as STS in accordance with Article 27, the compliance with such requirements as mentioned (e.g. monthly or quarterly reports / deal documentation).

In the case of fully supported ABCP programme, institutional investors shall consider the features of the ABCP programme and the full liquidity support.

5.2.3 Minimum requirements of institutional investors

An institutional investor shall *at least*:

1. establish appropriate written procedures that are proportionate to the risk profile of the securitisation position and, where relevant, to the institutional investor's

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trading and non-trading book, in order to monitor, on an ongoing basis, compliance with the above paragraphs (due diligence requirements set forth in Article 5) and the performance of the securitisation position and underlying exposures.

Where relevant those written procedures shall include monitoring of the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, recovery rates, repurchases, loan modifications, payment holidays, collateral type and occupancy, and frequency distribution of credit scores or other measures of creditworthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis;

2. in the case of a securitisation other than a fully supported ABCP programme, regularly perform stress tests on the cash flows and collateral values supporting the underlying exposures or, in the absence of sufficient data on cash flows and collateral values, stress tests on loss assumptions, having regard to the nature, scale and complexity of the risk of the securitisation position;
3. in the case of a fully supported ABCP programme, regularly perform stress tests on the solvency and liquidity of the sponsor;
4. ensure internal reporting to its management body so that the management body is aware of the material risks;
5. be able to demonstrate to its competent authorities, upon request, that it has thorough understanding of the securitisation positions and its underlying exposures and that it has implemented written policies and procedures for the risk management and for maintaining records of the verifications and due diligence in accordance with the above paragraphs and of any other relevant information; and
6. in the case of exposures to a fully supported ABCP programme, be able to demonstrate to its competent authorities, upon request, that it has a comprehensive and thorough understanding of the credit quality of the sponsor and of the terms of the liquidity facility provided.

While a highly formalised due diligence process with regards to securitisation investments is understandable for higher risk junior or mezzanine investments, this may be disproportionate when it comes to high-rated senior tranches, especially in comparison with to the due diligence requirements for similarly risky investments in corporate bonds

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and other asset classes. In this context, we think it is important for the EU authorities to apply the proportionality principle and assess the required extend of documentation based on the risk position to be taken. A RTS on the due diligence requirements giving some principle-based guidance and examples for the proportionate application would therefore be helpful.

5.2.4 Delegation to third parties

Where an institutional investor has given another institutional investor (managing party) authority to make investment management decisions that might expose it to a securitisation and has instructed the managing party to fulfil its due diligence obligations under Article 5, and if such managing party has failed to do so sanctions may be imposed on the managing party and not on the institutional investor who is exposed to the securitisation.

However, Article 5 is not sufficiently clear in whether a delegation of duties to a non-EU managing party is permitted, given the fact that the EU supervisory authorities would have no jurisdiction over such managing investor and would, in this situation be prevented from applying sanctions against the instructing institutional investor, which is obviously not a satisfactory result. It seems that EU regulators have also not yet consistently interpreting this paragraph.

5.2.5 Due diligence with regard to third countries securitisations

The due diligence requirements under Article 5 are also applicable where an EU institutional investor invests into a securitisation where none of the sell-side entities is located in the European Union. Although the sell-side entities would not in this scenario be subject to the supervision of the EU regulators ensuring compliance with the EU Securitisation Regulation and might not for this reason be interested in providing the necessary information (in particular, under Article 5(e) requiring the institutional investors to verify whether the information required by Article 7 has been made available, in accordance with frequency and modalities provided for in that Article), the European Commission has found in its Report on the functioning of the EU Securitisation Regulation[13] that "*differentiating the scope of information to be provided, depending on whether the securitisation is issued by EU entities or by entities based in third-countries, is not in line with the legislative intent*.". Furthermore, the Commission believes that the envisaged measures to amend the technical standards that set out transparency requirements of Article 7 and reporting template for private securitisations might help reducing the competitive disadvantage for EU institutional investors.

[13] Report from the Commission to the European Parliament and the Council on the functioning of the EU Securitisation Regulation – October 2022.

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5.3 TRANSPARENCY REQUIREMENTS FOR ORIGINATORS, SPONSORS AND SSPEs (ARTICLE 7)

5.3.1 Minimum transparency requirements for originator, sponsor and SSPE

The originator, sponsor and SSPE of a securitisation shall make at least the following information available to holders of a securitisation position, to the competent authorities (for instance for Luxembourg SSPE to the CSSF) and, upon request, to potential investors:

1. information on the underlying exposures on a quarterly basis, or, in the case of an ABCP, information on the underlying receivables or credit claims on a monthly basis;

2. all underlying documentation that is essential for the understanding of the transaction, including but not limited to final offering document, prospectus, asset sale agreement, servicing and backup servicing agreement, and trust deed.

3. That underlying documentation shall include a detailed description of the priority of payments of the securitisation;

4. where a prospectus has not been drawn up in compliance with EU Directive 2003/71/EC, a transaction summary or overview of the main features of the securitisations;

5. in the case of STS securitisations, the STS notification;

6. quarterly investor reports, or, in the case of an ABCP, monthly investor reports, containing all materially relevant data on the credit quality and performance of underlying exposure, information on events which trigger changes in the priority of payments or the replacement of any counter-parties and information about the risk retained;

7. any inside information relating to the securitisation that the originator, sponsor or SSPE is obliged to make public in accordance with EU Regulation No 596/2014; or any other significant event such as breach of any obligation or any material amendment to transaction documents. Such information shall be made available without any delay.

In the case of an ABCP, the relevant information shall be made available in aggregate form to holders of securitisation positions and, upon request, to potential investors. Loan-level data shall be made available to the sponsor and, upon request, to competent authorities.

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The originator, sponsor and SSPE of a securitisation shall comply with national and EU law governing the protection of confidentiality of information and the processing of personal while complying with the above requirements.

To address some of the above transparency requirements, ESMA has made available 15 template reports[14]. In its consultation paper dated 21 December 2023, ESMA also sought the views of market participants on whether a dedicated and simplified private securitisation template shall be developed.[15]

Based on discussions with market participants and multiple publications in this respect, the complexity and granularity of the Art. 7 reporting seems to be a significant burden for originators and issuers. This is even more important, when the originator is not a well-established player handling high volumes but rather a SME intending to use securitisation to refinance is business for the first time. The extensive reporting requirement may thus represent an entry barrier to the capital markets for SME which is contradictory to the objectives of the Capital Markets Union. Also, investors seem to be sufficiently satisfied with less standardised and less granular information for their ongoing monitoring, especially when it comes to private securitisations. We are excited to see the outcome of ESMAs consultation and actions taken.

5.3.2 Selecting an entity for information requirements

The originator, sponsor and SSPE of a securitisation shall designate among themselves one entity to fulfil the information requirements. Such entity shall make the information for a securitisation transaction available by means of a securitisation repository.

In other cases, such entity shall make the information available by means of a website that:

1. includes a well-functioning data quality control system;
2. is subject to appropriate governance standards and to maintenance and operation of an adequate organisational structure that ensures the continuity and orderly functioning of the website;
3. is subject to appropriate systems, controls and procedures that identify all relevant sources of operational risk;
4. includes systems that ensure the protection and integrity of the information received and the prompt recording of the information; and

[14] The disclosure technical standards and reporting templates are available for download from the ESMA website in the section entitled "Disclosure requirements and templates".

[15] ESMA Consultation Paper on the securtisation disclosure templates under Article 7 of the Securitisation Regulation – December 2023.

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5. makes it possible to keep record of the information for at least five years after the maturity date of the securitisation.

The final documentation related to the above requirements shall be made available to investors at the latest 15 days after closing of the transaction.

5.3.3 Further requirements relating to transparency (Articles 22 and 24)

1. The originator and the sponsor shall make available data on static and dynamic historical default and loss performance for substantially similar exposures and the sources of those data together with the basis for claiming similarity, to potential investors before pricing. Those data shall cover a period of at least five years; except in the case of an ABCP securitisation, the data relating to trade receivables and other short-term receivables shall cover a historical period no shorter than three years.
2. A sample of the underlying exposures shall be subject to external verification prior to issuance of the securities resulting from the securitisation by an appropriate and independent party.
3. The originator or the sponsor shall make available, before and after the pricing of the securitisation on an ongoing basis, to potential investors/ investors, a liability cash flow model which precisely represents the contractual relationship between the underlying exposures and the payments.
4. In the case of a securitisation where the underlying exposures are residential loans or auto loans or leases, the originator and sponsor shall publish the available information relating to the environmental performance of the assets financed by such residential loans or auto loans or leases.
5. The originator and the sponsor shall be responsible for compliance with Article 7.

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6 CREDIT ENHANCEMENT: TRANCHING VS GUARANTEES, INSURANCE SCHEMES AND LIQUIDITY COMMITMENTS

6.1 GENERAL CONSIDERATIONS

Under the EU Securitisation Regulation there is no explicit definition of the term credit enhancement. Nevertheless, in accordance with established market practice, credit enhancement refers to a variety of techniques aiming to mitigate the credit risk associated with a financial product and/or improve its credit rating. In the context of securitisation transactions, the most common forms or credit enhancement are guarantees, insurance policies or collaterals provided at issuer level.

The provision of guarantees constitutes the most popular credit enhancement technique observed in the Luxembourg securitisation market. Typically, either the originator or third parties, guarantee the performance of the underlying assets, e.g., receivables of the securitisation structure. As a result, the performance of the securitisation instruments (or loans) is not dependent only on the underlying receivables but also on the creditworthiness of the guarantor. In this respect, an underperformance or total default of the pool of receivables would be covered by the guarantee thus not affecting the performance of the securitisation instruments/loans. An increasingly common structure in securitisation transactions is the provision of a guarantee by the European Investment Fund to the investors of the securitisation vehicle. This structure seems to have a variety of advantages also from a regulatory point of view. Securitisation notes being guaranteed by the EIF are assigned an AAA/Aaa/AAA rating, and a zero risk-weight factor in the context of the provisions of the CRR.

The establishment of an insurance policy at the level of the underlying assets, most commonly trade receivables, also constitutes a form of credit enhancement. In practice, the issuer enters into a contractual relationship with a credit insurer, in order to cover the credit risk relating to the portfolio of the assigned receivables. The features of the credit insurance policy can be tailored/negotiated with the insurer to the extent of coverage, eligibility criteria, deductible, threshold loss or a minimum amount, etc.

Finally, it might also be possible for liquidity commitments to be entered into between the issuer and a liquidity-providing party (or liquidity-providing parties) with the issuer as sole beneficiary. The economic purpose is to bear any losses of the loan portfolio of the issuer.

6.2 TRANCHING

Each of the forms of credit enhancement analysed above could directly or indirectly create tranching. In this respect, it is important to analyse whether the credit enhancement is

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provided to the issuer or directly to the noteholders. The discussion made under Section 4 is also relevant in this context.

In line with Section 4.2.13, one could argue that credit enhancement provided to the issuer should be conceptualised as being part of the pool of underlying assets. Indeed, the economic purpose such credit enhancement is to absorb any losses of the underlying assets held by the issuer. As a result any amounts paid under the credit enhancement will be passed to investors in accordance with the applicable waterfall of payments. On the other hand, as discussed under Section 4.2.12 above, the provision of credit enhancement to the noteholders could lead to the creation of tranching. In any event, a case-by-case analysis would be required to infer on whether credit enhancement techniques could create a tranche.

6.3 DEPENDENCY TEST

At the same time, the provision of credit enhancement directly to the noteholders could affect the characterisation of a transaction as securitisation under the EU Securitisation Regulation. Such a credit enhancement could result in a situation where one could argue that "payments in the transaction or scheme are" not "dependent upon the performance of the exposure or of the pool of exposures" since if the pool of exposures does not perform, repayments under the notes are guaranteed/insured by the originator/third parties. In this respect, it could be argued that the definition of the term securitisation as set out in the EU Securitisation Regulation is not satisfied. Nevertheless, a case-by-case approach is always required in order to determine whether the particular characteristics of a structure would meet the so called "dependency test" or nor.

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7 NON–APPLICATION OF SECURITISATION REGULATION – SPECIALISED LENDING EXEMPTION

Provided that the securitised credit risk constitutes "specialised lending" as defined in Article 147(8) of the CRR and as further described in the **EBA RTS**

the issue of several classes of notes should benefit from the exemption under article 2(1)(c) of the Securitisation Regulation and hence not qualify as securitisation under the Securitisation Regulation. This exception usually applies to single loan securitisations where the ultimate goal of the loan is project financing. The requirements set under Article 147(8) of the CRR should be assessed at the level of the underlying loan agreement provided by the securitisation vehicle to the borrower, in order to measure whether it could qualify as a specialised lending. The requirements are the following:

a) *the exposure is to an entity which was created specifically to finance or operate physical assets or is an economically comparable exposure;*

b) *the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate;*

c) *the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.*

The first criterion under point a) essentially indicates that the loan should be provided by the securitisation vehicle to a special purpose vehicle which was created specifically to finance or operate physical assets or is an economically comparable exposure. The EBA RTS provide in this respect that one class of specialised lending can be "*where the purpose of the specialised lending exposure is to finance the development or acquisition of large, complex and expensive installations, in particular, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure, so that the income generated by the assets is the money generated by the contracts for the facility's output obtained from one or several third parties ('project finance exposures')*".

With respect to the requirement that the securitisation vehicle should have a "*substantial degree of control over the assets and the income that they generate*", the EBA RTS explicitly state that an indication of such control would be the existence of "*Lender's control over cash flows (e.g. cash sweeps, independent escrow accounts)*" and "*strength of the covenant package (mandatory prepayments, payment deferrals, payment cascade, dividend restrictions)*". Such elements can be typically found in covenants contained in the loan agreement or ancillary documentation thereto. For example, covenants could subject

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the disbursements of the financing to a number of conditions to be fulfilled on an ongoing basis by the borrower. Similar provisions could also impose a number of information disclosure obligations to the borrower. Another typical covenant would bind the borrower to comply with certain business and financial ratio covenants, use of certain accounts and reserves, debt service special accounts, limits on payments and distributions, etc. The existence of pledges over the physical assets or accounts/receivables of the borrower would constitute a further indication of the control that the issuer would exercise over it. In this respect, it is commonly observed that the borrower grants an unconditional and irrevocable power of attorney in favour of the issuer for the enforcement of the pledges, an element which further strengthens the controlling position of the issuer.

The operations of the borrower will determine whether the repayment of the loan obligations are dependent upon the income generated by the physical assets. Typically in these type of transactions the borrower is a special purpose vehicle which does not perform any business activity other than the administration of the physical assets. This is also ensured by contractual covenants contained in the financing documents prohibiting the borrower from being engaged in other activities.

Finally, the exemption for specialised lending serves also an economic policy purpose at EU level, which is to grant a special beneficial regulatory treatment to this type of lending. The beneficial regulatory treatment is to escape the reporting requirements under the Securitisation Regulation and to enjoy a lighter regulatory capital treatment under the CRR, even if technically (because of the existence of tranching) a transaction could provide for certain key elements, which qualify as a securitisation under the EU Securitisation Regulation. The rationale behind this exemption is, however, to encourage this form of lending and the investment in sustainable infrastructure within the EU.

In any event, it is important to note that the application of the “specialised lending exemption” must be carefully analysed on a case by case basis and be supported by a thorough due diligence of the underlying credit risk.

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8 EXAMPLES AND APPROACHES

This section provides an analysis of diffrent structures under the EU Securitisation Regulation. It examines the credit risk, the tranching and the conclusion on the applicability of the EU Securitisation Regulation for each structure.

8.1 DEFERRED PURCHASE PRICE

- **Structure Description**: The main element in this scenario is that only a fraction of the purchase price of the instruments is paid at the delivery of the purchased instruments and the remaining amount is paid at a later stage, depending on the occurrence of contractually agreed events.

  The deferred payment is not senior or subordinated to the initial payment or any other financing arrangements.
- **Credit Risk and Tranching**: In the absence of any subordination arrangements, a mere existence of a deferred purchase price element would not have the consequence that the instruments could be considered as tranched and / or that a portion of the instrument is considered as subordinated to the other portion.

EU Securitisation Regulation Conclusion

The transaction would not fall within the scope of the EU Securitisation Regulation.

8.2 RESERVES IN TRADE RECEIVABLE STRUCTURES

- **Structure Description**: The main concern in securitising trade receivables are the reserves required by lenders for overcollateralization to cater to the risk pertaining to the securitised portfolio of assets.

  The reserves can take a different legal and economic form. These reserves, meant to cover dilution risk (i.e. reductions in collection of receivables that are not due to the default of the obligors, such as rebates granted by the seller, quality disputes etc), are often provided by the seller in the form of deferred purchase price, where a portion of the price is paid at closing and the remaining portion only at the collection of the securitised receivables.

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The payment of the deferred purchase price would depend upon the performance of the underlying receivables.

In practice, lenders financing the structure would normally require that the seller's claim for the payment of the deferred purchase price is subordinated to the lenders' claim under the relevant financing arrangements.

- **Credit Risk and Tranching**: The seller's claim for the payment of the portion of price at collection can potentially constitute a tranche under the EU Securitisation Regulation.

EU Securitisation Regulation Conclusion

The transaction could fall within the scope of the EU Securitisation Regulation if there is a senior financing 1 at the level of the securitisation vehicle and subordination arrangements are in place. However, if it is a mere deferred purchase price with no contractual subordination, the analysis remains the same as the first example.

8.3 SYNTHETIC STRUCTURES – TOTAL RETURN SWAP

- **Structure Description:** Within the context of risk mitigation and hedging, the question may arise whether or not a total return swap ("TRS") can constitute a tranche within the sense of the EU Securitisation Regulation and trigger the obligations under the EU Securitisation Regulation. This shall exclude TRS relating to risks other than credit risks.
- **Credit Risk and Tranching:** A TRS may indeed consist of a "tranche" under the EU Securitisation Regulation, a position which was shared by Committee of European Banking Supervisors (CEBS) Guidance [16] confirming that a TRS in its

16 In its proposed guidance on Art. 122a of Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).

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own right can be a tranche. Indeed, the EU Securitisation Regulation does not exclude synthetic or derivative positions from the concept of tranches. Conversely, this implies that satisfying the risk retention obligations under Article 6 of the EU Securitisation Regulation may also be done on a synthetic or derivative basis.

This does not mean however, that a TRS, will automatically constitute a tranche for the purpose of the EU Securitisation Regulation. For example, a scenario where a securitisation vehicle (SV) issues a series of notes and the SV as total return payer enters into a TRS with a swap bank (the total return receiver) should not necessarily trigger the application of the EU Securitisation Regulation even if the swap bank ranks senior to the noteholders.

If the swap bank provides credit protection to the SV on particular risks, such as for example default risk, it could be considered as the party bearing the losses on the reference assets, in particular if it has an independent payment obligation to the SV. In such case, it is the swap counterparty taking market and default risk and the subordination of the tranches would not determine the losses on the exposures during the ongoing life of the transaction. This is irrespective of other characteristics making a transaction or scheme a securitisation (such as different tranches of notes with subordination of losses).

EU Securitisation Regulation Conclusion

The specific characteristics of the transaction or scheme would determine whether it is a transaction falling under the EU Securitisation Regulation.

8.4 SENIOR FACILITY SECURED BY UNCALLED COMMITMENTS UNDER SUBORDINATED NOTES

- **Structure Description:** A securitisation vehicle issues subordinated profit participating notes ("PPNs") on a commitment basis, meaning that the noteholders would not fund the vehicle on day one, but only upon request by the issuer in the course of the transaction. In order to bridge the time between the purchase of the debt portfolio and the drawdown of the committed funds, the securitisation vehicle borrows cash from institutional lenders under a senior facilities agreement ("SFA"). The SFA contains a contractual priority of

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payments that subordinates the payout of distributions under the PPNs to the prior servicing of the loan.

- **Analysis:** For the purpose of this analysis, we assume that the assets held by the securitisation vehicle bear credit risk. The focus of this analysis is thus restricted to whether the transaction is tranched. The subordination provisions indeed appear to establish a contractual hierarchy of payments. However, if in practice, the SFA is repaid with the capital drawn down under the PPNs, rather than with the proceeds from the investments, it can be argued that the SFA and the PPNs do not constitute tranches within the meaning of the Securitisation Regulation. Indeed, the lenders under the SFA and the noteholders under the PPNs are looking at a different collateral pool - the lender looks at the undrawn commitments under the PPNs, while the noteholders look at the underlying investments.

  In case the subordination provisions entirely prohibit distributions under the PPNs before the full repayment of the SFA, it may additionally be argued that the transaction fails to distribute the losses among tranches *during the ongoing life of the transaction*, as required by limb (b) of the securitisation definition of the Securitisation Regulation. The distributions under the PPNs could only occur after the segment established by the SFA has ceased to exist.

EU Securitisation Regulation Conclusion

A securitisation vehicle issuing PPNs on a commitments basis that are subordinated to a senior facilities agreement may not fall within the scope of the Securitisation Regulation if the proceeds from the PPNs are used to repay amounts outstanding under the senior facilities agreement and/or if the subordination provisions prevent a distribution under the PPNs prior to the full repayment of the SFA.

8.5 REPACK OF DEBT FUND

- **Structure Description:** the SV is financed by senior debt provided by senior lenders and junior debt provided by junior lenders (together the "Lenders").

  The SV intends to subscribe for units of a fund (the “Fund”) and the Fund in turn intends to invest into a debt portfolio.

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Question may then arise as to whether the financing provided by the Lenders to the SV in the above structure could constitute a securitisation exposure for the purposes of the EU Securitisation Regulation, assuming that Article 2(1)(c) of the EU Securitisation Regulation is not relevant to this structure.

- **Credit Risk and Tranching:** For the debt provided by the Lenders to the SV to constitute a securitisation exposure, there are two credit risk related criteria:
  - there must be an underlying pool of credit exposures; and
  - payments to the Lenders must be dependent upon the performance of that pool of exposures.

Although the Lenders are lending to an SV which is investing in equity (fund units), this is not by itself sufficient to conclude that these criteria are not met. The economic substance of the entire transaction needs to be considered when conducting an EU Securitisation Regulation analysis.

In this structure, there is an underlying pool of credit exposures (the debt portfolio held by the Fund). The key question here is therefore whether payments to the Lenders are dependent on the performance of that debt portfolio.

Various factors are relevant when considering this question and the specific facts will have a significant impact on the analysis. In general the distinction to be drawn is between whether (1) the Lenders are investing in a business such that the Lenders are reliant on the skilled management of the intervening vehicles and assets (i.e. a corporate exposure) or (2) the Lenders are investing in a predominantly passive debt portfolio where only minimal management (such as normal, day-to-day servicing) is required to produce the income stream from the investment (i.e. investing in a passthrough structure where payments to the Lenders are dependent upon the performance of the debt portfolio).

The distinction may be difficult to draw and in reality, it is more of a spectrum. The more the debt portfolio is a static portfolio, identified or identifiable in advance of the Lenders granting the loans to the SPV, with little discretion on the part of the Fund or the Fund manager to make changes, the more it appears that the Lenders are taking credit risk on the debt portfolio bearing principal losses when they lend to the SV (i.e. that the Lenders' exposure is to the debt portfolio and that any payments to the Lenders are dependent on the performance of that debt portfolio). The more the Fund or the Fund manager has broad discretion to acquire, dispose of and manage the assets constituting the debt portfolio in an ongoing, continual way, the more it appears that the Lenders are relying on the skill and management of the Fund or Fund manager (and have a corporate exposure rather than a securitisation exposure).

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- **Evaluation of the tranching:** For the debt provided by the Lenders to the SV to constitute a securitisation exposure, there are also two tranching related criteria (in addition to the credit related criteria discussed above):

  - the credit risk associated with the pool of exposures must be tranched; and

  - the subordination of the tranches must determine the distribution of losses during the ongoing life of the transaction or scheme.

  For the purposes of the EU Securitisation Regulation, "tranche" means "a contractually established segment of the credit risk associated with an exposure or a pool of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment [...]".

  In this structure above as the SV has entered into both senior and junior loans we would expect there is tranching as between these loans (i.e. that contractually payments under the senior loans would rank above payments under the junior loans). This would need to be checked in the transaction documents. If there is tranching between the senior and junior loans, it is important to consider whether this would determine the distribution of losses during the ongoing life of the transaction.

  The "ongoing life" criterion is about how credit losses on the underlying loans are allocated to the senior and junior debt. If this is done only once (typically on default or termination of the arrangement) then the transaction is not a securitisation. If, however, credit losses are allocated to the tranches throughout the life of the arrangement (e.g. as they accrue on the underlying loans) then this criterion will generally be met. A useful rule of thumb is that if, under the transaction documents, the transaction would continue even if the junior debt were in default, then this criterion is probably met. If the transaction is likely not to continue once the junior debt is in default, this will generally indicate that the "ongoing life" criterion is not met.

EU Securitisation Regulation Conclusion

The dividing line between what does and does not constitute a securitisation exposure is therefore not always clear and can be somewhat subjective. When determining whether debt provided by a particular Lender constitutes a securitisation exposure, the view such Lender takes of the investment will be an important factor.

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Each Lender should, as a matter of regulatory compliance, have a policy that is reasoned and applied consistently. Such policy should ideally be a written policy, informed by expert advice. Whether the structure should be treated as a securitisation exposure of the Lenders for the purposes of the EU Securitisation Regulation would need to be determined on a case-by-case basis.

8.6 LOAN/NOTES DUAL STRUCTURES

- **Structure Description:** the SV is investing in debt instruments and the SV is financed partly by loan(s) and partly by notes.
- **Credit Risk and Tranching:** As it is an investment in loans/receivables portfolio by way of origination and/or acquisition, there is an actual credit risk.

  Assuming that there is no intercreditor agreement giving a specific ranking between the notes and the loan, the loan and the notes should rank *pari passu*. This may change however with a specific agreement contained in an intercreditor agreement which provides otherwise.

  In relation to the evaluation of the dependence criteria (i.e., dependence of the payments to be made by the SV to the performance of the underlying assets during the ongoing life of the transaction), both the yield under the notes and the ability of the SV to make payment on the senior loan will depend on the returns under and the performance of under the underlying assets. Accordingly, the dependence criteria is verified.

EU Securitisation Regulation Conclusion

The loan/notes dual structure would not fall within the scope of the EU Securitisation Regulation if the notes and the loan rank *pari passu*. The solution may be different if an intercreditor agreement provides for different ranking

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9 GLOSSARY

This paper is an update of a LuxCMA paper published in November 2021 and we encourage you to read the additional papers focusing on different types of transactions and underlying assets available on our website.

A	**ABCP**	means Asset Backed Commercial Paper.
	AIFMs	means Alternative Investment Fund Managers.
	ATAD 1	means the Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

C	**Conditions**	means the conditions set out in Article 47a(3) of the CRR: For the purposes of point (m) of Article 36(1), the following exposures shall be classified as non-performing: (a) an exposure in respect of which a default is considered to have occurred in accordance with Article 178; (b) an exposure which is considered to be impaired in accordance with the applicable accounting framework; (c) an exposure under probation pursuant to paragraph 7, where additional forbearance measures are granted or where the exposure becomes more than 30 days past due; (d) an exposure in the form of a commitment that, were it drawn down or otherwise used, would likely not be paid back in full without realisation of collateral; (e) an exposure in form of a financial guarantee that is likely to be called by the guaranteed party, including where the underlying guaranteed exposure meets the criteria to be considered as non-performing. For the purposes of point (a), where an institution has on-balance-sheet exposures to an obligor that are past due by more than 90 days and that represent more than 20 % of all on-balance-sheet exposures to that obligor, all on- and off-balance-sheet exposures to that obligor shall be considered to be non-performing.

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C	**CRR**	means the Capital Requirements Regulation: Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2014 on prudential requirements for credit institutions and investments firms, as amended).
	CSSF	means the Commission de Surveillance du Secteur Financier, responsible for the financial regulation in Luxembourg.

E	**EBA**	means the European Banking Authority, an independent body of the European Union set up in 2011 in the aftermath of the great financial crisis. Its main tasks are to set consistent rules for EU banks, ensure a level playing field and protect consumers of financial services, with the overall objective of contributing to financial stability in the EU.
	EBA RTS **on specialised lending exposures**	means the final draft of the Regulatory Technical Standards on the assignment of risk weights to specialised lending exposures under Article 153(9) of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR), as published by the European Banking Authority on 13 June 2016.
	ECB	means the European Central Bank, the central bank responsible for monetary policy of those European Union (EU) member countries which have adopted the euro currency.
	ESMA	means the European Securities and Markets Authority, the independent European Union (EU) Authority that contributes to safeguarding the stability of the EU´s financial system by enhancing the protection of investors and promoting stable and orderly financial markets.

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E	**EU Securitisation Regulation**	means the 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.
	EU Securitisation Regulation Amendments	means the Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021 amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 crisis.
	Excluded Securitisations	means compartments of an SSPE which do not qualify as securitisation under the definition of Article 2(1) of the STS Regulation.

L	**LuxCMA**	means the Luxembourg Capital Markets Association, a not-for-profit association created on 1 March 2019 which represents the common interests of all stakeholders of the primary capital markets industry of Luxembourg.

N	**Non-STS Securitisations**	means securitisations that do not meet the criteria for the Simple, Transparent and Standardised (STS) designation under the EU Securitisation Regulation, typically involving more complex, opaque or less standardised financial structures.
	NPE Securitisation	means a securitisation backed by a pool of Non-Performing Exposures (NPE), the nominal value of which makes up not less than 90 % of the entire pool's nominal value at the time of origination and at any later time where assets are added to or removed from the underlying pool due to replenishment, restructuring or any other relevant reason (Article 2(24) of the EU Securitisation Regulation).

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P	**Publication**	means this document and the information contained therein, prepared by LuxCMA for information purposes only.

R	**RTS**	means Regulatory Technical Standards (RTS), and are detailed rules developed by the European Supervisory Authorities (ESAs), i.e., the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), to ensure consistent and harmonised implementation of EU legislation across Member States.
	(2023) RTS on risk retention	means the Commission Delegated Regulation (EU) 2023/2175 of 7 July 2023 on supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council with regard to regulatory technical standards specifying in greater detail the risk retention requirements for originators, sponsors, original lenders, and servicers.

S	**Securitisation Law**	means the Luxembourg Law of 22 March 2004 on securitisation, as amended, governing Luxembourg securitisation vehicles.
	SSPE	means a Securitisation Special Purpose Entity (SSPE), a vehicle created specifically to isolate financial assets in a securitisation transaction, as defined under the EU Securitisation Regulation.
	STS	means Simple, Transparent and Standardised securitisations complying with the criteria set out in 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.

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U	UCITS	means Undertakings for Collective Investment and refers to those investment funds established in accordance with the provisions of the amended Luxembourg Law of 17 December 2010 (the "UCI Law", also known as the "Fund Law"), implementing EU Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS).

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About the LuxCMA – Luxembourg Capital Markets Association

Created on 1 March 2019, the LuxCMA is a not-for-profit association (a.s.b.l.), registered at the RCSL (F12205), whose registered office is 6 rue Jean Monnet, L-2180 Luxembourg. The LuxCMA today represents memberships detailed on LuxCMA's website (www.luxcma.com), which is composed by banks, law firms and services providers, amongst others.

Working Group I Securitisation

The main purpose of the Securitisation Working Group is to monitor and comment on developments in the European and Luxembourg regulatory environment for securitisation.
The objective is to develop recommendations to enhance the attractiveness of Luxembourg as a centre for the domicile, administration and/or management of regulated and non-regulated securitisation vehicles or funds.
The group is composed of representatives of the main Luxembourg law firms, audit firms, corporate service providers, banks and the stock exchange. This structure enables the working group to develop a holistic view of the market on various issues and to represent the Luxembourg capital markets community vis-à-vis Luxembourg and European regulators.

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