IN-DEPTH

Securitisation Law

EDITION 5

Contributing editor
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LEXOLOGY

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Preface

Michael L Urschel

Securitisation, broadly defined as the conversion of assets into marketable financial securities, has been used as a method of raising capital since as early as the 1970s in the United States. The use of securitisation as a form of borrowing has increased globally since then, and bodies of law have been established in many jurisdictions to allow borrowers to access capital in this manner, while protecting potential investors. Regulatory considerations include tax structuring, bankruptcy considerations and economic-driven regulation focused specifically on securitisation.

Securitisation regulatory frameworks have developed at different rates globally and largely depend on a variety of factors, including the economic state of a given jurisdiction, the broader legal frameworks already in existence (including tax and bankruptcy law), particular asset classes available to securitise and habits of local consumers. Although certain assets, such as mortgage loans, are frequently securitised across many jurisdictions, other asset classes can vary. For example, in the United States and many developed countries, in addition to mortgage loan securitisation, securitisation of automobile loans and consumer debt is extremely common, and significant expansion into other operating assets such as leases and royalties is occurring. In certain other countries, more purpose-driven and asset-class specific monetisation transactions are relevant. Economic events, such as the 2008 recession in the United States, have had a great impact on the regulatory framework, not only in the United States, but also in jurisdictions such as Japan that were affected by the recession, and the effects of the covid-19 pandemic and have led to certain government responses in bolstering the securitisation market. Although 2020 and 2021 were robust years for the securitisation markets, with increased deal volume and substantial innovation in the asset class across the globe, we are currently witnessing the securitisation market's reaction to multiple macroeconomic events, such as increased inflationary pressures and higher interest rates.

In this fifth edition of *The Securitisation Law Review*, we aim to provide securitisation attorneys, borrowers, lenders and other market participants with insight into a sample of structural frameworks and regulatory issues surrounding the industry in a broad array of jurisdictions. This volume is not intended to be a comprehensive overview of securitisation regulation and structures in every jurisdiction, but rather to provide a frame of reference for, and a comparison of, the various structural features available and the regulatory considerations necessary in securitising assets globally. As the asset securitisation industry continues to develop and expand to new and more esoteric asset classes, such a comparison will undoubtedly be useful to those innovating in global securitisation markets.

I would like to thank the contributors for the chapters that follow. I hope that this volume will produce grounds for continued discussion in the global securitisation industry.

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New York
October 2023

Chapter 1

Argentina

Pablo Gayol and Sergio Tálamo[1]

Summary

I OVERVIEW

The 2018 crisis resulted in a sudden stop in the foreign financing to Argentina and a step increase in the interest rates in pesos, which have a negative impact on the consumer lending market. Since much of the financing being securitised is consumer lending, the securitisation market suffered. In addition, upon the outbreak of covid-19, the global economy in general and Argentina in particular have been negatively impacted, causing the disruption of financial markets.

Since 2020, Argentina has been immersed in a debt restructuring process to restore the sustainability of its public external debt. During 2021 and 2022, Argentina negotiated with the Paris Club, and in October 2022 they agreed to reschedule 100 per cent of the total amounts of principal and interest due by Argentina (estimated at US$1.9 billion) and reduce the applicable interest rates.

On 28 January 2022, the International Monetary Fund (IMF) and the Argentine government reached an understanding to restructure the current debt with the IMF. This agreement was approved by the IMF's executive board on 3 March 2022 and approved by the Argentine Congress on 17 March 2022 (the Staff-Level Agreement). Ultimately, the Staff-Level Agreement was approved by the IMF's executive board on 25 March 2022. The Staff-Level Agreement seeks to continue creating the necessary stability conditions to address existing structural challenges and to strengthen the foundations for sustainable and inclusive growth and includes quarterly reviews to the Argentine government to ensure compliance with the targets established in the agreement.

The economic slowdown resulting from the covid-19 pandemic, together with the process of debt restructuring, have added to the difficulties in the securitisation market. Nevertheless, there has been a recovery over the past years. The accumulated placement of financial trusts during 2022 amounted to 162.905 million Argentine pesos, representing a positive variation of 70 per cent compared with the level registered in 2021. During this period, 154 financial trusts were issued, representing an increase of 4 per cent from the previous year. During the first six months of 2023, the accumulated placement of financial trusts amounted 138.070 million Argentine pesos, a positive of 111 per cent compared to the same period in the previous year. However, during this period 62 financial trusts were issued, with a negative variation of 17 per cent compared to 2022.[2]

Securitisation structures have been very popular as a means of financing consumer spending. Securitisation structures have been used for years by the main participants in the market, such as banks, home appliance retail chains and consumer finance companies, to fund their retail financing activities and they have become the framework under which the system runs, representing 74 per cent of the issuances during 2023.

Several factors have boosted the use of securitisation structures in Argentina, including:

- the low real interest rates of term deposits, which led investors to seek better investment opportunities;
- the absence of a long-term credit market as a result of a high and volatile cost of funding, which has led banks and companies to focus on shorter-term consumer financing;
- the option for banks and retail chain companies to transform illiquid assets into liquid assets, while at the same time obtaining balance-sheet relief;
- the possibility of transferring the collection risk from the originator of the credits to the investors;
- tax advantages that have been in place for years;
- an improvement in the mechanisms for monitoring collections; and
- cheaper funding costs.

To mitigate the economic impact from the covid-19 pandemic, the Argentine Securities and Exchange Commission (CNV) implemented different programmes and measures, such as establishing a special regime for the settlement of financial trusts to financially assist national, provincial and municipal public sectors and also approving a special and differentiated regime for collective investment products for venture capital, applicable to mutual funds and trusts.

The CNV has also been working hard on a sustainable finance programme approving a new framework applicable to mutual funds and financial trusts that invest in securities with an environmental, social and corporate governance impact. However, in 2022 only a financial trust was issued with the aim of financing renewable energy generation.

There were 178 issuances of financial trust during 2022, including the first public infrastructure and solidarity trust to finance the NASA IV financial trust, destined to finance works to extend the life of the nuclear power plant Atucha I for up to US$600 million.

In August 2021, the CNV approved certain amendments to the small and medium business regime with the objective of promoting their growth and further development. Moreover, during 2022 a fee reduction was implemented for small and medium businesses, looking to provide them with capital market financing tools.

In addition, the CNV authorised the public offering of an unprecedented financing operation for the local development of vaccines, including those for covid-19.

During January 2023, the CNV modified the regulations applicable to the marketing period for placing trust securities, granting in certain cases the possibility of reducing this period to one business day, with the objective of expediting the financing mechanisms that can be accessed through the capital markets.

Finally, in July 2023 the CNV submitted for public consultation the new legal regime applicable to publicly offered financial trusts, with the purpose of adjusting the regulation to the new market structures.

II REGULATION

i Introduction

Securitisation can be defined as a financial transaction in which assets are pooled and transferred to a trust (which serves as a special purpose vehicle) and the trustee issues securities representing interests in the pooled assets of the trust. In this way, illiquid assets are transformed into liquid assets. For example, a company that grants consumer loans aims to raise money to grant more loans. It can sell its existing loans, but it is unlikely to find a strong and liquid secondary market for those loans. A good alternative in this scenario would be to pool the consumer loans and sell securities or interests in the pool to investors, who, in turn, may find this investment more attractive than others. The debtors of the consumer loans will continue paying their debts, but these payments will flow to the investors (once expenses are paid).

In general, any class of assets with a relatively predictable cash flow can be securitised. The most common assets include automobile and consumer loans, credit cards, mortgages, corporate debt, future collections and lease payments. However, in Argentina certain requirements are imposed in the interests of an efficient tax treatment. For example, the assets must consist of credit instruments and must be homogenous.

ii Regulation

As a general principle, there is no specific legislative regime under which securitisations are carried out, other than regulations issued by the Central Bank of Argentina relevant to vehicles purchasing receivables from financial institutions.

However, financial trusts are used as vehicles in securitisation transactions. Financial trusts are currently governed by the Argentine Civil and Commercial Code (CCC), which entered into effect in August 2015. Additionally, when securitisation involves a public offering of securities, the offer must be authorised by the CNV.

The CCC delegates the power to regulate securitisation transactions to the CNV, and therefore when trust securities are issued publicly, the provisions of Chapter IV, Title V of the CNV Rules apply.

iii Financial trusts

A financial trust is a trust established by a party (the originator, settlor or trustor) who transfers title of certain assets to a financial entity or other institution (the trustee) specially authorised by the capital markets regulatory authority.[3] The trustee holds the assets off the balance sheet and manages them for the economic benefit of holders of debt securities or pass-through certificates (the beneficiaries). On the expiry of a certain term or the fulfilment of a certain condition the trustee is bound to transfer those assets to the originator, the beneficiaries or to a final beneficiary.

Under the CCC, the following general requirements must be fulfilled to ensure that the trust is effective against third parties in a securitisation process, as well as to constitute the trust as a separate entity and the originator as no longer owner of the assets held in trust.

There must be an agreement between the settlor and the trustee (the Agreement), which must specify, among other things:

- a description of the assets to be held in trust, or objective parameters for their determination;
- a determination as to how other assets can be incorporated into the trust;
- the manner in which other property may become part of the trust;
- the term (in principle, no more than 30 years) and conditions to which the trust property is subject;
- appointment of the beneficiary or the criteria to appoint the beneficiary thereafter;
- the rights and obligations of the trustee and how to replace the trustee, if necessary;
- the possibility of appointing a manager to administer the assets; and
- a determination as to what will happen to any assets held in trust on termination of the trust.

In the case of financial trusts, the Agreement must also include:

- the name of the financial trust;
- the rules for decision-making by the beneficiaries, which will include provisions for the eventuality of insufficiency or insolvency of the assets held in trust; and
- the terms and conditions for the issuance of securities.

The Agreement must be registered with the relevant public registry corresponding to the purpose of the trust. In the case of public financial trusts approved by the CNV, no registration is necessary.

The trustor must concurrently, or thereafter, transfer the assets to the trustee to be held in trust, according to the rules applicable to the type of asset (for example, assignment, endorsement, public notice requirements, public deed and delivery of possession of real goods).

The transfer of assets to be held in trust must not be fraudulent in relation to the originator's creditors.

iv Trustees

Any individual or entity may be appointed as trustee of an ordinary trust. However, only those entities authorised by the CNV (Argentine financial institutions and other entities incorporated in Argentina) may serve as financial trustees. The trustee must comply with certain obligations imposed by the CNV Rules and the CCC. In addition, these ordinances establish a standard of conduct for the performance of the trustee, requiring trustees to act with the care and prudence of sound businesspersons and to respect the confidence with which they have been entrusted. The trustee has a legal duty to manage the trust's assets in the best interests of the beneficiaries. Generally, trustees delegate certain management functions to administer the trust on behalf of the beneficiaries according to the express terms and provisions of the trust agreement.

The CNV Rules impose certain requirements on the appointment of trustees, such as a minimum net worth of 950,000 units of purchasing value,[4] which indexes the capital based on the variation of inflation.

The trustee is entitled to receive certain fees for its services and to be reimbursed for its expenses related to the trust.

v Classes of assets or receivables

The most common classes of assets for securitisation are as follows: consumer loans; mortgage loans; credit card repayments and interest payments; commercial documents (invoices, notes and deferred payment checks); lease agreements; and tax collection.

There are no legal restrictions applicable to any class of asset. All types of receivables can be securitised, even future receivables.

vi Public offerings of trust securities

To publicly offer trust securities, an application to the CNV requesting authorisation for a public offering of securities must be filed. The filing has to include a draft of the prospectus (describing the assets, the settlor, the business, the securities and the trustee), a draft of the trust agreement and related documents (e.g., custody agreement, paying agency agreement, administration agreement and placement agreement) and copies of the trustee's corporate authorisation for the creation of the trust and the issue of securities.

After the famous *Bonesi* and *Saturno* cases, the requirements set out by the CNV Rules for the public offering of securities were increased. This change tightened the information requirements for obtaining authorisation from the CNV to offer securities; increased the liability of the trustee (as organiser or expert with responsibility for the custody of the instruments and sale of the trust property); and required the appointment of a supervisory agent to control and review both the trust assets and the obligations of the collection agent under the trust agreement.

vii Taxation of the trust

Income tax

The trust will be taxed on its worldwide income. The general corporate tax rate was 30 per cent for fiscal years until 31 December 2020, and between 25 per cent and 35 per cent plus a fixed amount for fiscal years beginning on or after 1 January 2021. The taxable base is determined by deducting from the gross income all ordinary and necessary expenses incurred in obtaining, maintaining and preserving the taxable income.

Operating losses incurred during any fiscal year may be carried forward and set off against taxable income obtained during the following five fiscal years.

Some specific losses, such as those arising from the sale or other disposal of stock and other forms of equity, may only be set off against capital gains arising from the disposal of the same type of asset, and foreign-source losses may only be set off against foreign-source income.

Foreign paid taxes will be allowed as a tax credit against the Argentine tax liability to the extent that the foreign tax does not exceed the Argentine tax.

The law also provides for withholding tax regimes for foreign beneficiaries, which apply at different rates depending on the nature and origin of the income. These rates can be reduced by tax treaties.

Value added tax

This tax applies to the sale of goods, the provision of services and the importation of goods. Under certain circumstances, services rendered outside Argentina that are effectively used or exploited in Argentina are deemed to be rendered in Argentina and are therefore subject to value added tax (VAT). VAT is paid at each stage of the production or distribution of goods or services upon the value added during each of the stages. Thus, this tax does not have a cumulative effect.

VAT is levied on the difference between the 'tax debit' and the 'tax credit'. The tax debit is the tax corresponding to sales made by the taxpayer or services rendered by him or her. It is obtained by applying the tax rate to the price of the sales or services. The tax credit is the tax indicated in the invoices of the suppliers of goods or services contracted by the taxpayer. The difference between the tax debit and the tax credit, if positive, constitutes the amount to be paid to the Argentine Tax Authority.

Tax on debits and credits in bank accounts and other transactions

This tax is levied upon debits and credits in Argentine bank accounts and upon other transactions that, because of their special nature and characteristics, are similar to or could be used in substitution for a checking account (such as payments on behalf or in the name of third parties, procedures for the collection of securities or documents, or drafts and transfers of funds made by any means) when these transactions are performed by entities regulated by the Financial Entities Law No. 21,526.

Transfers and deliveries of funds also fall within the scope of this tax, regardless of the individual or entity performing them, when those transactions are made through organised systems of payment in substitution for checking accounts.

Argentine tax law and its regulations provide several exemptions to this tax, such as the transfer of funds to a foreign bank account belonging to the transferor.

The general rate of the tax is 0.6 per cent. An increased rate of 1.2 per cent applies in cases in which there has been a substitution for the use of a checking account. Owners of bank accounts subject to the general tax rate of 0.6 per cent are eligible for a tax credit of 33 per cent of the tax paid on credits and 33 per cent of the tax paid on debits to those bank accounts. These amounts can be utilised as a credit against income tax and the tax on presumed minimum income, and the rest is deductible for income tax purposes as expenses if it is related to taxable income. The amount used as credit is not deductible for income tax purposes.

Turnover tax

Turnover tax is a local tax levied on gross income. Each of the provinces and the city of Buenos Aires apply their own respective tax rates. The tax is levied on the amount of gross income resulting from business activities carried on within the respective provincial jurisdictions. The provinces have executed an agreement[5] to avoid double taxation on activities performed in more than one province, whereby gross income is distributed among the provinces by applying a formula based on income obtained and on expenses incurred within each jurisdiction.

Stamp tax

This is a local tax levied by Argentine provinces and by the city of Buenos Aires. In general, this tax will be triggered by the execution of any written agreement. Legal instruments are taxed in the jurisdiction where agreements are executed or in the jurisdiction in which they have any effect. 'Effect' is defined by the legislation of each jurisdiction. Most Argentine provinces apply a 1 per cent rate on the value involved in the relevant instrument. If a deed is required for the assignment of loans, stamp taxes are due as from the execution of the deed.

viii Taxation on the investor

Tax treatment of the lender and holders of certificates of participation

Profits

Dividends and other similar income (profits arising from certificates of participation), obtained by individuals and undivided estates will be taxed at the rate of 7 per cent on net income. This tax will also be applicable for dividends and profits that are paid to foreign beneficiaries by way of withholdings made by the Argentine entity at the time of payment.

Capital gains

The Argentine-source net profits of individuals and undivided estates resulting from transfers of securities will be exempt from tax considering that the securities are listed on stock exchanges or markets authorised by the CNV. The same treatment shall apply to non-Argentine residents that do not reside in non-cooperative jurisdictions or the funds invested do not come from non-cooperative jurisdictions.

Tax treatment of the lender and holders of debt securities

Capital gains and interest

Capital gains and interest received under debt securities for individuals who are Argentine residents are exempt from income tax if the securities are listed on a stock exchanges or market authorised by the CNV.

For foreign beneficiaries, there is also an exemption for capital gains and interest related to debt securities of financial trusts that are carried out through stock exchanges or stock markets authorised by the CNV. Note that these provisions apply to foreign beneficiaries on condition that they do not reside in non-cooperative jurisdictions and the funds invested do not come from non-cooperative jurisdictions.

III SECURITY AND GUARANTEES

In the most common securitisation structures, the asset being securitised is some type of credit. Therefore, the securtisation process generally involves the transfer of a credit by the settlor to the trustee, on behalf of the trust.

Such a transfer of credits is governed by the CCC. The CCC defines an assignment of credit as an agreement under which one party transfers a credit to another.[6] Any type of credit can be assigned, unless prohibited by law or by the agreement that created it.[7] To the extent that it is not modified by the specific regulations governing assignments of credits, the transaction will be governed by the terms of the sale agreement if the credit is transferred for a consideration.[8] If the assignment is under guarantee, the relationship between assignor and assignee will be governed by the terms of the pledge.[9]

The agreement has to be in writing, but this does not have to be an instrument in the form of a public deed unless the assigned credit is documented in a public deed or the credit is being contested in court.[10] The assignor must transfer to the assignee the documents evidencing the credit or, if the assignment is partial, a certified copy of the documents.[11] The assignment will have effects in relation to third parties from the moment that the assignment is notified by means of a public deed or an instrument with a certified date.[12] Any payment by the assigned debtor to the original creditor (or any other action that extinguishes the credit) made prior to the notification will be effective.[13] If there are several assignees, the assignee who first notified the assignment to the assigned debtor will have priority, even if the assignment agreement was entered into after the others.[14] In cases of partial assignment of the credit, the assignee does not have any preference over the assignor unless a preference is agreed.[15] In the event of bankruptcy or reorganisation of the assignor, the assignment will not be effective in relation to other creditors if it is notified after the filing for reorganisation or the declaration of bankruptcy.

The assignor guarantees to the assignee the existence and enforceability of the credit as at the time of the assignment, but (in the absence of bad faith) does not guarantee the solvency of the debtor, unless it is agreed otherwise.[16] If the assignor guarantees the solvency of the assigned debtor, the regulations for guarantees will apply. The assignee can only bring an action against the assignor after first pursuing the assets of the assigned debtor or if the debtor is bankrupt or under reorganisation.[17]

i Rules on factoring

The CCC regulates factoring agreements, which were unregulated until the enactment of the CCC. Factoring is defined as an agreement whereby one of the parties has the obligation to purchase for a determined or determinable amount of money credits originated in the ordinary course of business by the other party, by paying an advance (or not) and taking the risks of those credits (or not).[18] The originator can make a global assignment of all or part of its credits, whether present or future, to the extent that they can be determined.[19]

The purchase of the credits can be supplemented with management and collection services and commercial, administrative and technical assistance regarding the credits.[20]

The agreement must include a description of the transferred credits, and the information necessary to identify the document that represents the credits – the amount, issuance date and maturity date or the elements that permit its identification when the factoring is determinable.[21] Notice of the assignment of the credit has to be issued by the debtor by any means that reasonably evidences its receipt by the debtor. The factoring agreement is sufficient title for the transfer of the credits.[22] The securities on assets, the personal guarantees, haircuts and the withholding of a percentage of the price are valid and are maintained until the payment of the obligations of the assignor.[23] When collection of the assigned credit is not possible for any reason related to the transaction from which the credit arises, the assignor is liable for the loss in the value of the credit, even if the factoring was without recourse or guarantee.[24]

ii Process to assign credits

The assignment of a credit documented by an invoice must be effected through an instrument in the form of a written document that clearly identifies the credit being assigned. The document evidencing the credit must be delivered by the assignor to the assignee. If the credit is only documented in an electronic invoice, we recommend that a printed copy of the document signed by the assignor is delivered to the assignee. The assignment of the credit must be notified to the assigned debtor. To be effective in relation to third parties, the notification has to be made by means that certify receipt of the notification and the date. Traditionally, this was achieved by using a notary public, but, under the new CCC, a notice delivered by certified mail by Correo Argentino, the Argentine mail service, will be considered sufficient notice to perfect the assignment of the credit in relation to third parties.

iii Process to transfer negotiable instruments

The transfer of negotiable instruments, such as promissory notes, bills of exchange and cheques, are generally assigned by endorsement. In the event of assignment to a financial trust that has registered its securities under the public offering regime, the endorsement can be implemented through a global endorsement using a public instrument that identifies the documents being endorsed.[25]

The perfection of the transfer of certain assets, such as credits secured with registered pledges or mortgages, would require registration in the relevant public register.

IV PRIORITY OF PAYMENTS AND WATERFALLS

Usually, financial trusts issue two types of securities: trust debt securities and certificates of participation.

Under Argentine law, there is no legal subordination. Nevertheless, there are three methods of subordination: contractual subordination, structural subordination and inter-creditor arrangements.

It is clear that the proceeds from the realisation of trust assets should be distributed to trust creditors according to the waterfall agreed under the Agreement, and the status of priority creditors should be preserved.

The most common structure is to have three tiers of securities issued by the trustee: senior debt securities, junior debt securities and certificates of participation.

In relation to the waterfall, is it common to apply all cash flow in the following order of priority:

- payment of trust expenses, including taxes and trustee and servicing fees;
- payment of interest on debt securities in priority order;
- payment of principal on debt securities in priority order;
- payment of principal on certificates of participation; and
- reimbursement of expenses paid by the trustor.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

Under Section 1,685 of the CCC, the assets held in trust form an estate separate from the trustor's, the trustee's and the beneficiaries' estates. The assets held in trust are therefore protected from both the trustor's and the trustee's creditors, except in the event of fraud.

Additionally, because the financial trust is a separate estate, in the absence of fraud, assets transferred to a financial trust are not affected by the bankruptcy of the grantor or of the trustee.

The Bankruptcy Law No. 24,522, as modified, allows scrutiny of the originator's transactions during the period between the date of suspension of payments and the final judgment or declaration of bankruptcy (known as the look-back period). The date established for the suspension of payments cannot be earlier than two years before the date bankruptcy is adjudicated or preventive insolvency proceedings are filed.

The transfer of assets may be declared void if it is proven to have occurred to defraud creditors. Moreover, the transfer of assets may be declared void without it being necessary to produce evidence, if the transfer is one of the following:

- the advance payment of debt with maturity on the date of the bankruptcy adjudication or later – in a securitisation; this can occur if the trust securities are provided by the bankrupt's creditors through offsetting the subscription price against the receivables;
- the creation of a priority over a non-matured obligation that was originally unsecured (for example, an exchange of an obligation for trust securities that are secured by the assets held in trust, and therefore sharply improving the creditor's position); and
- a transfer made during the look-back period – such transfers can be declared void if the transferee is aware of the originator's suspension of payments and the transfer damaged the originator's general creditors.

To avoid a transfer being declared void, the trustee must prove that there has been adequate consideration for the transfer in trust of the relevant assets and, consequently, that the originator's estate has not been affected. This can be easily proved if trust securities were placed through public offering, as the subscription price of the securities (which generally is the consideration received by the originator) results from the interaction of supply and demand.

VI OUTLOOK

Argentina is undergoing a severe economic and financial crisis and is faced with the effects of a long recession, high inflation and foreign exchange control. Although Argentina reached an agreement with the IMF, there is still uncertainty whether the Argentine government will be able to comply with the macroeconomic objectives set forth by the IMF in the agreement.

In this context, the securitisation market has suffered considerably.

However, as expected, securitisation is the first financing structure to see a substantial increase in activity, even when the market is still far from a total recovery. Securitisations are short term, peso-denominated and with low structuring costs, and do well in scenarios in which short-term domestic currency financing dominates the market. In this sense, securitisations have proved to be one of the more resilient financing structures in the Argentine market.

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Endnotes

1 Pablo Gayol and Sergio Tálamo are partners at Marval O'Farrell Mairal.
2 Argentine Securities and Exchange Commission. Monthly report on capital market financing.
3 Section 1,690, Argentine Civil and Commercial Code (CCC).
4 The unit of purchasing value, or UVA, is adjusted daily with reference to an index of inflationary variation in Argentine pesos published by the Central Bank of Argentina.
5 The Multilateral Agreement, dated 18 August 1977.
6 Section 1,614, CCC.
7 Section 1,616, CCC.
8 Section 1,614, CCC.
9 Section 1,615, CCC.
10 Section 1,618, CCC.
11 Section 1,619, CCC.
12 Section 1,620, CCC.
13 Section 1,621, CCC.
14 Section 1,622, CCC.
15 Section 1,623, CCC.
16 Section 1,628, CCC. If the credit does not exist, the assignor has to reimburse the price plus interest, but if the assignor acted in bad faith, the assignor has to pay the difference between the price and the amount of the credit (Section 1,629, CCC).
17 Section 1,630, CCC.
18 Section 1,421, CCC.
19 Section 1,423, CCC.
20 Section 1,422, CCC.
21 Section 1,424, CCC.
22 Section 1,425, CCC.
23 Section 1,426, CCC.
24 Section 1,427, CCC.
25 Section 1,839, CCC as amended by Law No. 27,440.

Chapter 2

Canada

Francesca Guolo, Mark Surchin, Brian Empey and Jon Northup[1]

Summary

I OVERVIEW

Canada boasts a well-developed and sophisticated securitisation market. While the Canadian securitisation market emulates those of the United States and Europe, it does, however, remain comparatively smaller and less mature.

The 2008 global financial crisis and the covid-19 pandemic did not spare the Canadian securitisation marketplace. While Canada arguably fared better than its US and European counterparts, volumes declined sharply in the crisis and the market experienced a consolidation of issuers. The pandemic similarly affected the market and adversely impacted performance.

Participation in the Canadian securitisation market is dominated by regulated financial institutions. That has generally led to conservative risk-focused approaches and decision making. This characteristic of the market, together with its relatively small size and the impact of the global financial crisis of 2008 and more recent covid-19 pandemic, have contributed to a market that emphasises traditional products and simple structures differentiated from the complex and esoteric products and structures seen in other markets.

The idiosyncrasies of the Canadian securitisation market, including its diminutive size relative to other markets, the predominance of prudentially regulated participants in the market and the significant proportion of the market represented by asset-backed securities backstopped by the government underscore the need for Canada to emulate and harmonise with global standards and practices in the securitisation market.

While less extensive than reforms in key global markets, Canada has enacted significant regulatory changes designed to implement the recommendations of the Basel Committee on Banking Supervision, enhance marketplace disclosure and align with global standards in liquidity and credit support. The regulatory and policy outlook for the Canadian securitisation market continues to be focused on transparency, simplification and efficiency.

As at 31 March 2023, the total amount outstanding in the Canadian securitisation market, including private placements, was estimated to be C$100.4 billion. Term asset-backed securities (ABS) accounted for 47.5 per cent of the total market while asset-backed commercial paper (ABCP) and private placements accounted for 42.9 per cent and 9.7 per cent, respectively, of the total market. The Canadian securitisation market (excluding private placements) continued to be dominated by credit card and auto-related transactions, accounting for 39.0 per cent and 19.8 per cent, respectively, of the total market, while residential mortgage transactions, home equity credit line transactions and commercial mortgage transactions accounted for 18.7 per cent, 6.3 per cent and 4.6 per cent, respectively, of the total market.[2]

Securitisation structures in Canada typically utilise a bankruptcy remote special purpose entity (SPV) to which the assets securitised are assigned or sold. There are no specific legal requirements imposed on SPVs and no legal restrictions on the type of assets that may be securitised. A common law trust often serves as the SPV, but limited partnerships and corporations can also be used depending upon the circumstances. Limited partnerships are creatures of statute and, like trusts, are relationships, not entities per se. If a trust is used, an institutional trust company will serve as the trustee holding title to the securitised asset portfolio. If a limited partnership is used, its general partner must also be an SPV. A trust SPV issues to investors co-ownership interests in, or notes secured by, the securitised assets. The beneficiaries of the trust will usually be non-profit or charitable entities. The originator of the securitised assets commonly administers and manages the pool of securitised assets. Currency and interest rate risks are normally mitigated through the use of derivatives. Forms of credit enhancement used will align with those used in other jurisdictions. There is no requirement for risk retention on the part of a sponsor or seller in a Canadian securitisation.

The market for retail investor involvement in securitisations is limited, except for residential mortgage securitisations. Canada Mortgage and Housing Corporation (CMHC) is Canada's national housing agency with a mandate to provide mortgage liquidity to Canadian lenders while facilitating a sustainable, affordable and stable housing market.[3] To accomplish this broad mandate, CMHC offers or administers a number of programmes that are constantly evolving to respond to broader economic changes. Four CMHC programmes are of key relevance to Canada's securitisation industry:[4]

- the CMHC insurance programme, which provides insurance against default for high loan-to-value mortgages;
- the National Housing Act Mortgage-Backed Securities (NHA MBS) Program, which affords financial institutions the opportunity to offer securities backed by pools of residential mortgages insured by CMHC;
- the Canada Mortgage Bonds (CMB) Program, under which bonds guaranteed by CMHC are issued and the proceeds used to acquire pools of NHA MBS securities; and
- CMHC also administers registered covered bond programmes pursuant to which nine Canadian chartered banks offer bonds backed by uninsured residential mortgage portfolios.

NHA MBS and CMB investments are effectively considered government-backed securities and are more accessible and appealing to the retail investor base.

II REGULATION

Canada is a federation with legislative authority divided between the federal parliament and 13 provincial and territorial legislatures.[5] Each province (other than Quebec, a civil law jurisdiction) also operates as a common law jurisdiction with judicial decisions informing certain aspects of the regulatory framework.

There is neither a single regulator, nor a single body of legislation or regulation governing securitisations. The type of assets securitised, the nature and domicile of the participants to a securitisation and the manner of offering to investors will each influence the legislation, regulations and regulatory oversight applicable to the transaction. Generally:

- provincial securities legislation will govern the offering of securitised products;
- federal banking legislation, regulatory guidance for financial institutions and anti-money laundering legislation imposes requirements on a securitisation and its participants;
- federal insolvency legislation and provincial fraudulent conveyances and preferences legislation will dictate the status of an SPV as bankruptcy remote;
- provincial personal property security legislation and land registration systems will apply to the grant of security over a securitised asset portfolio;
- federal and provincial consumer protection and privacy legislation may impose requirements on a securitisation based on the type of assets securitised; and
- federal and provincial tax legislation will influence the choice of SPV and structure of a securitisation.

i Offerings of securitised products

The regulation of ABS and the securitisation market has been swept into the regulation of securities and capital markets generally in Canada, with infrequent distinctions drawn for securitisations.

The regulation of securities is a matter of provincial jurisdiction. While each province has autonomous authority, effort has been made to harmonise securities regulation across the country (often through national or multi-lateral instruments) and the provincial regulators coordinate their efforts through their umbrella organisation, the Canadian Securities Administrators (CSA).

Securities laws impose prospectus requirements on securities offerings to the public and require intermediaries facilitating, or advising in relation to, these offerings to be registered as broker-dealers or advisers. However, exemptions from the prospectus requirements are available. A widely-used prospectus exemption is for offerings to institutions or to individuals that possess a stipulated net worth (accredited investors).[6] Securities offered in reliance on an exemption from prospectus requirements are subject to resale restrictions.

Offerings of ABS typically take place in the exempt market as the vast majority of investors are institutions and, accordingly, accredited investors.

While less common, public offerings of ABS must generally comply with the prospectus requirements, which prescribe specific disclosure and mandate full, plain and true disclosure of all material facts.[7] Issuers of ABS offered by way of prospectus will also be subject to continuous disclosure requirements. Exception is made for offerings of highly rated short-term securitised products (such as ABCP) and offerings of NHA MBS and CMB securities. Issuers of short-term securitised products are required to prepare and provide to investors an information memorandum, monthly reports and updated disclosure, each in prescribed form.[8] NHA MBS and CMB securities need only comply with the disclosure requirements imposed on these offerings by CMHC.

Credit rating agencies that rate securities offered under a prospectus at non-fixed prices or offered in reliance upon the exemption for short-term securitised products must apply for designation under the CSA's National Instrument 25-101 – Designated Rating Organizations (NI 25-101). NI 25-101 imposes governance, independence, record keeping and disclosure requirements on designated rating organisations.

ii Federally regulated financial institutions

The preponderance of originators, service providers and investors in Canadian securitisations are financial institutions subject to the prudential regulation and oversight of the Office of the Superintendent of Financial Institutions (OSFI). OSFI promulgates rules and guidance in relation to the capital adequacy, accounting practices, risk management and governance of regulated entities as well as their participation in specific transactions such as securitisations. In particular, OSFI's Capital Adequacy Requirements (CAR) Guideline and Guidelines B-5 and B-5A set out the capital treatment of securitisation exposures and investments in securitisations. The Guidelines align with the recommendations of the Basel Committee on Banking Supervision Basel II and III frameworks.[9]

Originators, issuers and service providers in NHA MBS and CMB securitisations are also required to comply with the requirements established by CMHC for those programmes.

iii Anti-money laundering legislation

Canada's anti-money laundering and terrorist financing legislative regime is embodied primarily in Canada's Criminal Code and Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA). The Criminal Code applies to all persons. The PCMLTFA applies only to specified entities, among them federally regulated financial institutions. Neither statute includes provisions expressly applicable to securitisation transactions. However, financial institutions involved in the Canadian securitisation market are obligated to monitor all flows of funds for suspicious activity and maintain robust records in relation to all their activities, including their participation in securitisation transactions.

iv Consumer protection

Where the assets of a securitisation consist of consumer receivables, federal and provincial legislation designed to protect consumers may require structural or operational accommodations in the transaction. These legislative provisions can be found in provincial consumer protection statutes, the governing statutes of financial institutions, the Criminal Code and the Interest Act. In relation to consumer receivables, these consumer protections can impose disclosure requirements, afford rescission and prepayment rights, and limit interest rates, fees and penalties.

v Privacy

Again, where the assets of a securitisation consist of consumer receivables, regard must be had for Canadian privacy legislation. The federal Personal Information Protection and Electronic Documents Act and certain provincial privacy legislation regulate the use, collection and disclosure of personal information of an identifiable individual. If consumer data containing such personal information is required to be stored, managed, transmitted or otherwise disclosed for purposes of a securitisation, steps must be taken to anonymise this information or obtain the prescribed consents.

vi French language laws

In May 2022, Quebec passed Bill 96 to promote the use of the French language in the province by significantly amended the Charter of the French Language (Bill 101) commencing 1 September 2022.

Bill 96's enhanced requirements for French language usage and translation affect all businesses operating or having employees in Quebec and present challenges for securitisations and, in particular, the perfection of true sales.

vii Tax

Canada's tax regime is governed by the federal Income Tax Act (ITA) and its regulations, as well as the sales and other tax laws of Canada and its provinces. The primary basis for income taxation in Canada is the taxpayer's residence. Canadian residents (including corporations and trusts) generally are subject to Canadian tax on their worldwide income. A partnership generally is not subject to tax in Canada, but the partnership's income is allocated to its members based on their respective partnership interests.

Non-residents generally are subject to Canadian income tax only on certain types of Canadian-source income, including income from carrying on business in Canada and withholding tax in respect of certain types of Canadian-source passive income.

The structure adopted for a securitisation will depend on a number of factors, including the income and sales tax issues arising from the types of assets being securitised and the nature and domicile of the participants. Absent a specific provision in the ITA to the contrary, or a finding that the arrangements are a sham, the characterisation and treatment of securitisations for Canadian tax purposes largely will follow the bona fide legal arrangements (and should not be recharacterised based on their economic substance).

In cross-border securitisations, there is no Canadian withholding tax on interest payments paid by a resident of Canada to an arm's-length non-resident, other than participating debt interest (which is typically not a feature of securitisations).

Cross-border payments of rent, royalties and dividends are generally subject to 25 per cent Canadian withholding tax, subject to certain specified exemptions and relief available under applicable tax treaties.

Transactions involving these payments are typically structured with a Canadian SPV holding the securitised assets and a cross-border loan from the foreign issuer or investor. Non-resident issuers participating in a cross-border securitisation involving Canada will need to restrict their activities in Canada to ensure the issuer could not be considered to be carrying on business in Canada (and, accordingly, be subject to tax in Canada) by virtue of acquiring, holding or servicing the underlying Canadian assets, and will often similarly use an intermediate Canadian SPV to hold the assets.

The federal Department of Finance has released draft legislation implementing proposed earnings stripping rules, referred to as the 'excessive interest and financing expenses limitation' (EIFEL) rules. The EIFEL rules seek to introduce a limit on the amount of net interest and financing expenses that resident and non-resident corporations and trusts can deduct in computing income. The basic regime under the EIFEL rules generally limits the deduction of net interest and financing expenses to 30 per cent of the taxpayer's 'adjusted taxable income' (i.e., tax EBITDA), with a transitional rate of 40 per cent for taxation years beginning on or after 1 October 2023 but before 1 January 2024.

As the rules were initially drafted, most Canadian securitisation vehicles would have been subject to deduction restrictions that would prevent them from running flat from an income tax perspective. Subsequent proposed amendments have sought to lessen the extent of this issue. However, the impact of the EIFEL rules, if any, on a particular securitisation transaction should be considered and will depend on the nature of the securitised assets (and the income generated thereon) and the final legislation adopted.

Canada's goods and services tax (GST) is a comprehensive value-added tax on the consumption of nearly all property and services in Canada, but generally excludes financial instruments. The rate of GST is currently 5 per cent.

Each province (other than Alberta) also levies a sales tax on most sales of property and services provided within the province. Several provinces (including Ontario) have harmonised their sales taxes with the GST to form a single harmonised sales tax (HST). The tax regime for the GST and the HST is ordinarily the same. Quebec's provincial sales tax mirrors, but is not harmonised with, the federal GST.

Sales of financial instruments (such as loans and receivables) generally are exempt from GST/HST as well as provincial sales taxes.

To the extent possible, securitised assets in Canada are usually sold or contributed to the SPV on a fully serviced basis, so that there is not a separate supply of these services that would be subject to non-recoverable GST/HST. Other services fees, such as collection agent services, generally will be subject to GST/HST.

III SECURITY AND GUARANTEES

In a typical Canadian securitisation, the SPV holding title to the securitised assets will grant a charge or lien over those assets in favour of the investors as security for its obligations under the notes issued to them. The credit support or credit enhancement may include a guarantee.

Generally, the SPV will enter into a trust indenture with a professional trustee contemplating both the issuance of the notes and the grant of the security interest. The indenture trustee will hold the benefit of the security granted for the investors as beneficiaries. In Quebec, the security interest will be granted to the trustee through a prescribed document known as a hypothec, accompanied by specific formal requirements. There is no prescribed form of trust indenture in the other provinces of Canada. Similarly, there are no special formalities to be observed in providing a guarantee.

i Statutory framework for secured interests

Security can be taken over all types of assets: real (or immovable) property and personal (or movable) property (both tangible and intangible), with a different regime applicable to each.

Provinces are responsible for 'property and civil rights' in their respective jurisdictions. Matters pertaining to security and guarantees therefore fall within the purview of the provinces.

The common law provinces have personal property security legislation (PPSA) modelled on Article 9 of the pre-2002 Uniform Commercial Code (UCC) in the United States. While the specifics of each province's PPSA may differ, they are consistent in basic concepts and overall structure. Quebec does not have a PPSA; however, its Civil Code contains provisions that function in a manner similar to the PPSA, including a public registration system for security granted on personal property.

The PPSA applies to every transaction involving personal property, regardless of form, that in substance creates a 'security interest'. This includes financing leases and conditional sales agreements. The PPSA sets out various rules for establishing priority among secured parties. It contains provisions specifying the rights of debtors who grant security interests and those of secured parties who hold and enforce their security. These statutory provisions supplement the terms of the parties' negotiated documentation.

To protect its rights in personal property as against third parties, a secured party (e.g., the indenture trustee) must have a written security agreement, which grants it a security interest in the identified collateral (e.g., the portfolio of securitised assets). The security interest must both 'attach' to the collateral and be perfected.[10] Attachment generally requires that the debtor granting the security interest (namely, the SPV in a typical Canadian securitisation) has rights in the collateral, that value has been given and that the parties sign a valid security agreement adequately describing the collateral. A secured party perfects its security interest by taking control of the secured collateral (either by possession or a control agreement) or by registering its interest against the debtor in a central computerised registration system. Secured parties must register against the correct debtor name and ensure other required information is accurate. Registrations should be amended as circumstances change, including if the debtor changes its name. Notably, any postponement and assignment of claims by a guarantor contained in a guarantee can be characterised as a security interest that should be registered against the guarantor.[11]

Where accounts receivable are to be securitised, they are sold or assigned by the originator to an SPV. In relation to such sale or assignment, a financing statement is registered under the PPSA, with the originator identified as the 'debtor'. Under Quebec's Civil Code, a securitisation transaction cannot be perfected unless the transaction encompasses all receivables of a certain type that have been generated by the originator in the specified time period (a 'universality of claims').

Cash collateral is a common feature of Canadian securitisation transactions. As with any other asset, a valid and enforceable security interest over a deposit account or any other cash collateral requires attachment and perfection. While an account control agreement is not required to achieve perfection, deposit account control agreements are common. These allow the account bank and the secured party to agree as to their respective rights in the cash held in the bank account. Over the past several years, there has been an organised movement to amend the PPSA so that secured parties can perfect by control over a bank account. This would harmonise Canada's system with the UCC system in the US.

In some provinces the PPSA allows for perfection by control in respect of electronic chattel paper, affording 'perfection by control' priority over 'perfection by registration'. This is relevant where the collateral of a securitisation includes car loans and similar assets and is an example of the PPSA being amended over time to align with similar provisions of the UCC.

Securities transfer legislation and related amendments to the PPSA (together, the STA) have been adopted by all provinces. The STA implements rules governing property rights that exist whenever investment property (such as securities, futures and other financial assets) is bought, sold or used as collateral to secure obligations. The rules are based on Revised Article 8 of the UCC. Among other things, they address perfection steps in connection with any security interest granted in securities directly held by a debtor, and securities and other financial assets that are indirectly held through a securities intermediary. The rules are intended to accommodate modern securities settlement systems where securities are held indirectly through intermediaries and where computerised book entries are relied on for settlement. The STA also provides additional certainty with respect to priority of perfection by allowing secured parties to perfect by control.

ii Impact of insolvency on secured interests

If an SPV becomes subject to an insolvency proceeding after granting a security interest in the underlying assets of the securitisation, the transaction may be scrutinised under Canada's Bankruptcy and Insolvency Act or Companies' Creditors Arrangement Act by the insolvency official (e.g., the trustee in bankruptcy or monitor) appointed in respect of the SPV's estate.

Generally, the priority of perfected security interests over unsecured creditors is respected in an insolvency, with certain specific statutory exceptions. However, the insolvency official, sometimes with the assistance of the court, will determine whether the transaction preferred one creditor of the SPV over its other creditors, or whether the SPV transferred (or granted security interests in) its assets for conspicuously less than fair market value.

Assuming the debtor (e.g., the SPV) and the secured creditor (e.g., the indenture trustee on behalf of the investors) deal at arm's length and the security interest only secures newly issued debt, it is unlikely there would be a basis for attacking the securitisation as a preference or transfer at undervalue. The look-back periods for arm's-length transactions are three months before the commencement of insolvency proceedings for a preference and 12 months for a transfer at undervalue.

IV PRIORITY OF PAYMENTS AND WATERFALLS

Where the collateral is personal property, priorities among creditors are governed primarily by the PPSA, subject to contractual arrangements among creditors (including inter-creditor agreements and subordination agreements). In the case of securitisations, the trust indenture will often address respective priorities (as would any necessary deed of hypothec in Quebec).

The priority of security interests perfected by registration generally is a matter of 'who registered first', with certain exceptions (including for a 'purchase money security interest' in certain collateral). A security interest perfected by possession or control (e.g., a share certificate delivered under a pledge of shares) generally has priority over a security interest in the same collateral that is perfected by registration.

Unperfected security interests commonly rank last among secured creditors having security in the same collateral and are not effective against a trustee in bankruptcy of the debtor.

Notably, the PPSA does not address all priorities of payments as between secured and unsecured creditors. In particular, waterfall priorities as they relate to unsecured creditors are generally dealt with by other pieces of legislation in addition to long established common law doctrines (except in Quebec). Various federal and other provincial statutes additionally provide statutory priority to specific creditors that do not have security interests perfected under the PPSA, such as various tax and other governmental authorities.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

Fundamental to a typical Canadian securitisation is the sale (or contribution) of assets by the originator to the SPV that, in turn, issues a debt instrument to investors. Care is taken to ensure the sale or contribution is 'true' so the transaction will not be recharacterised, for example, as a grant of a security interest by the originator in favour of the SPV.

Bankruptcy remoteness is achieved through the 'true sale' and the separateness of the SPV from the originator. For the investor in the securitisation, bankruptcy remoteness ensures that, if the originator enters insolvency, the assets of the SPV will not be available to satisfy claims of the originator's other creditors. For the originator, it means that investors in the securitisation will not have recourse to the originator for any losses suffered except as expressly provided in the documentation.

The trust indenture will require compliance with 'separateness covenants' included in governing or constating documents of the SPV, which serve to limit the business of the SPV to that of owning and holding the securitisation assets and performing its obligations under the securitisation's transaction agreements.

Bankruptcy remoteness would be defeated by an order for substantive consolidation of the SPV and the originator (or other parties that are not also special purpose entities). In Canada, substantive consolidation is an extraordinary remedy and is rarely ordered over the objection of third party creditors. Nevertheless, separateness covenants and other aspects of a securitisation's transaction documents will be aimed at preventing or limiting actions that Canadian courts have identified as factors to be considered for purposes of substantive consolidation:

- difficulty in segregating assets;
- presence of consolidated financial statements;
- profitability of consolidation at a single location;
- commingling of assets and business functions;
- unity of interests in ownership;
- existence of intercorporate loan guarantees; and
- transfer of assets without observing corporate formalities.[12]

The presence of any of these factors will not necessarily be determinative as the court will apply a balancing of interests test, in the context of those elements, to determine whether the benefits of consolidation outweigh the prejudice to particular creditors and, finally, determine whether consolidation is fair and reasonable in the circumstances.

Typically, a non-consolidation opinion in respect of the SPV and originator is provided as part of the closing of a securitisation transaction.

The issue of 'true-sale' generally relates to the characterisation of a transaction as a sale of an asset or, conversely, as some form of financing transaction. The Supreme Court of Canada has concluded that in characterising a transaction or instrument for commercial purposes, the starting point is the parties' intention, objectively determined. Unless proven otherwise, the parties' intention is to be found in the words used in the transaction documents. Generally, Canadian courts will only recharacterise a transaction or instrument if the label attached to it by the parties does not properly reflect its actual legal effect. The parties are entitled to structure their contractual relationships as they see fit, absent a sham or public policy considerations. Canada is therefore different from other jurisdictions where the comparable test is focused on the economic effect of the applicable documents, as opposed to the legal effect.

In determining the 'real nature' of a transfer (e.g., whether the transfer constitutes a sale or a loan), courts generally consider the following factors, with items (e), (f) and (g) applying only in the case of a sale of receivables:

- the parties' intention as evidenced by the language of the applicable agreement, the factual circumstances and purpose of the agreement (including the desired commercial result);
- whether the risks of ownership are transferred to the purchaser and the extent and nature of recourse to the seller;
- certainty of determination of the purchase price;
- the extent to which the purchased assets are identifiable;
- the right of the seller to surplus collections;
- responsibility of the seller in collecting the receivables; and
- whether the seller has a right to redeem the receivables on paying a specified amount.[13]

Typically, a true sale opinion is provided as part of the closing of a securitisation transaction.

VI OUTLOOK

In the face of a challenging macroeconomic and geopolitical environment, new issuance activity and credit performance in Canadian securitisations were resilient in 2022. New term ABS, ABCP and private deals, combined, achieved record levels as did covered bond issuances.[14]

The outlook for the Canadian securitisation market is balanced, although it is expected that high interest rates, inflationary pressures, anticipated increases in the levels of unemployment, heightened geopolitical risk and uncertainties in the Canadian housing sector will place some strain on both new issuances and credit performance.[15]

The implementation of the final Basel III reforms in relation to capital adequacy,[16] evolving derivatives regulation and the transition from the Canadian Dollar Offered Rate (CDOR) to the Canadian Overnight Repo Rate Average (CORRA) as the key Canadian dollar interest rate benchmark[17] may continue to impact investment decisions, compliance obligations, risk management and supporting infrastructure of Canadian securitisations.

Finally, it is anticipated that the Canadian securitisation marketplace may experience a continued increase in cross-border transactions, bespoke transactions, transactions involving more 'esoteric assets' (including royalty and distribution streams) and transactions influenced by ESG factors.

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Endnotes

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2 https://www.dbrsmorningstar.com/research/415165/dbrs-morningstar-releases-march-2023-canadian-securitization-market-overview-report.
3 http://www.cmhc-schl.gc.ca/.
4 http://www.bankofcanada.ca/wp-content/uploads/2015/12/fsr-december2015-mordel.pdf.
5 There are 10 provinces and three territories. In this chapter, references to the provinces should be construed to also be references to the Canadian territories.
6 National Instrument 45-106 – Prospectus Exemptions.
7 National Instrument 41-101 – General Prospectus Requirements.
8 National Instrument 45-106 – Prospectus Exemptions.
9 https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR22_chpt6.aspx; https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b5-19.aspx; https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b5a.aspx.
10 Certain assets will require additional registration and perfection (e.g., certain intellectual property, aircraft, maritime vessels and ships, railcars and rolling stock, and life insurance policies).
11 The process for taking security over real estate differs. A party taking security in real property (by way of a mortgage or hypothec) must register such security on title to the property.
12 *Northland Properties Ltd, Re* [1988] BCJ No 1210 (SC), aff'd [1989] BCJ No 63 (CA), in which the court considered the 'elements of consolidation' set out in the US Bankruptcy Court case *Vecco Const. Indust. Inc., Re* 4 BR 407 (US Bankr ED Va 1980).
13 *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.* (2003), 30 BLR 3d 288 (Ont Sup Ct J).
14 https://www.dbrsmorningstar.com/research/410349/canadian-structured-finance-2022-year-in-review-and-2023-outlook.
15 ibid.
16 In June 2023.
17 The transition of benchmarks from CDOR (which will cease publication by 28 June 2024) to CORRA has begun, with newer derivative products shifting from CDOR to CORRA by 30 June 2023 (as required by OSFI). Many securitisation transactions have already accommodated the switch.

Chapter 3

France

Fabrice Faure-Dauphin and Caroline Marion[1]

Summary

I OVERVIEW

France has an active securitisation market supported by origination from European banking heavyweights, specialised lenders and large corporates. Securitisation continues to play an important role in providing, notably, a diversified and attractive source of financing and asset derecognition solutions.

As elsewhere, the stigma of the global financial crisis can still be somehow perceived, but with a good set of active issuers and investors, the securitisation industry is active. More recently, the impact of the pandemic on the French market was commensurate to what other European jurisdictions have witnessed, with lower generation of assets and a temporary drop in payment rates, in part because of legally[2] or contractually awarded payment holidays.

Some of the most active asset classes include auto asset-backed securities (ABS) and other consumer ABS; trade receivables and corporate securitisation; residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS); and synthetic collateralised loan obligations (CLOs). The simple, transparent and standardised (STS) label under the European Securitisation Regulation 2017/2402[3] (the Securitisation Regulation) has been widely adopted when available and the market is also supported by transactions seeking favourable prudential treatment through a significant risk-transfer approach. One – non-surprising – expectation of a number of market participants is that deteriorated macro-economic conditions will support the growth of the non-performing loan (NPL) segment, which has remained timid so far.

This market would not be witnessing such level of activity absent a solid and favourable legal environment. This environment is primarily provided by the specific provisions of the Monetary and Financial Code (CMF), which regulates securitisation vehicles and provides useful tools to implement securitisation and structured finance transactions. Quite often, these tools are used in transactions with a minimum French nexus but this is not always the case and the flexibility and efficiency of these tools prove to be very useful in a much broader context.

Such legal framework governs, inter alia, the creation of specific securitisation vehicles, how their assets and liabilities may be managed and true sale requirements. This chapter elaborates on the content of such legal and regulatory framework and how it serves the needs of the securitisation market.

II REGULATION

i Legal and regulatory framework

The first legislation introducing securitisation dates back to 1988.[4] This regime has been amended on a regular basis and codified within the CMF. The latest substantial overhaul of the legal regime took place under the terms of Ordinance of 4 October 2017[5] (as supplemented by implementing decrees in 2018).[6]

Initially, and until 2008, the securitisation mutual fund (FCT), formerly known as a receivables mutual fund (FCC), was the only existing vehicle under French law dedicated to securitisation. It was by an Ordinance of 13 June 2008[7] that the option of setting up a securitisation vehicle in the form of a commercial company (ST) was introduced into French law.[8] With the Ordinance of 2017 mentioned above, securitisation vehicles (OTs) (designating the FCT and the ST) were included in the new category of financing vehicles, which also includes the then newly created specialised financing vehicles (OFS).

ii The merits of a specific legal framework

The need for such a legal framework arose to remove certain obstacles that could hinder the implementation of securitisation transactions governed by French law or involving French originators or French assets. Some of the main drivers for an ad hoc regime include:

- a specific vehicle engaged in securitisation or financing transactions must first be authorised to carry on its activity without infringing upon the monopoly of credit institutions (since, in particular, the acquisition of unmatured receivables and the granting of loans, which is authorised to OTs, otherwise falls under the monopoly of credit institutions);[9] OTs thus benefit from a derogation[10] to carry out those activities;
- it was therefore imperative to have a vehicle that did not expose investors, other creditors and stakeholders to the risk of bankruptcy (as to which see below), and that was sufficiently flexible and secure;
- a specific regime for the assignment of receivables has also proved necessary, both to ensure its flexibility and its effectiveness, including in the event of the assignor's bankruptcy;
- for the risks of a securitisation transaction to be properly managed, a debt recovery regime allowing for the creation of specific rights for the OTs over the amounts collected in the servicer's account by means of the dedicated account mechanism also proved necessary;[11] and
- more recently, this regime has made it possible for French securitisation vehicles to satisfy some of the European regulatory requirements (some aspects of which are discussed below).

III SECURITY AND GUARANTEES

OTs are defined in the CMF[12] as vehicles whose purpose is to be exposed to certain risks,[13] which include exposures over receivables or other assets, loans or insurance risks and to fully finance or cover such risks, under the conditions laid down in the CMF, in particular, by issuing units, debt securities, shares, loans or by having recourse to other debt resources or commitments.[14]

i Legal form

OTs exist either in the form of unincorporated funds (by far the most popular form), in which case they are referred to as securitisation mutual funds (FCT), or in the form of incorporated companies (less common), in which case they are referred to as securitisation companies (ST).[15]

An OT may comprise different compartments if the articles of association or the regulations of the OT so provide. Each sub-fund then gives rise to the issue of units or shares and, where applicable, debt securities. Unless otherwise provided in the articles of association or the regulations of the OT, the assets of a given sub-fund are liable only for the debts, commitments and obligations and benefit only from the rights and assets relating to that sub-fund.

In each case, an OT is managed by a portfolio management company approved by the French Financial Markets Authority (the AMF) and designated in the articles of association or regulations. As an exception, an OT may also be established by a sponsor within the meaning of Article 4 of Regulation (EU) 575/2013 of 26 June 2013 if it delegates the management of its portfolio to a portfolio management company.

The custody of the vehicle's assets is provided by a custodian (this must be a credit institution or need to be otherwise approved for carrying out such activity), which also monitors the legality of the management company's decisions.

ii Variety of OT activities and eligible assets

The articles of association (if the OT is set up as an ST) or the regulations (if the OT is set up as an FCT) of the OT specify the activities and the assets that it may acquire, subscribe for or hold. These can be very varied given the broad purpose of OTs.[16]

In particular, an OT may acquire, subscribe for or hold receivables, debt securities or other assets, grant loans under certain strict conditions or enter into contracts constituting forward financial instruments or transferring insurance risks, guarantees, security interests, risks or cash sub-participations. The OT is the only vehicle under French law that allows the transfer of insurance risk.

The OT, therefore, offers the flexibility needed to be used in a wide variety of structures and underlying assets; it is thus the essential vehicle for any securitisation transaction, receivables financing requiring the establishment of a special purpose vehicle, refinancing involving a transfer of loan receivables or debt funds in particular. All categories of securitisation transactions are concerned, including ABS on loans to professionals or consumers, leases with or without a purchase option, credit card receivables, CLO, CMBS or RMBS, trade receivables or synthetic securitisation.

iii Establishment

As a matter of principle, the creation of an OT is not subject to any authorisation or approval, unless its purpose is to bear insurance risks, in which case it must be authorised by the French prudential supervisory and resolution authority (the ACPR).[17]

An FCT has no legal personality and is described as a co-ownership entity by the CMF; it is represented by its management company for the purpose of its activities.

The ST is created by its founding partners as for any other company. It may take the form of a public limited company (SA) or a simplified joint-stock company (SAS). If the ST is incorporated as an SA, some of the organisational constraints provided for by the French Commercial Code do not apply to it.[18]

The FTC has the advantage of not requiring a minimum capital (apart from the issue of a minimum of two units with a nominal value of €150 each) and offers great flexibility in its organisation and operation. The company form, however, makes it possible to offer a vehicle with legal personality.

iv Regulatory status of the OT

An OT constitutes a securitisation special purpose entity (SSPE) within the meaning of the Securitisation Regulation if it participates in a securitisation transaction and is structured to meet the other requirements of Article 2.2 of the Securitisation Regulation, which includes in the definition of SSPE any:

> *entity, other than an originator or sponsor, established for the purpose of carrying out one or more securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator.*

The requirement imposed on the SSPE to have an activity limited to the completion of a securitisation is satisfied by the legal and contractual limitation (in the regulations or articles of association, as applicable) of the purpose of the OT. The isolation of the obligations of the OT from those of the originator is ensured by specific provisions protecting the 'true sale' and isolating the vehicle from the risk of insolvency.[19]

Managers of OTs who enter into securitisation transactions under the meaning of the Securitisation Regulation will not be subject to the AIFM Directive.[20] For other types of transactions, the question of the extent to which the manager of the OT should be subject to the AIFM Directive is otherwise relatively complex and is the subject of detailed provisions of the CMF,[21] which distinguishes between OT for which the manager benefits from a derogation from the AIFM Directive and those subject to the provisions of the AIFM Directive, as transposed into French law.

In essence, the AIFM regime will remain inapplicable if the purpose of the OT is not to be exposed for more than 50 per cent of its assets to risks in the form of either financial securities[22] or any other asset that does not constitute an exposure to an insurance or credit risk managed on a discretionary basis by the management company or in the form of financial contracts entered into, managed or terminated on a discretionary basis. Also excluded from this regime are, among others, economy financing funds (FPE), SSPE (as mentioned above) and certain commercial paper issuers.

IV PRIORITY OF PAYMENTS AND WATERFALLS

The securitisation legal regime provides for a number of protections to investors, which include:

- rules governing the funding of the OT;
- rules governing the capital structure and the payment and allocation rules;
- protection against insolvency risk to a very large extent;
- a clear support for flexible governance and decision-making rules; and
- commingling risks protection.

i Funding

When the OT is set up as an FCT, it issues at least two units that constitute financial securities[23] of an initial nominal unit amount of a unit that is at least €150 or its equivalent in the monetary unit of the issue. When an OT is set up as an ST (SA or SAS), it issues shares.

An OT may – and will in a typical public ABS transaction – issue (in addition to units or shares) bonds, negotiable debt securities or debt securities issued based on a foreign law. It may also use other resources, such as borrowings.

As for the shares of an ST, the payment of sums due in respect of units issued by an FCT is subordinated to the payment of sums due under borrowings of the FCT or commitments resulting from contracts constituting forward financial instruments.[24]

Holders of securities issued by an OT are liable only to the extent of their investment. Holders are therefore not liable for the OT's debts beyond the amounts they have invested.

ii Protection of the capital structure and enforceability of payment and allocation orders

Units or shares and debt securities issued by the securitisation vehicle may give rise to different rights, in particular to capital or interest.[25] The regulations or articles of association of the vehicle and any contract entered into by it may provide that the rights of certain classes of unitholders, shareholders, holders of debt securities or certain creditors of the vehicle are subordinated to the rights or interests of other classes of unitholders, shareholders, holders of debt securities or other creditors of the vehicle.

More generally, the articles of association or the regulations of the OT determine the payment orders made by the OT to its creditors and the rules for the allocation of its assets and the amounts received by the OT.

These rules are binding on unitholders, shareholders, holders of debt securities of all classes and other creditors who have accepted these rules – notwithstanding the initiation against them – where applicable, of insolvency or prevention proceedings under Book VI of the French Commercial Code (the Insolvency Law) or equivalent proceedings under foreign law.[26] These rules are applicable including in the event of liquidation of the OT.[27]

These principles are important in that they provide a legal basis for the rules governing the allocation of sums owed by the OT and the resulting ranking of creditors. The preservation of the efficiency of these allocation rules in case of insolvency proceedings against the creditor protects certain important mechanisms, such as 'flip clause' mechanisms by which the ranking of certain payments due to a creditor is downgraded if such creditor is defaulting (including if such default is due to that creditor's insolvency proceeding).

iii A regime largely derogating from bankruptcy law and protecting creditors

In addition to the derogations from bankruptcy law referred to in the preceding paragraphs, OTs and their transactions are substantially exempt from ordinary bankruptcy law.

OTs, whether they are set up as FCT or ST, cannot be the subject of any insolvency proceedings, as the Insolvency Law does not apply to them.[28] Accordingly, these structures do not generally provide that the OT would secure its obligations towards investors by granting security or otherwise as there is no risk for the investors not to have access to the cash available to the OT (subject always to application cash allocation rules and priority of payments as mentioned above).

In addition, each OT (and each of its sub-funds) is only liable for its debts (including to holders of debt securities) up to the amount of its assets and according to the ranking of its creditors as defined by law or as provided for in its articles of association or regulations or the contracts entered into by it.

iv Flexible and secure decision-making rules

The articles of association or the regulations of the OT or of a sub-fund may provide for rules relating to the decisions of the management company; these rules and the resulting decisions are to be binding on unitholders, shareholders, holders of debt securities of all classes and creditors who have accepted them.[29] This means that authority may be given to investors or certain categories of investors (e.g., a controlling class) to adopt certain decisions or to be consulted specifically on certain key matters.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

The protections offered by the provisions of the CMF to achieve bankruptcy remoteness of the structure (beyond those protections that relate to the OT itself as mentioned above) primarily include:

- provisions protecting the true sale of assets to the OT;
- provisions allowing the OT to acquire exposure by extending loans; and
- provisions protecting against commingling risk of the servicer.

i True sale

Under French law, the concept of 'true sale' means, on the one hand, that the transaction whereby the assets are transferred by the assignor does indeed constitute a transfer of ownership of the transferred assets and, on the other hand, that the assignment of the assets to the vehicle, which were initially the property of the assignor, cannot subsequently be called into question even in the event of the latter's bankruptcy.

The acquisition of receivables by an OT can be done[30] in the following ways:

- by means of a specific transfer form established by the CMF to facilitate such type of transfers;[31]
- by any other method of acquisition, assignment or transfer under French or foreign law;
- when the assets are financial instruments, in accordance with the specific rules applicable to the transfer of such instruments, where applicable, by the direct subscription of such instruments at the time of their issue; and
- when the assets are professional receivables, by way of another specific regime ('daily transfer form'), which generally allows the simplified transfer by way of true sale or security of those receivables.[32]

When carried out by means of a transfer form, the acquisition or assignment of receivables is particularly effective because it takes effect between the parties and becomes enforceable against third parties (including the assigned debtor or debtors and the bodies of any collective proceedings that may be initiated against the assignor) on the date affixed to the transfer form by the management company when it is delivered by the assignor to the management company, irrespective of the creation, maturity or due date of the receivables, without the need for any other formality, and irrespective of the law applicable to the receivables and the law of the debtors' country of residence.

Delivery of transfer forms automatically entails the transfer of the security interests, guarantees and other ancillary rights and commitments attached to the assigned receivables, including mortgage securities and trade receivables that would have been assigned by way of guarantee or pledged under the conditions laid down by Articles L. 313-23 et seq. of the CMF, in addition to the enforceability of this transfer against third parties without the need for any other formality.

The OT also benefits from a favourable regime that exempts its assets from the consequences of the bankruptcy of the assignor or pledgor of the assets transferred or pledged to it.

The acquisition or assignment of receivables or the creation of any security interest or guarantee for the benefit of the OT retains its effectiveness notwithstanding the insolvency of the assignor or the pledgor at the time of such acquisition, assignment or creation or the initiation of one of the proceedings referred to in the Insolvency Law or equivalent proceedings under foreign law against the assignor or the pledgor following such acquisition, assignment or creation.[33]

Neither payments made by the OT (in particular, payment of the purchase price of the receivables), nor acts for valuable consideration performed by or for the benefit of the OT – provided that such contracts or acts are directly related to its object – may be cancelled based on certain clawback provisions provided under the Insolvency Law.[34] These rules are important to secure the transactions made by an OT but also to meet the (no severe claw back provisions) requirements set out in the Securitisation Regulation for a transaction to be considered 'STS'.[35]

Finally, the CMF provides that when the receivables assigned to the OT results from a leasing agreement with or without purchase option (including a financial lease), such agreement may not be discontinued as a result of the initiation of an insolvency proceeding or the transfer of assets subject to that contract within the framework of any such proceeding against the lessor.

ii Option to grant loans under certain conditions

The reform of 2017 established the option for any OT to grant loans under certain conditions, which are essentially those enacted for another type of vehicle (the specialised professional funds (FPS)).[36]

Such loans (including leasing agreements, with a purchase option (including financial leases) and the subscription of loan notes) must satisfy the following conditions:

- the beneficiaries may only be (1) sole proprietorships or private legal entities engaged primarily in a commercial, industrial, agricultural, craft or real estate activity, or (2) private legal entities whose sole or main purpose, in addition to carrying out a commercial, industrial, agricultural, craft or real estate activity, is to hold directly or indirectly one or more equity interests in the capital of legal entities referred to in (1) or to finance such legal entities;
- the regulations or articles of association of the OT must specify the date of its liquidation, but may provide for a right of temporary extension of its life, and the conditions for exercising such a right;
- the loans granted may not be made for a term exceeding the remaining life of the OT; and
- receivables arising from loans granted by the OT must be held by the OT until maturity, unless a specific programme of activity of the management company is approved or under certain exceptions (liquidation of the OT, 'clean-up call', the units come to be held by a single shareholder, to meet its obligations under a financial instrument contract, secured loan or sub-participation, in the event of a doubtful or disputed debt or to comply with its investment rules).[37]

In addition, an OT that engages in lending activity for more than 10 per cent of its net assets[38] is subject to additional restrictions, namely:

- it may borrow, but subject to certain limits (notably, in terms of the maximum leverage, borrowing conditions, maturity and repayment or refinancing terms and conditions of which must be consistent with the liquidity profile of the OT and must not exceed the remaining life of the OT, and the proportion of the assets encumbered for such liquidity borrowing that must not exceed the percentage of the OT's net assets at the time of the borrowing);
- it must not use financial contracts other than for the purpose of hedging interest rate and currency risks;
- it may not engage in short selling of financial instruments;
- it may not have recourse, in excess of 10 per cent of its net assets, to techniques and instruments involving eligible financial securities and money market instruments, and in particular repurchase agreements and similar transactions for the temporary purchase or sale of securities; and
- the maximum net loss or commitment made by the OT, valued at any time by taking into account the hedges it benefits from, in respect of drawdowns of a loan granted or the acquisition of receivables arising from drawdowns of loans, forward financial instruments, guarantees or risk sub-participation, may not exceed the value of its assets and, where applicable, the uncalled amount of subscriptions.[39]

Finally, the management company must comply with certain obligations, such as having a risk analysis system, having a process for obtaining up-to-date information on borrowers, implementing a credit risk selection procedure, complying with anti-money laundering provisions and providing the AMF with quarterly information on the unmatured loans granted.

iii Commingling risk protection: dedicated account mechanism

Sums collected on its own bank account by the servicer may be considered by an administrator or a court-appointed liquidator as part of the assignor's assets in the event of the assignor's bankruptcy. To mitigate this 'commingling' risk, the CMF39[40] provides that the OT's management company and the servicer may agree for the bank account in which these sums are collected to be specially dedicated for the benefit of one or more OT or, where applicable, sub-funds.

The specially dedicated nature of this account takes effect upon the signature of an account agreement between the management company, the custodian, the servicer and the account-holding institution, without the need for any further formality.

- The protection provided by this dedicated account mechanism includes the following: the sums credited to the account are exclusively for the benefit of the OT, and the OT's management company (acting in the name and for the benefit of the latter) may only dispose of these sums under the conditions laid down in the account agreement;
- the creditors of the servicer may not take enforcement actions against this account, even in the event of proceedings initiated against this entity based on the French insolvency regime enacted pursuant to the Insolvency Law or equivalent proceedings under foreign law;[41]
- the initiation of any insolvency proceedings referred to in the Insolvency Law or of an equivalent proceedings under foreign law against the servicer may not result in either the termination of the dedicated account agreement or the closure of the specially dedicated account; and
- the account-holder is subject to certain obligations or prohibitions, including:
  - the obligation to inform any third party that attempts to seize the account that the account is specially dedicated for the benefit of the OT, making the account and the sums held in it unavailable;
  - the prohibition on merging the account with another account; and

- the obligation to comply solely with the instructions of the OT's management company, for account debit transactions, unless the account agreement authorises the entity responsible for collecting sums due to or benefiting directly or indirectly the OT to debit the account under conditions defined by it.

VI OUTLOOK

The French securitisation market has shown its resilience over the past few years, and it is expected to continue that way. In particular, with the recent modification of the general regulations of the AMF implementing the last clarifications on the role of the OT's custodian further to the French legislative reform of 2017, the French securitisation legal framework now appears stabilised, which most participants expect will help attract issuers and investors and supply new market sectors (such as the refinancing of NPLs). Where transactions take the full benefit of the provisions protecting securitisation transactions, the potential for growth therefore clearly exists.

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Endnotes

1 Fabrice Faure-Dauphin is a partner and Caroline Marion is counsel at Allen & Overy LLP.
2 Ordonnance No. 2020-306 of 25 Mars 2020 (JORF 26 March 2020).
3 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No. 1060/2009 and (EU) No. 648/2012.
4 Law No. 88-1201 of 23 December 1988 supplemented by a Decree No. 89-158 of 9 March 1989.
5 Ordinance No. 2017-1432 of 4 October 2017.
6 Decree Nos. 2018-1004 and 2018-1008 of 19 November 2018.
7 Ordinance No. 2008-556 of 13 June 2008.
8 This same Ordinance introduced the concept of the securitisation vehicle, bringing together FCT (formerly known as special purpose vehicles (FCC) and renamed securitisation mutual funds (FCT)) and new securitisation companies.
9 Article L. 511-5 of the CMF.
10 Article L. 511-6 of the CMF. This derogation has recently been extended to certain foreign SPVs when the securitised assets are loans granted for business purposes under certain specific conditions.
11 See Section V.iii.
12 Article L. 214-168 of the CMF.
13 Article L. 214-168 of the CMF.
14 Article R214-223 of the CMF.
15 Article L. 214-168 of the CMF.
16 Article L. 214-175-1, I. of the CMF.
17 Article L. 214-189 of the CMF.
18 Article L. 214-179 of the CMF, in particular as regards its share capital, rules on quorum at general meetings and concurrent holding of corporate offices, among others.
19 See Section V.i.
20 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010.
21 Article L. 214-167-I of the CMF.
22 Debt securities subscribed directly with issuers are not taken into account in calculating the 50 per cent proportion in accordance with Article D. 214-232-2-4° of the CMF.
23 Within the meaning of Article L. 211-1 of the CMF.
24 Article R. 214-235 of the CMF.
25 Article L. 214-175-1 of the CMF.
26 Article L. 214-169, II. of the CMF.
27 Article L. 214-169, II. of the CMF.
28 Article L. 214-175, III. of the CMF.
29 Article L. 214-169, II of the CMF.
30 Article L. 214-169, V of the CMF.
31 The wording and form of which are set forth in Article D. 214-227 of the CMF.
32 Articles L. 313-23 et seq. of the CMF.
33 Article L. 214-167, V., 4° of the CMF.
34 Article L. 632-2 of the Commercial Code.
35 Articles 20.2 and 24.2 of the Securitisation Regulation.
36 Article L. 214-175-1, V. of the CMF.
37 Article R. 214-234 of the CMF.
38 Article R. 214-203-7 of the CMF.
39 Article L. 214-175-1, VI of the CMF.
40 Articles L. 214-173 and D. 214-228 of the CMF.
41 Article L. 214-173 of the CMF.

Chapter 4

India

Nihas Basheer[1]

Summary

I OVERVIEW

Securitisation in India started taking shape in an unregulated environment (with the first securitisation transaction having been concluded in the early 1990s) and, until 2006, there were no specific regulations governing securitisation transactions (in relation to performing assets) in India. The Reserve Bank of India (RBI) formulated guidelines in 2006 (which were modified in 2012 and then in 2021) for governing securitisation of standard assets (Securitisation Guidelines). Standard assets (or performing assets) under Indian law, would generally be assets where amounts due have not been outstanding for more than 90 days.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (Securitisation Act) largely dealt with resolving, restructuring and securitisation of non-performing assets (NPAs) and accordingly, references to securitisation in this chapter concern only securitisation of standard (or performing) assets.

Securitisation transactions in India were largely dominated by single-loan securitisations until approximately 2008. In such transactions, a financial institution lent money to a large corporate entity and thereafter immediately securitised the cash flows, with the interval between the loan origination and the securitisation being greatly reduced to one or two days. Following the global economic crisis and an unfavourable interpretation of tax laws applicable to securitisation trusts, securitisation transactions in India came to a halt in 2008. Securitisation transactions made a comeback in the Indian market in 2013 after the RBI revised the Securitisation Guidelines and the relevant tax laws were modified to introduce specific provisions affirming the pass-through status of a securitisation trust.

In the past decade, there have been various mortgage-backed securitisations (MBS) and asset-backed securitisations. The key asset pools securitised have been housing loans, property-backed loans, vehicle loans, equipment loans and consumer durable loans.

The investors in securitisation transactions are mostly banks and non-banking financial companies. The investment by banks in these transactions is also driven by the priority sector lending targets stipulated by the RBI for banks. However, the market has also seen new entrants such as mutual funds, high net worth individuals and insurance companies participating as investors.

The key features in a typical securitisation transaction in India are as follows:

- the acquiring entity (a special purpose vehicle (SPV)) is set up in the form of a private trust. While the option to incorporate as a company exists, the taxation principles applicable to a company make it unattractive as a vehicle for securitisation transactions;
- the SPV issues pass-through certificates (PTCs) to the investors, for raising the funds required to acquire the assets;
- the sale is structured on a 'par' basis, with the originator entitled to residual cash flows;
- the originator makes available credit enhancement and also undertakes the servicing obligations;
- credit enhancement is typically structured as a cash collateral placed in a fixed deposit with a bank – there are instances where the credit enhancement also comprises over-collateralisation (or equity tranche) or a second-loss piece in the form of a bank guarantee;
- the assets securitised have to be held on the books of the originator for a minimum period, prior to securitisation; and
- the originator is also required to retain a minimum exposure to the securitisation transaction (from 5 per cent to 10 per cent), which is typically met by the credit enhancement made available by the originator.

There has been some activity in the market in relation to securitisation transactions that are not regulated by the RBI (i.e., where the originator is not a financial institution or the assets are not typical finance assets (e.g., leased assets)); however, the number of transactions on this front is not comparable to the number of transactions originated by financial institutions. In these transactions, the requirements for minimum holding period and minimum retention would not be applicable. The RBI has also restricted the ability of regulated financial institutions to participate in securitisation transactions where the originator is not a regulated financial institution, which has restricted the growth of this market.

Securitisation transactions have been on the rise, with the first quarter of financial year 2022–2023 seeing an increase in terms of both deal value and volume in comparison with the previous financial year. The increase in activity is a direct result of the liquidity availability in the financial system and the desire to increase exposure to retail loans.

The guidelines introduced by the RBI in 2021 have overhauled the existing securitisation framework. The key changes include:

- introducing the framework for simple, transparent and comparable securitisation transactions (which will provide a reduced and uniform risk weightage for participants);
- incentivising residential mortgage-backed securitisation; and
- removing the prohibitions on single loan securitisation and securitisation of acquired assets.

II REGULATION

The Securitisation Guidelines prescribe a minimum retention requirement of 5 per cent to 10 per cent of the assets being securitised, and also that the assets be held on the books of the originator for a minimum period (normally from three to six months since either completion of security perfection or first repayment) prior to securitisation. There are no minimum retention requirements or minimum holding period requirements in relation to transactions that fall outside the Securitisation Guidelines.

The choice is left to the seller to fulfil the risk retention requirements either through investment in the securities issued by the SPV or through the provision of credit enhancement. Normally, this is met through the provision of first-loss credit enhancement or participation in equity tranches and if that is not sufficient, by subscribing to senior tranches of the securities issued by the SPV. The minimum retention requirement has to be met by the originator only and cannot be met by any other company forming part of the same group of companies, even though for the purposes of the Securitisation Guidelines the term 'originator' would include group companies.

i Prohibited securitisations

The Securitisation Guidelines stipulate certain assets that cannot be securitised, including securitisation exposures, revolving credit facilities, loans with bullet payment and loans with resiudal maturity of less than 1 year.

Under the latest Securitisation Guidelines, the RBI has removed the restriction on securitisation of acquired assets and furthermore, the RBI has provided clarity that loans that have a bullet payment structure for principal but frequent payments of interest can be securitised (i.e., only loans with bullet payment structure for both principal and interest cannot be securitised).

ii Taxation

The taxation issues surrounding securitisation transactions have been clarified in the relevant tax laws insofar as regulated securitisations are concerned (i.e., securitisation transactions governed by RBI regulations or regulations of the Securities and Exchange Board of India (SEBI), the capital markets regulator). However, even for unregulated securitisations, the tax laws that govern taxation of private trusts – the most commonly used securitisation vehicle in India – provide pass-through tax treatment to such vehicles, so long as the trust is not seen to be doing business.

Tax can be imposed on securitisation transactions in relation to the following elements:

- tax on income received by the SPV from the underlying loan assets;
- tax on fees payable by the SPV to any service provider, including collection and servicing agents, escrow banks or credit enhancement providers;
- tax on distribution of income by the SPV to the investors; and
- tax on the transfer of assets from the originator to the SPV.

Under current regulations, it is clear that there will be no Indian tax applicable on income received by the SPV from the underlying loan assets. In relation to fees payable by SPVs to service providers, goods and services tax would apply; however, these taxes can be passed on to the service providers and factored in the fee payable to them.

In relation to distribution of income by the SPV to investors, the SPV is required to deduct tax at source, which means that although payment of tax is made by the SPV, the benefit of the payment is provided to the investors. Therefore, as long as the investor is an Indian tax resident, this deduction will not impact the commercial considerations of the transaction; however, for offshore tax residents this will impact commercial considerations.

In relation to tax on the transfer of assets from the originator to the SPV, although there is no impact under the laws specifically governing direct or indirect taxation, laws governing payment of stamp duty and registration fees have to be considered. Stamp duty would be applicable on all legal instruments executed in connection with a securitisation transaction. Stamp duty in India varies according to the state in which the document is being executed.

An assignment transaction under stamp laws applicable in India would be considered a conveyance transaction and stamp duty would have to be paid accordingly. Stamp duty applicable on a conveyance transaction could vary from 3 per cent to 11 per cent of the debt being assigned, depending on the state in which the transaction is being executed. Given the significant costs associated with a conveyance transaction, certain states in India, such as Maharashtra, Delhi, Rajasthan, Punjab, West Bengal and Gujarat, have reduced the stamp duty applicable for securitisation transactions. Given that only certain states offer this benefit of a reduction in stamp duty, most securitisation transactions in India are concluded in these states.

Furthermore, given that mortgage debt is treated at par with immovable property (i.e., land) for the purposes of transfer laws, in any MBS, registration of the deed of assignment transferring the mortgage debt also has to be considered. Here again different states have different applicable rates and parties choose the state according to the fees payable. In fact, in certain transactions, to reduce the incidence of stamp duty, parties also adopt structures wherein the underlying security interest is not transferred and therefore there is no registration requirement.

iii Authorisations and licences

Under Indian laws, any entity that has financial assets that constitute more than 50 per cent of its total assets and financial income that constitutes more than 50 per cent of its total income is required to be registered with the RBI as a non-banking financial company. Therefore, most lenders in the Indian market, who do not have a banking licence, are registered as non-banking financial companies.

The trustee of the SPV would normally be an entity that is registered with SEBI as a 'debenture trustee'.

The rating agencies that rate the PTCs would have to be registered with SEBI.

Domestic investors in the PTCs would not require any specific registration for investing in the PTCs; however, the test for determining status as a non-banking financial company should be borne in mind. The only route available to foreign investors looking to invest in PTCs directly is for the investor to be registered as a foreign portfolio investor (FPI) with SEBI and to invest in the PTCs under the relevant foreign exchange laws stipulated in the Foreign Exchange Management Act, 1992 and in accordance with the rules and regulations issued under that Act.

There are no specific licences required for acting as a servicing agent for the SPV. However, given the number of people employed and the offices used for performing services for the servicing agent, general licences and registrations related to employment and business would have to be considered.

III SECURITY AND GUARANTEES

In relation to loan assets that are commonly securitised in India, the key security interests created for securing loans would be as follows: mortgage, hypothecation, pledge, institutional guarantee and personal guarantee.

Generally, a mortgage is created over immovable property and a hypothecation is created where movable property is involved. Institutional guarantees could be made available by entities set up specifically for this purpose, such as the National Housing Bank or mortgage guarantee companies. Personal guarantees are obtained either from family members of the borrower (in the case of individual borrowers) or from directors or promoters of the borrower (in the case of incorporated borrowers).

The collateral over which mortgages are created includes land (both residential and commercial), buildings and houses. The mortgages themselves can be of different kinds, with the most common forms being an equitable mortgage (where the mortgage is created simply by depositing title deeds of the property with the lender and no documents are executed for creation of the mortgage), an English mortgage (where the mortgage is created by way of a written instrument that is duly registered with the relevant authorities and whereby all rights, title and interest in the mortgaged property are conveyed to the lender, subject to the right of the owner to obtain a reconveyance) and a simple mortgage (where the mortgage is created by way of a written instrument that is duly registered with the relevant authorities). The formalities required for creation and the manner of enforcement will vary according to the form of mortgage adopted.

The collateral over which hypothecation is created includes vehicles (two-wheelers, three-wheelers, four-wheelers and trucks used for both personal and commercial purposes), equipment (e.g., construction and medical) and receivables (whether from financing or trading activities). A hypothecation is usually created via a written instrument. Furthermore, in relation to hypothecation created over vehicles, the registration certificate of that vehicle will also note the name of the financier.

A pledge is generally created over movable properties by handing over possession of the relevant property to the lender. This form of security creation is mostly followed when creating security over shares or gold. Although there are no documents specifically required for the creation of security interest in this manner, an agreement between the parties would normally record the terms of the pledge or at least receipt evidence of the goods pledged.

In relation to the creation of a security to the extent that the owner of the collateral is a company, the company would be required to make the appropriate filings with the registrar of companies to record the creation of the security interest. Apart from this and the registration requirements with respect to mortgages noted above, there are no generally applicable legal formalities required of the borrower (or the security provider) with respect to the creation of a security. The lenders, if governed by the Securitisation Act, are expected to register security interests created in their favour with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India.

There is currently no standard form of documentation followed in India for security creation, even though attempts are being made to streamline documentation.

The security created can be set aside if the owner of the collateral is subject to bankruptcy proceedings within the 'suspect period' (i.e., the period leading up to the bankruptcy order) set out in the applicable law. The principles in Indian law regarding the suspect period as applicable to companies are explained below (see Section V) and these principles would apply even for the setting aside of the security interest created.

Credit enhancement for securitisations

The credit enhancement made available for securitisation transactions could include cash collateral placed in the form of fixed deposits, investment in equity tranches, corporate guarantees provided by the originator or a group company and bank guarantees provided by a third party over collateral made available by the originator.

There are questions as to whether credit enhancement made available by the originator, whether in the form of subscription to equity tranches or fixed deposits held in the name of the originator, would be bankruptcy remote in relation to the originator (see Section V).

While there are no fixed limits on the credit enhancement that can be made available, the Securitisation Guidelines do provide that where the exposure of the originator to the securitisation transaction exceeds 20 per cent (taking into account all exposure, including the credit enhancement made available), the originator will have to risk-weight the excess exposure at a much higher level.

IV PRIORITY OF PAYMENTS AND WATERFALLS

The typical waterfall mechanism in a securitisation transaction would be as follows:

- statutory dues;
- costs and expenses of the SPV, including fees payable to servicers of the SPV;
- payment of expected cash flows on PTCs;
- reinstatement of the credit enhancement made available (with the second loss being reinstated prior to the first loss); and
- residual cash to the originator.

It is important to ensure that underlying cash flows are sufficient to meet the payments set out under the waterfall mechanism. While there are no statutory dues currently payable by an SPV set up in the form of a private trust, this could change. In relation to fees and expenses, the fees and expenses of the collection and servicing agent and credit enhancement providers would get covered. In this regard, it is typical for the agreements to provide that the servicer will only be entitled to a fixed fee, and all costs and expenses of the servicer that are incurred in connection with recovery or follow-up will be borne by the servicer (if not recovered from the borrowers) to ensure that there are no claims on the SPV beyond the fixed fee amount.

Given that originators continue as the collection and servicing agent in most securitisation transactions, the commingling risk of the originator must also be considered. Typically, all cash flows arising from securitised assets are collected in the bank accounts of the originator and are transferred to the SPV only on a monthly basis with the time lag between collection by originator and deposit with SPV extended to 30 (or even 60) days in some cases. Therefore, it may be prudent to monitor the credit situation of the originator and also to have triggers in place in the documentation that would require the originator to transfer the cash flows more frequently if the identified triggers have occurred.

In the event that all cash flows from a particular set of assets that have been securitised are being received by the originator in an identified account, investors may also consider entering into escrow arrangements with respect to that account to avoid commingling issues. Security can be taken over a bank account in India. The typical process for this is to mark a lien over the bank account and the monies credited to the account in the records of the bank. Additionally, in some cases a hypothecation is also created over the bank account and the monies credited to the account through a deed of hypothecation and this document is filed with the relevant registrar of companies.

Given that most securitisation transactions are carried out on a par basis, there would be an excess spread in each such transaction on account of the difference between the underlying loan rates and the agreed rate on the PTCs. This spread is normally subordinated and will be paid to the originator on a monthly basis only if all payments due on the PTCs have been met and the credit enhancement has been reinstated. However, in certain transactions, this excess spread may also be trapped (or used for acceleration of payments due on the PTCs) until the PTCs have been repaid in full.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

The Securitisation Guidelines codify the parameters for achieving 'derecognition' in connection with a securitisation transaction.

The derecognition parameters as set out under the Securitisation Guidelines require one to look into the economic characteristics of the transaction, as an asset can be derecognised from the accounts books of the seller only once the substantial risks and rewards associated with the asset have been transferred. In relation to whether substantial risks and rewards have been transferred, the Securitisation Guidelines do provide that the originator continuing to act as collection and servicing agent or providing credit enhancement would not vitiate the derecognition parameters.

Therefore, the test for determining a derecognition under the Securitisation Guidelines would be to establish whether there are any obligations being undertaken by the originator apart from the servicing obligations and the credit enhancement. In this regard, even if representations are provided regarding the future performance of the securitised pool, these representations would be treated as retention of risk in the assets, through the implied indemnity for breach of representations.

In relation to the collection and servicing arrangement, it should be ensured that the originator, as an agent of the SPV, is not undertaking any obligations as servicer that an independent third party would not take.

In relation to credit enhancement being made available by the originator, the Securitisation Guidelines stipulate that if the exposure of the originator to the SPV exceeds 20 per cent of the loans securitised, the capital should be provided against the entire exposure of the originator. Therefore, if on account of credit enhancement being made available the exposure of the originator is going beyond the stipulated level, the parties should also analyse whether this would result in substantial risk being retained by the originator.

Notably, the accounting standards in India have undergone a change during the past decade pursuant to the implementation of standards in line with internationally accepted accounting standards, and the revised accounting standards do not permit derecognition of assets sold in a securitisation transaction if the credit enhancement made available by the originator is higher than the inherent risk in the assets securitised. On account of the revised accounting standards, most originators are not able to achieve balance sheet derecognition for assets securitised (as credit enhancements made available are typically in the range of 5 per cent to 10 per cent, whereas inherent risk in these assets could range from 3 per cent to 4 per cent) even though they meet the 'derecognition' requirements under the Securitisation Guidelines (which permits credit support up to 20 per cent).

The revised accounting standards do present a challenge when it comes to testing bankruptcy remoteness of securitised assets, as the general principle of bankruptcy applicable in India is that all assets shown on the balance sheet will form part of the estate of the debtor under bankruptcy. However, under Indian insolvency laws, for assets held in trust, there is also a carve-out from the estate of the debtor under bankruptcy, and therefore in relation to the assets securitised, it could be argued that these should not be treated as assets of the originator, especially when the RBI derecognition standards have been met. The Securitisation Guidelines also seem to suggest a delinking between accounting treatment and legal treatment, as the RBI has set out that once derecognition standards under the RBI guidelines are met, the originator is not required to provide any capital against the assets securitised (indicating that they do not constitute a balance sheet risk for the originator anymore).

In this regard, the law regarding insolvency of banks, non-banking financial companies and housing finance companies has undergone changes, as the Insolvency and Bankruptcy Code, 2016 (IBC). This is a standalone ordinance governing bankruptcy, and initially excluded from its ambit 'financial service providers', which would generally include banks and non-banking financial companies. However, certain 'financial service providers' being non-banking financial companies and housing finance companies, which fulfil specified criteria, have now been brought under the purview of the IBC, with the RBI being empowered to have regulatory oversight over such insolvency proceedings. These rules, which have brought the said 'financial service providers' under the IBC framework, categorically reaffirm the position that assets being held in trust for the benefit of third parties will not be treated as assets of the debtor under winding-up.

As stated in Section III, any securitisation transaction may also be set aside pursuant to the provisions of law dealing with the suspect period, which is codified in Sections 328 and 329 of the Companies Act, 2013 and Sections 43 and 45 of the IBC.

These provisions set out the following two principles. First, if the winding-up of the originator commences (or is deemed to have commenced), within one year of the transaction being entered into, then the assignment of the assets may be challenged on the grounds of 'fraudulent preference' or 'preferential transaction'. However, in the event of such a challenge, it may have to be first established that the assignment was made in favour of a creditor (or a surety or a guarantor in respect of any of the liabilities of the company being wound up), and not made in favour of a bona fide transferee or for valuable consideration. Second, if the winding-up of the originator commences (or is deemed to have commenced), within one year of the transaction being entered into, then the assignment of the assets may be challenged on the grounds that the assignment is void. However, in the event of such a challenge, it has to be first established that the transfer was not made either in the ordinary course of business of the originator, or in good faith and for valuable consideration.

VI OUTLOOK

Given that the worst impact of the covid-19 pandemic is behind us, there has been increased activity in the financial sector and the increased focus of financial institutions to increase their retail exposure has only helped increase securitisation activity. We also think that given the growth in co-lending transactions under the co-lending guidelines by the RBI (which permits banks to acquire loans from non-banking financial companies without complying with minimum holding period requirements) will lessen the number of securitisation transactions where banks are the investors.

While the industry has been pushing the regulators to move towards achieving uniformity of stamp duty and registration laws governing securitisation, there are various hurdles in achieving it. If this were to be achieved, it would definitely be a shot in the arm for securitisation activity in India.

There has also been a clamour to rationalise the withholding tax applicable in relation to FPIs investing in PTCs and corporate bonds. If this were to happen, investments in PTCs would also become an attractive avenue for foreign investors.

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Endnotes

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Chapter 5

Japan

Kazunari Onishi and Hikaru Naganuma[1]

Summary

I OVERVIEW

i Recent trends of the Japanese securitisation market

After weathering the 2008 Lehman crisis and the Great East Japan Earthquake in 2011, the Japanese securitisation market saw a robust recovery. The outbreak of the covid-19 pandemic in 2020, however, disrupted the positive trend. The pandemic triggered a voluntary market lockdown in April 2020, with the declaration of a state of emergency that lasted until the end of May 2020. In 2021, the declaration of a state of emergency was issued three times during the period from January to September. The Japanese economy experienced severe damage as a result. As of August 2023, however, Japan has removed border restrictions and the Japanese economy is moving into the post-pandemic era where economic and social activity is normalising.

During the covid-19 pandemic, the Japanese securitisation market was not spared as many transactions were temporarily suspended in light of the socio-economic uncertainties. However, the market is now seeing a steady recovery as an increasing number of domestic and overseas investors with surplus funds seek investment opportunities. This investment demand has also propped up the price of real estate in Japan, particularly in urban areas.

According to a survey conducted by the Japan Securities Dealer Association and Japanese Bankers Association,[2] the outstanding balance of securitisation products as of March 2023 was approximately ¥26,450.2 billion, up 3.7 per cent from September 2022. Looking at the underlying assets, residential mortgage-backed securities (RMBS) accounted for 83.5 per cent (¥22,108.2 billion). Among the RMBS products, Japan Housing Finance Agency mortgage-backed securities accounted for 67.8 per cent (¥14,999 billion).

Focusing on securitisation of real estates, another survey conducted by the Ministry of Land, Infrastructure, Transport and Tourism (MLIT)[3] shows that the amount of acquisitions of securitised real estate (including acquisitions by J-REITs but excluding private funds) in fiscal year 2022 was approximately ¥2.0 trillion, which was a slight decrease from fiscal year 2021, in which the acquisition amount was ¥2.4 trillion.

ii Common structures for securitisation

In Japan, the most commonly used forms of securitisation are as follows:

- the GK-TK structure;
- the TMK structure; and
- the trust structure.

Each of the foregoing structures has been adopted by investors for the purposes of assuring bankruptcy remoteness and tax benefits.

The GK-TK structure has mainly been utilised for securitisation of real estate properties. Under the GK-TK structure, a ***godo kaisha*** (GK), which is one of the corporate forms available under the Companies Act of Japan, having similar features to a limited liability company, is selected as a special purpose vehicle (SPV) holding the target assets. The GK is financed by way of loans or ***tokumei kumiai*** (TK) investments under the Commercial Code of Japan, in an arrangement whereby TK investors form a silent partnership to conduct the GK's business. TK investors are entitled to tax benefits by deducting the amount of distributed profits from the GK's taxable income as expenses (see Section II.ii). The GK's assets, including trust beneficiary interests (TBIs) and account receivables, are provided as collateral in favour of lenders. The GK has the merit of being a flexible corporate structure with stability in bankruptcy as it is not subject to the Corporate Reorganisation Act of Japan, which may restrict security holders' rights in corporate rehabilitation proceedings. In a typical scenario, the assets are entrusted by an originator to a trustee and the GK acquires the TBIs because the GK has to obtain governmental approval for operating the business of real estate-specified joint enterprises under the Real Estate Specified Joint Enterprise Act of Japan (RESJEA) if it accepts TK investments and utilises such investments for the acquisition and (self-management) of real estate property. However, amendments to the RESJEA in 2013 and 2017 introduced certain exemptions that allow an SPV to engage in a real estate-specified joint enterprise by filing a notification with the MLIT, rather than obtaining governmental approval, subject to certain conditions being fulfilled. This exemption has been utilised recently, but the TBI structure is still prevalent because taxes are not imposed on the transfer of TBIs.

In a TMK structure, a *tokutei mokuteki kaisha* (TMK) is utilised as an asset-holding vehicle. A TMK is an SPV introduced by the Japanese Act on Asset Securitisation (the Securitisation Act) in 1998 to facilitate asset securitisation. Prior to the commencement of business, a TMK is required to file with the relevant local finance bureau a business commencement notification and an asset liquidation plan (ALP), which is the constitutional document of a TMK. A TMK is typically financed by specified bonds, loans or preferred shares. A TMK enjoys various tax benefits, including preferential rates of real estate acquisition tax and real estate registration tax, as well as the deduction of distributed profits from its taxable income, subject to the satisfaction of certain 'tax-conduit' requirements. For a TMK to meet the tax-conduit requirements, 75 per cent of its asset portfolio must consist of real estate-related properties. In this context, the TMK structure is mainly utilised for securitisation of real estate properties. A TMK is subject to supervision by the Financial Services Agency of Japan (FSA) and the scope of its business is restricted to that set out in the ALP.

In a typical trust structure, an originator entrusts its assets with a trustee and includes TBIs in the entrusted assets. TBIs are divided into the senior portion that is sold to investors, and the subordinated portion that is retained by the originator as initial trustor. Trusts can be formed flexibly under the Trust Act of Japan pursuant to the terms and conditions of trust agreements. In some cases, investors make an investment by way of loans to the trustee, in which case, the trustee will redeem the senior portion of the TBIs to repay loans with cash inflow from the entrusted assets. The trust structure is adopted for securitisation of both real estate properties and receivables. As a general rule for corporate income taxation, a trust itself is not subject to taxation. The concept of 'self-trust' was introduced in 2006 with the amendment to the Trust Act, and subsequently gained popularity as a means for originators to securitise their assets by way of self-declaration of trust, particularly for securitisation of receivables with no-assignment clauses.

The real estate investment trust (REIT) is another type of securitisation vehicle. The J-REIT, introduced with the amendment to the Act on Investment Trusts and Investment Corporations in Japan in 2000, is a legal entity used mainly for holding real estate properties and for financing by way of loans and issuance of investment units. There are two types of REIT in Japan: public REITs, which are listed on the stock exchange, and private REITs. In general, the term 'J-REIT' typically refers to those listed on the stock exchange. In contrast to the GK-TK and TMK structures, which can be adopted for developing new real estate properties, the J-REIT is mainly utilised for the securitisation of existing real estate properties that generate a cash flow from leases.

II REGULATION

i Regulatory regime

GK-TK structure

Financial Instruments and Exchange Act

The Financial Instruments and Exchange Act of Japan (FIEA) contains the main securities regulatory framework in Japan. In 2007, the FIEA was amended to broaden the definitions of securities and financial instrument business, as a result of which securitisation became subject to stricter regulations.

Under the FIEA, TBIs and TK investments are deemed regulated securities (Type II securities), and licensing is required to engage in solicitation, purchase, sale and brokering of regulated securities. Accordingly, a GK has to retain an operator registered to conduct Type II finance instruments business to solicit TK investors to provide TK investments. In addition, a GK's business of investment in TBIs with the funds obtained through TK investments requires registration as an investment management business operator under the FIEA. Certain exemptions, however, are available for GKs to avoid these registration requirements. One exemption is the 'Article 63 business exemption', which requires a GK simply to file a notification with the relevant local finance bureau if its TK investors consist of the following:

- at least one qualified institutional investor (QII); and
- 49 or fewer non-QIIs who satisfy certain requirements (including legal entities registered as business operators under the FIEA, listed companies, joint-stock corporations under the Companies Act of Japan with stated capital exceeding ¥50 million, foreign companies and certain high-net-worth individuals). Under other exemptions, the GK will not be required to register as an investment management business operator if it delegates its entire investment authority to a registered investment manager under a discretionary investment management contract.

RESJEA

A business operator who holds real properties and accepts investments through certain legal arrangements (including through a TK) is required to obtain governmental approval under the RESJEA. However, because it is impractical for an SPV to obtain such approval, GKs typically hold the property in the form of a TBI.

Certain exemptions to the licensing requirements were introduced by the amendments to the RESJEA in 2013 and 2017, subject to fulfilment of certain conditions, including:

- delegation of all asset management activities to a licensed asset manager; and
- all investors involved being qualified special investors.

TMK structure

Securitisation Act and supervision by the FSA

As briefly explained in Section I, a TMK is regulated under the Securitisation Act. Under the Securitisation Act, a TMK is required to file a business commencement notice and an ALP setting out an overview of the TMK's business, including its securitised assets and the terms and conditions of the asset-backed securities or asset-backed loans to be issued or borrowed by the TMK. There are certain restrictions on amendments to an ALP and, in most cases, material changes to an ALP will require the unanimous consent of the interested parties. A TMK's business is restricted to the scope set out in an ALP. In particular, securitised assets are required be specified from the outset in an ALP and there is some restriction on the TMK obtaining additional assets, especially real estate properties.

A TMK is not subject to the RESJEA. However, if the securitised assets are acquired and held in the form of fee simple properties, the asset manager must meet certain financial and organisational requirements, including the requirement to obtain governmental approval under the RESJEA.

Furthermore, a TMK is subject to supervision by the FSA. The FSA's authority extends to site investigations and various administrative orders. In addition, a TMK is required to file certain periodical reports with the relevant local finance bureau in respect of its business.

FIEA

Under the FIEA, specified bonds and preferred shares issued by a TMK are deemed regulated securities (Type I securities) and a certain licence is required for handling solicitation, purchase, sale and brokering of regulated securities. Accordingly, a TMK has to retain an operator registered to conduct Type I finance instruments business to solicit both subscribers for specified bonds and investors for TK investments. In addition, if a TMK delegates its TBI asset management, the asset manager must be qualified as a registered investment manager or registered investment adviser.

Trust structure

Trust Act

In principle, TBIs are created pursuant to a trust agreement between trustors and a trustee under the Trust Act of Japan. Trustees engaged in the trust's business will be subject to various regulations, including licensing requirements and fiduciary requirements under the Trust Act of Japan.

FIEA

As noted above, TBIs are regarded as regulated securities (namely Type II securities) and licensing is required for handling solicitation, purchase, sale and brokering of regulated securities.

ii Tax issues

Stamp tax

Stamp tax is levied by the national government on certain documents, including various contracts. For instance, a contract for the sale and purchase of real estate properties will be subject to a stamp tax of up to ¥480,000, depending on the purchase price. Moreover, a contract for assignment of TBIs and receivables will be subject to a stamp tax of ¥200.

Registration and licence tax

Registration and licence tax is levied on registrations of transfers or creation of mortgages over real estate properties, receivables or TBIs. The rate of the registration tax varies depending on the type of the transaction and the value of the relevant assets or secured claims. For instance, the tax rate for registration of transfer of a nonresidential building is 2 per cent of the property value, which will be reduced to 1.3 per cent if the transferee is a TMK. By contrast, creation of a trust on a non-residential building is subject to taxation of 0.4 per cent of the property value. The tax rate for registration of transfer of a TBI (change of trust beneficiary) is ¥1,000 for each trust property.

Real estate acquisition tax

A real estate acquisition tax is levied on the acquisition of land or buildings at the tax rate of 3 per cent (for land and residential buildings) or 4 per cent (for non-residential buildings) of the tax base of the subject property. A TMK is entitled to the benefit of a reduction in the tax base to 40 per cent of the subject property. However, acquisitions of TBIs and receivables are free from acquisition tax.

Corporate tax

If an SPV that is utilised for a securitisation transaction is treated as a taxable entity, it will recognise taxable income and will be subject to corporate income tax. This may cause double taxation, with income taxation on both the profits of the SPV and the profits distributed to investors, which would result in a decrease in investment returns. Investors can avoid such double taxation by adopting a tax-efficient structure.

Under a GK-TK structure, the taxable income of a GK will be subject to corporate tax. However, the profits distributed to TK investors are recorded as a deductible expense at the level of the GK, as an operator of the TK partnership, and investors can thus avoid double taxation.

Similarly, under the TMK structure, although a TMK is a taxable entity and subject to corporate tax, the profits distributed to preferred shareholders are recorded as a deductible expense at the level of the TMK if certain tax-conduit requirements under the Act on Special Measures Concerning Taxation are met. The tax-conduit requirements include:

- all specified bonds, specified loans and preferred shares are provided (or are expected to be subscribed for) by certain qualified institutional investors, among others;
- more than 50 per cent of the TMK's preferred shares (and certain common shares) are planned to be offered in Japan under the ALP;
- the TMK's accounting period does not exceed one year; and
- more than 90 per cent of the distributable amount is distributed as dividends.

Under the trust structure, the trust itself will not be regarded as a taxable entity. However, the beneficiaries owning the TBIs will be treated as possessing the trust properties for tax purposes.

III SECURITY AND GUARANTEES

i Security in loan transactions

For security transactions in which acquisition funds are raised by way of loans, the assets of SPVs are usually provided as collateral for securing the loan obligations of the SPVs. The form of security and method of perfection vary depending on the type of the subject assets.

Real estate

The most common form of security interest over real estates is the mortgage. A mortgage is perfected by registration in the relevant property registry.

Receivables

The principal forms of security interest over receivables (e.g., bank account receivables, trade receivables and loan receivables) are (1) pledges; and (2) collateral assignments. Both pledges over, or collateral assignments of, receivables are perfected against the debtor of the receivables by giving notice to, or obtaining consent from, the debtor. By using an instrument bearing a certified date of the notice or consent, the security interests will be perfected against third parties other than the relevant debtor. In addition, the creation of pledge and collateral assignments can also be perfected against third parties other than the relevant debtors by registration at the loan assignment registry if the assignor of the claims is a corporation.

TBIs

The most common form of security interests over TBIs is the pledge. A pledge over TBIs is perfected against the relevant trustee by giving notice to, or obtaining the consent from, the relevant trustee. As is the case with a pledge for receivables, perfection against third parties other than the trustee can be achieved by using an instrument bearing a certified date of the notice or consent.

Equity interest in SPVs

Equity interests in an SPV (e.g., membership interests in a GK or specified shares in a TMK) will be subject to security interests in the form of a pledge. The methods for perfection of a pledge over equity interests depend on the type of membership interest involved (namely procurement of consent from the SPV and other members, registration in the shareholders' register or delivery of share certificates).

ii Security in bond transactions

In respect of security transactions in which the acquisition funds are raised by way of bonds without any loan element, under the Secured Bond Trust Act of Japan, certain cumbersome restrictions (including the retention of a security trustee) will apply in the creation of security interests over specific assets to secure the bond.

However, in a TMK structure where a TMK raises funds by issuing specified bonds, the specified bonds will be secured by a general lien under the Securitisation Act. A general lien is a kind of statutory lien granted over all the properties belonging to the TMK by virtue of law. A general lien is registrable in the corporate register of the TMK, but generally does not require performance of any perfection procedures for assertion of the general lien against third parties.

IV PRIORITY OF PAYMENTS AND WATERFALLS

i Cash management

One of the key aspects of securitisation transactions in Japan is the strict control over usage of an SPV's cash flow imposed by covenants in the relevant financing documents. Typically, all the cash belonging to the SPV will be managed in the bank account of the financing banks. In addition, the order of priority in a cash waterfall is predetermined to prevent the leakage of cash from the SPV. The typical order of priority in a cash waterfall is as follows:

- payment of costs required for the purpose of maintaining the transaction scheme (e.g., trust fees) and management of the SPV;
- establishment of scheduled cash reserves for the purpose of meeting future cash outlays (such as CAPEX);
- payments of the principal and interest amounts under debt obligations; and
- distribution of excess cash to equity investors as dividends.

ii Subordination

In Japanese securitisation transactions, equity investors' monetary claims against SPVs are subject to contractual subordination arrangements that typically involve:

- restriction of distribution of excess cash to equity investors upon the occurrence of certain trigger events, including non-satisfaction of certain criteria that measure the financial index of the SPV's cash flow and value of the securitised assets (which are curable upon discontinuation of the trigger event);
- suspension of all the monetary obligations of the SPVs to equity investors upon the commencement of any insolvency proceedings or default of senior debt obligations until all the senior claims have been fully repaid; and
- in the case of insolvency, characterising the monetary claims of equity investors against SPVs as consensually subordinated insolvency claims that are subordinate to other insolvency claims by virtue of insolvency law.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

i Bankruptcy remoteness

In Japan, the concept of bankruptcy remoteness is generally understood to mean that (1) securitised assets will not be affected by the originator's bankruptcy or insolvency proceedings; and (2) the SPV itself will not be subject to bankruptcy or insolvency proceedings.

ii Isolation of assets – true sale

To achieve the isolation of assets from bankruptcy proceedings in respect of the seller (that is, the originator), it is important to ensure that the asset transfer constitutes a true sale.

The concept of 'true sale' under Japanese law generally requires that (1) the transfer of assets by the originator is not regarded as provision of collateral; and thus (2) the transferred assets no longer belong to the originator's insolvency estate. No statutes clearly stipulate the explicit conditions under which a transfer of assets will be regarded as a true sale. Rather the existence (or otherwise) of true sale is generally understood to be determined by careful consideration of several elements, including:

- the intentions of the transferor and transferee;
- whether the asset transfer has been perfected;
- the reasonableness of the transfer price;
- whether the transferor has the right or obligation to repurchase the asset;
- whether the asset is recorded on the balance sheet of the transferor; and
- whether the rights of control remain with the transferor.

In respect of item (f) above, the following measures will typically be taken to isolate the SPV and the securitised asset from the right of control of the originator as transferor:

- causing the SPV's common shares to be held by another SPV that is independent from the originator. The independent SPV typically takes the form of a general incorporated association under the General Incorporated Association and General Foundation Law of Japan (or a Cayman charitable trust); and
- appointing independent directors (who are often public certified accountants or judicial scriveners) to the SPV and its common shareholders.

iii Minimising risk of an SPV's bankruptcy

The principal way of minimising the risk of an SPV's bankruptcy or insolvency is the imposition of contractual restrictions on the SPVs' capacity to engage in any activities related to the acquisition, management and disposition of the securitised assets. SPVs are also prohibited from amending their constitutional documents without the approval of the financing parties. In addition, the cash flow of SPVs is strictly controlled by an agreed cash waterfall (see Section IV.ii).

Moreover, the parties in contractual relationships with SPVs are also subject to certain contractual arrangements, such as limited recourse clauses (which obligate the parties to waive any of their monetary claims against the SPV that remain unpaid after the disposition of all the SPV's assets) and non-petition clauses (which prohibit the parties from making a petition for commencement of bankruptcy and insolvency proceedings against the SPV). It is uncertain whether Japanese courts will uphold the validity of non-petition clauses when a petition for insolvency proceedings is actually made in violation of such a clause.

It is also important to isolate the SPV from the originator's control by the measures set out in (a) and (b) in the final paragraph of Section V.ii to prevent any insolvency proceedings from being commenced by the SPV's directors at the originator's discretion.

VI OUTLOOK

The Amendments to the Civil Code of Japan came into force on 1 April 2020. The Amendments cover a broad range of items, including statutes of limitation, guaranties, contracts and assignments of claims. While many of the provisions were revised based on existing court precedents and other legal theories generally accepted in Japan, the Amendment also introduced some new rules. One of the features affecting securitisation transactions relates to assignments of non-assignable receivables, namely receivables that are contractually prohibited or restricted from assignment. Under the former legislation, assignment of such non-assignable receivables would have been deemed null and void. Self-trust was adopted as a securitisation scheme for the non-assignable clause on the basis that a self-trust by a creditor of receivables does not constitute an assignment because the receivables are not transferred to parties other than the creditor. By contrast, under the amended Civil Code, an assignment of non-assignable receivables is deemed valid in principle. The new regime under the amended Civil Code provides more options for the securitisation of non-assignable receivables. However, an assignment of non-receivables can still be deemed a breach of contractual restrictions, which can result in the cancellation of the contracts underlying the receivables.

As with the global economy, Japan has come out of the shadow of covid-19 and the Japanese securitisation market is showing robust growth and signs of expansion.

In terms of real estate, Japan had seen increasing demand for inbound investments into accommodation facilities (especially in the Greater Tokyo Area). In addition, there are continuing demands for logistics properties driven by the growth in e-commerce services. Healthcare facilities are also anticipated to expand in light of the demographic trends in Japan. In addition, data centre facilities are attracting more attention from both investors and debt finance providers.

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Endnotes

1 Kazunari Onishi and Hikaru Naganuma are partners at Anderson Mōri & Tomotsune.
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Chapter 6

Luxembourg

Frank Mausen, Paul Péporté, Jean Schaffner, Alexis Poisson and Zofia White[1]

Summary

I OVERVIEW

On 22 March 2004, the Luxembourg Act of 22 March 2004 on Securitisation (the Securitisation Act) came into force, providing the general framework for securitisation transactions. Ever since, the Grand Duchy of Luxembourg has been a major market participant and a significant European hub for securitisation transactions, mainly because of its flexible and innovative legal and regulatory framework and favourable tax regime. According to the European Central Bank's statistics, approximately 28 per cent of the European securitisation transactions are performed via Luxembourg (as of 31 December 2022). On 9 February 2022, the Luxembourg parliament adopted Law No. 7825 (the Law) amending, among others, the Securitisation Act. It had been long awaited by market participants and was prepared to take account of the requirements of a changing market, to implement the EU Securitisation Regulation[2] and to provide for even more flexibility to structure and collateralise securitisation transactions, among others.[3]

The number of active Luxembourg securitisation undertakings has been constantly growing since the entry into force of the Securitisation Act, with approximately 1,450 active securitisation undertakings as at January 2023, which between them have more than 6,000 compartments and represent more than €395 billion[4] in total assets under management.

Pursuant to the Securitisation Act, a securitisation undertaking may be set up either as a securitisation company[5] or as a securitisation fund that has no legal personality, consists of a co-ownership of assets and is represented by a management company.

The private limited liability company is the most commonly used form of securitisation undertakings. We estimate that less than 100 active securitisation funds exist at the time of writing.

Only securitisation undertakings issuing financial instruments to the public on a continuous basis are subject to the supervision of the Luxembourg financial regulatory authority (CSSF). At the time of writing, only 28 securitisation undertakings were regulated. Both regulated and unregulated securitisation undertakings benefit from the provisions of the Securitisation Act.

Deliberately broad in its scope of application, the Securitisation Act defines securitisation as the transaction whereby a securitisation undertaking acquires or assumes, directly or through another undertaking, risks relating to claims, other assets or obligations assumed by third parties or inherent in all or part of the activities of third parties, and issues financial instruments or enters into any type of loan agreements, whose value or yield depends on those risks.[6] Compared with other jurisdictions or legislation at an EU level, the definition of securitisation is less restrictive in Luxembourg. The EU Securitisation Regulation, for instance, only applies to securitisation transactions in which a credit risk associated with an exposure or a pool of exposures is tranched.

The EU Securitisation Regulation was developed in the aftermath of the subprime crisis, as part of the package of regulatory reforms for securitisation under the EU capital markets union action plan, to foster investor protection in the European Union. It entered into force on 17 January 2018 and has applied in general since 1 January 2019 (subject to certain grandfathering provisions). It lays down a general framework for securitisation and creates a specific framework for simple, transparent and standardised (STS) securitisation. Furthermore, the EU Securitisation Regulation provides for the following:

- risk retention obligations for the sponsor, originator or original lender;
- disclosure requirements to the investors and the competent authority regarding the underlying assets; and investor-specific due diligence regimes and suitability tests.

At the time of writing, only 46 issuances by a Luxembourg securitisation undertaking qualifying as STS securitisation are registered.

The asset classes that are securitised in the Luxembourg securitisation market are mainly auto and mortgage loans, debt securities, equity (including fund units) and trade receivables. The acquisition of the underlying assets is typically financed via the issuance of debt securities. Most of the securities issued by regulated securitisation undertakings consist of structured products, the performance of which is linked to indices or swaps.

On 21 December 2018, the law implementing the Anti-Tax Avoidance Directive 1 (the ATAD 1 Law)[7] was published. The ATAD 1 Law applies for fiscal years starting on or after 1 January 2019 and has introduced interest deduction limitation rules (IDLRs) into the Luxembourg tax framework, which may limit the deductibility of exceeding borrowing costs (see Section II.vii) at the level of a securitisation company.[8]

II REGULATION

i Luxembourg securitisation regime

For the Securitisation Act to apply, the securitisation undertaking must, in respect of each compartment under which it carries out a securitisation transaction, acquire or assume risks relating to claims, other assets or obligations assumed by third parties or inherent in all or part of the activities of third parties and must issue financial instruments or enter into any type of loan agreement, for all or part of it,[9] whose value or yield depends on those risks. Consequently, on the liability side, it will issue equity or debt securities or borrow funds, and on the asset side, it will acquire or assume risks.

The regime of the Securitisation Act covers all types of assets. It is important, however, to ensure that the securitisation undertaking does not, in principle, generate its own risk and act as entrepreneur, but instead acquires or assumes risks generated by third parties or relating to assets of third parties. Generating and securitising own risks could be considered a transaction that is not a securitisation in the sense of the Securitisation Act.

ii Regulated securitisation undertakings

A securitisation undertaking that is subject to the Securitisation Act must be authorised by the CSSF and obtain a licence if it issues, financial instruments to the public on a continuous basis (these two criteria apply cumulatively). An issue of financial instruments is not deemed to be made to the public if the denomination is at least €100,000 or if it is offered to professional clients only.[10] A securitisation undertaking is deemed to issue financial instruments on a continuous basis if issuing more than three times per year. The question of whether a vehicle issues financial instruments to the public on a continuous basis would have to be assessed at the level of the vehicle with all compartments combined.

The status of a regulated securitisation undertaking implies prudential supervision by the CSSF and the requirement to keep its liquid assets in custody with a Luxembourg credit institution.

iii Securitising loans

A Luxembourg securitisation undertaking can carry out the securitisation of existing loans with a fixed interest rate and fixed repayment date or with a floating or variable interest rate (known as profit participation) under the Securitisation Act provided that the investor in the instrument issued by the securitisation undertaking to finance the acquisition of the loans is not linked to the borrowers under those loans (in accordance with the prohibition against intra-group securitisation transactions). As explained in Section II.v, Luxembourg securitisation undertakings benefit from a carve-out from the Luxembourg Act of 5 April 1993 on the Financial Sector, as amended (the Banking Act), and therefore do not require a licence to carry out securitisation activity under Luxembourg law. If securitising loans, however, it should be clarified whether there are any licensing requirements in the jurisdictions where the borrowers are located or under the governing laws of the loans to be securitised.

iv Financial statements and auditing

A securitisation undertaking subject to the Securitisation Act must always appoint a statutory auditor chartered in Luxembourg who is in charge of auditing the securitisation undertaking's annual financial statements.

Annual financial statements are established at the end of the securitisation undertaking's financial year. Those financial statements will provide for information on the assets of each of the securitisation undertaking's compartments, as well as consolidated accounts of the securitisation undertaking and will be made available to investors.[11]

v Banking Act

The Banking Act, which regulates credit institutions and other professionals in the financial sector, contains a specific carve-out for securitisation undertakings.

vi Alternative Investment Fund Managers Directive

Directive 2011/61/EU on alternative investment fund managers (AIFMD), which was designed to regulate all entities that manage arrangements or entities covered by the term 'alternative investment fund' (AIF), has been implemented in Luxembourg pursuant to the Luxembourg Act of 12 July 2013 on Alternative Investment Fund Managers (the AIFM Act). There are a number of arguments to the effect that a securitisation undertaking would not be caught by the AIFMD (although the analysis would have to be effected in respect of each compartment of the securitisation undertaking, and a transaction carried out under one compartment may have an impact on the overall status of the securitisation undertaking).

In line with the AIFMD, the AIFM Act contains an exemption for securitisation special purpose entities (SSPE), which are defined in the AIFM Act as entities that have the sole purpose of carrying out securitisations within the meaning of Article 1(2) of the European Central Bank's Regulation (EC) No. 24/2009, provided, however, that:

- first lenders (i.e., lenders securitising loans that they themselves have granted and that issue notes to finance their securitisation activities) are not considered ad hoc securitisation vehicles, as no asset (and hence no credit risk) is transferred to or purchased by that entity; and
- securitisation vehicles issuing structured products that primarily offer a synthetic exposure to assets other than loans (non-credit-related assets) do not benefit from the foregoing exclusion.

Regardless of whether or not the vehicle qualifies as an SSPE, the CSSF has, in its revised set of frequently asked questions on securitisation, specified that securitisation undertakings issuing only debt instruments shall not be considered AIFs and thus shall fall outside the scope of the AIFM Act.

In the event that a securitisation undertaking cannot rely on any of the above-mentioned exclusions, it could potentially be considered an AIF. If a Luxembourg securitisation undertaking is subject to the provisions of the AIFM Act, one consequence is the requirement to designate an AIF manager for the purpose of managing the securitised assets. Depending on the type and amount of assets under management, the board of directors of the securitisation vehicle may itself act as internal AIF manager, or the securitisation vehicle has to appoint a fully licensed external AIF manager. A fully licensed AIF manager is required to appoint a depositary in relation to securitised assets. This will inevitably result in an increase in the fees, costs and expenses of a Luxembourg securitisation undertaking, payable to various parties.

vii Tax aspects

Tax aspects applicable to a securitisation company

Corporation tax

A securitisation company is a fully taxable Luxembourg company.[12] As such, it is subject to corporate income tax at a rate of 17 per cent, municipal business tax at a rate of 6.75 per cent (in Luxembourg City (the rate varies from one municipality to another)) and a contribution to the unemployment fund of 7 per cent. The overall combined corporation tax burden thus currently stands at 24.94 per cent (in Luxembourg City).

The securitisation company is assessed based on its global profits, after deduction of allowable expenses and charges, determined in accordance with Luxembourg general accounting standards (subject to certain fiscal adjustments) and subject to the provisions of applicable tax treaties. Expenses that relate to an item of income that is not taxable in Luxembourg are not deductible for tax purposes.

However, the Securitisation Act provides for specific rules applying to a securitisation company in relation to tax deductibility. The Securitisation Act states that the obligations assumed by a securitisation company towards the investors (including shareholders) and any other creditors are to be considered tax deductible expenses. In other words, a securitisation company should be able to deduct any payments due or made to any investors, or to any other creditors, from its taxable profits, subject to the IDLRs, which have recently been introduced into Luxembourg tax law under the ATAD 1 Law (see 'IDLRs' below).

Investors may generally hold either equity or debt securities issued by a securitisation company. Therefore, any payments to the investors (whether they hold shares or notes issued by a securitisation company), whether in the form of dividends or interest, as well as any commitments to the investors, whether in the form of due and unpaid dividends or accrued and unpaid interest (regardless of the actual date of payment), will be deductible for tax purposes, subject to the IDLRs.

To the extent the IDLRs do not negatively impact the securitisation company, a securitisation transaction entered into by a securitisation company should not give rise to any corporation tax burden in Luxembourg, if properly structured (i.e., if it is ensured that, during each financial year, any income realised by a securitisation company may be offset by corresponding deductible expenses, including interest paid or accrued to the investors under the debt securities it has issued). The Luxembourg tax authorities do not require a securitisation company to realise any minimum profit margin that would be subject to tax.

IDLRs

The IDLRs have been introduced into Luxembourg tax law pursuant to the requirements under the ATAD 1 Law, which themselves are largely based on the work realised by the Organisation for Economic Co-operation and Development and the G20 in the context of the base erosion and profit shifting project, specifically on the 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update'.

The IDLRs have been applicable since 1 January 2019 with respect to accounting years starting on or after 1 January 2019 (subject to the grandfathering clause).[13] The IDLRs provide that taxpayers are only able to deduct 'exceeding borrowing costs'[14] up to the higher of €3 million and 30 per cent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).

For the purposes of the IDLRs, EBITDA is adjusted according to tax criteria and thus corresponds to net income, as increased by the adjusted amounts for exceeding borrowing costs, depreciation and amortisation. Tax-exempt revenues, as well as expenses related to such revenues, are excluded from EBITDA.

The ATAD 1 Law also contains a carve-out for loans used to fund long-term infrastructure projects as well as a carve-out for financial undertakings. Financial undertakings are defined broadly, in particular to (currently still) include SSPEs as defined under Regulation (EU) 2017/2402. Following scrutiny from the EU Commission, the carve-out for SSPEs is expected to be abolished with effect as of 1 January 2024. Luxembourg has also provided the option (at request) to deduct the entire amount of a taxpayer's exceeding borrowing costs if the taxpayer is a member of a consolidated group for accounting purposes and, among other conditions, it can demonstrate that the ratio of its equity over total assets (with a tolerance of 2 per cent) is equal to or higher than the equivalent ratio of the group based on the consolidated financial statements.

Finally, Luxembourg has opted for the full deductibility of borrowing costs for standalone entities, as defined in the ATAD 1 Law.

Net wealth tax

The Securitisation Act fully exempts securitisation companies from net wealth tax.[15]

Withholding tax

There is no withholding tax on interest payments or on dividends paid by a securitisation company.

Tax aspects applicable to a securitisation fund

Corporation taxes, withholding tax and net wealth tax

The Securitisation Act provides that a securitisation fund is subject to the same tax regime as a collective investment fund in the form of a mutual fund, save for the subscription tax. Therefore, it should generally be treated as transparent for Luxembourg tax purposes. Consequently, it should not be subject to Luxembourg corporation taxes, withholding tax or net wealth tax.

IDLRs

The IDLRs should not adversely impact the securitisation fund itself, given its tax transparent status under Luxembourg tax law. Indeed, a securitisation fund is not itself subject to Luxembourg corporation taxes, and therefore does not rely on deductibility, for tax purposes, of interest paid under the debt securities it issues to reduce its tax base in Luxembourg.

III SECURITY AND GUARANTEES

Pursuant to the Securitisation Act, a securitisation undertaking can only create security interest over its assets or transfer its assets for guarantee purposes to secure the obligations relating to the securitisation transaction.[16]

Owing to the segregation and limited recourse features and the bankruptcy remoteness of a securitisation undertaking, securitisation transactions in the Luxembourg market are often unsecured. For secured transactions, the most common Luxembourg law governed security package consists of a pledge over the cash or securities (or both) in a bank account of a Luxembourg based bank or a pledge over receivables being subject to the securitisation. All other types of security interest may be granted under foreign law.

There are rights of preference (e.g., tax payments, social security charges and wages) existing by operation of law and ranking prior to the ranking of security rights.

The Luxembourg Act of 5 August 2005 on Financial Collateral Arrangements, as amended (the Collateral Act) provides an attractive legal framework for security interests, liberalised rules for creating and enforcing financial collateral arrangements and protection from insolvency rules. It applies to any financial collateral arrangements and covers financial instruments in the widest sense, as well as cash claims and receivables.

The Collateral Act also provides for transfers of title by way of security and recognises the right of the pledgee to rehypothecate pledged assets. It enables the pledgee to use and dispose of the pledged collateral. Contractual arrangements allowing for substitution and margin calls are expressly recognised by the Collateral Act and are protected in insolvency proceedings in which security interests granted during the pre-bankruptcy suspect period can be challenged. Furthermore, under the Collateral Act, financial collateral arrangements are valid and enforceable even if entered into during the pre-bankruptcy suspect period.

Under Luxembourg law, collateral can be provided directly to the investors or to a security agent or security trustee acting for the benefit of the investors.

IV PRIORITY OF PAYMENTS AND WATERFALLS

Pursuant to the Securitisation Act,16 the articles of incorporation or management regulations of a securitisation undertaking and any agreement entered into by a securitisation undertaking may contain provisions by which investors and creditors accept the subordination of the maturity or the enforcement of their rights of payment to that of other investors or creditors. Therefore, it is generally recommended to insert in the articles of incorporation or the management regulations of a securitisation undertaking, as well as in any relevant agreement to which the securitisation undertaking is a party, a statement to the effect that by subscribing to the financial instruments to be issued by the securitisation undertaking, or by entering into an agreement with the securitisation undertaking, both the investors and the creditors expressly acknowledge and accept that the securitisation undertaking is subject to the Securitisation Act and that provision has been made for subordination and payment waterfalls.

In addition, the Law now also provides a complete set of rules for subordination that apply among various types of financial instruments issued by securitisation undertakings. According to the Securitisation Act:

- units of a securitisation fund are subordinated to other financial instruments issued by the securitisation fund and loans contracted by it;
- shares, corporate units or partnership interests in a securitisation company are subordinated to other financial instruments issued by such securitisation company and loans contracted by it;
- shares, corporate units or partnership interests in a securitisation company are subordinated to beneficiary shares issued by it;
- beneficiary shares issued by a securitisation company are subordinated to debt instruments issued and borrowings contracted by it; and
- non-fixed income debt financial instruments issued by a securitisation undertaking shall be subordinated to fixed income debt financial instruments issued by this securitisation undertaking.[17]

These are helpful clarifications, in that, for instance, prior to the new law, there were no legal provisions allowing to conclude that the units issued by securitisation funds were de facto subordinated, junior to a debt instrument issued by a securitisation fund.

Care should also be taken with the fact that, under the Securitisation Act, it is not possible to simply use the proceeds resulting from the issue of financial instruments to make a deposit in a bank (as there would not be securitisation in the sense of an assumption of a risk). However, if, for example, the sale proceeds of loans were deposited for a limited period in a bank account pending their application, on the next payment date in accordance with the waterfall provisions to redeem securities, this would, in our view, not give rise to concern under the Securitisation Act. Similarly, the securitisation undertaking could operate a cash reserve ledger or, instead of making a deposit of cash with a bank, buy 'risk-free' assets and enter into a synthetic transaction with a counterparty to give investors exposure to an index (the risk-free assets serving as collateral in that instance).

According to the Securitisation Act, a securitisation undertaking must be financed by the issue of financial instruments or by any type of loans whose value or yield depends on the risks assumed by the securitisation undertaking. Under the previous regime, Luxembourg authorities held that a securitisation undertaking could only be financed by way of loans if this financing remained ancillary. The Law now enables Luxembourg securitisation undertakings to be financed exclusively by way of loans. By doing so, it also allows Luxembourg securitisation undertakings to carry out any type of securitisation that falls within the scope of the EU Securitisation Regulation.

A Luxembourg securitisation undertaking cannot in principle actively manage the assets it has securitised. The management of the underlying portfolio of financial assets should not be such as to fall within the scope of the regulations on the functioning and management of undertakings for collective investment in securities and AIFs. The management of the securitised risks should be limited to the financial flows linked to the securitisation transaction, and a prudent and responsible person's approach should be adopted. The management of the underlying assets may not create an additional risk, which would be in addition to the inherent risks of the underlying assets being securitised. However, the Law now caters for the possibility of active management of collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs), which are placed in a private placement. The new Article 61-1 of the Securitisation Act provides that a securitisation undertaking may securitise a pool of risks consisting of debt securities, financial debt instruments or receivables, which is actively managed by the securitisation undertaking itself or by a third party, only if the financial instruments that are issued to finance the acquisition of the pool of risks are not publicly offered. The above applies irrespective of whether the management of the portfolio has been delegated to a third party or is carried out by the securitisation undertaking itself.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

i Forms of risk transfer

The transfer of the risk of the assets or rights to be securitised to the Luxembourg securitisation undertaking can be achieved either through a true sale or a synthetic transaction. In a true-sale securitisation transaction, the securitisation undertaking acquires legal and beneficial ownership of the underlying assets. In a synthetic securitisation transaction, the securitisation undertaking does not acquire legal and beneficial ownership of the underlying assets but assumes the risk related to the assets using derivative instruments (e.g., credit derivatives or swaps). In this context, the Securitisation Act exempts such securitisation transactions from the application of the Luxembourg laws governing the insurance sector.[18]

The Securitisation Act provides for the possibility to structure a securitisation with an issue vehicle (providing for the financing via the issuance of financial instruments to investors or the borrowing of any type of loans) and an acquisition vehicle (acquiring the assets to be securitised). In a double layer structure, the issue vehicle pays for the performance of the underlying assets held by the acquisition vehicle by means of back-to-back financing. This is mainly being used to create an investment mix at the level of the acquisition vehicle (the issue vehicle being invested in different acquisition vehicle compartments containing different asset types, for example) or to issue *shariah*-compliant financial instruments.

ii Compartments

The Securitisation Act allows the management of a securitisation undertaking to set up separate ring-fenced compartments. Each compartment forms an independent, separate and distinct part of the securitisation undertaking's estate and is segregated from all other compartments of the securitisation undertaking. Investors, irrespective of whether they hold equity or debt, will only have recourse to the assets encompassed by the compartment to which the securities they hold are allocated. They have no recourse against other compartments. In the relationship between the investors, each compartment is treated as a separate entity (unless otherwise provided for in the relevant issue documentation).

The compartment structure is one of the most attractive features of the Securitisation Act, as it allows the use of the same issuance vehicle for numerous transactions without investors running the risk of being materially adversely affected by other transactions carried out by the securitisation undertaking. This feature allows securitisation transactions to be structured in a very cost-efficient way without burdensome administrative hurdles. There is no risk-spreading requirement for the compartments. It is, hence, possible to isolate each asset of a securitisation undertaking in a separate compartment.

Furthermore, compartments are ring fenced during their lifetime, but also in the case of liquidation. Each compartment may be liquidated separately without entailing the liquidation of other compartments or the entire securitisation undertaking.

Finally, a compartment has no legal personality and therefore no agreement may be signed by it, nor can any action be brought against it, in isolation.

iii Bankruptcy remoteness and limited recourse

A securitisation company is structured as an insolvency-remote (but not insolvency-proof) vehicle. The ring-fencing of compartment assets, priority of payments, limited recourse, non-seizure of assets and non-petition for bankruptcy are protected not only by contractual arrangements but are also expressly recognised by the Securitisation Act. Legal proceedings initiated against a securitisation undertaking in breach of these provisions should therefore, in principle, be declared inadmissible by a Luxembourg court.

A securitisation undertaking will aim to contract with all parties in respect of a compartment on the basis that they accept the applicable priority of payments and limited recourse provisions, and that they will not be allowed to make an application for the commencement of the winding-up, liquidation or bankruptcy against that securitisation undertaking. A creditor who has not accepted these provisions may potentially initiate insolvency proceedings against a securitisation company, but its recourse should, in principle, be limited to the general estate of the securitisation company or, if its rights relate to a particular compartment, the assets allocated to that compartment only. If the assets are insufficient to discharge all liabilities relating to a compartment, claims of creditors for any shortfall will be extinguished and they may not take any further action to recover the shortfall. The failure of a securitisation company to make a payment because of insufficient assets in a compartment will not usually trigger an event of default under the terms and conditions of the securities issued by the company.

The bankruptcy remoteness of a securitisation company is strengthened if the securitisation structure is orphaned (i.e., the securitisation undertaking's shares or units are held by a trust or a foundation (typically a Dutch *stichting*)). Such a setup minimises the risk that the securitisation undertaking could be affected by the financial situation of its holding company or be otherwise subject to share or unit holders' decisions that could have a negative impact on the interests of investors.

VI OUTLOOK

The recent amendments to the Securitisation Act are considered by market players as a means to further strengthen and revamp the use of Luxembourg securitisation vehicles as a key tool to structure cross-border securitisations. It will be interesting to see to what extent structures such as CLOs will be channelled through Luxembourg securitisation vehicles in the future, as this is now expressly allowed.

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Endnotes

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

3 The authors refer to the amendments to the Securitisation Act implemented by the Law, where relevant, in the footnotes of this chapter.

4 This figure only takes into account the publicly available statistics of the European Central Bank based on the reporting of financial vehicle corporations; the reporting threshold being €70 million.

5 The following corporate forms are available following the entry into force of the Law: public limited liability company, partnership limited by shares, private limited liability company, cooperative society organised as a public limited liability company, partnership, limited partnership, special limited partnership and simplified joint stock company.

6 Article 1 of the Securitisation Act.

7 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.

8 Luxembourg implemented the Anti-Tax Avoidance Directive 2 (Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries) law of 20 December 2019. This law extends the existing anti-hybrid rules introduced by the ATAD 1 Law to cover hybrid mismatches that involve non-EU countries and certain additional hybrid mismatches. In a nutshell, hybrid mismatches are arrangements that exploit the differences in the tax treatment of a financial instrument or of an entity in two or more jurisdictions to achieve a double non-taxation (i.e., a double deduction or a deduction without inclusion). The anti-hybrid rules may, under certain circumstances, result in a disallowance of the deductibility of expenses at the level of a securitisation company or cause a tax transparent securitisation undertaking to become subject to Luxembourg corporate income tax. Furthermore, a law of 10 February 2021 has, effective as of 1 March 2021, introduced rules pursuant to which the deductibility of interest payments made to corporations established in jurisdictions that are considered as 'non-cooperative' by the European Union may be denied if certain conditions are met. Under normal circumstances, however, most securitisation undertakings should not be affected by any of these rules. A detailed analysis of these rules is therefore outside the scope of this chapter.

9 The Law has replaced the term 'securities' with the term 'financial instruments', which has a wider meaning than 'securities', encompassing also German *Schuldscheine*, for instance. In addition, the Law provides that a securitisation undertaking may enter into any form of borrowing, on an exclusive basis or in addition to the issuing of the financial instruments, which allows for securitised assets to be financed exclusively by a loan.

10 The Law has codified the existing guidance of the CSSF regarding the definitions of the terms 'offer to the public' and 'on a continuous basis'. Article 16 of the Securitisation Act now provides that a securitisation undertaking will fall under the supervision of the CSSF if it issues financial instruments more than three times per financial year: (1) to non-professional clients (within the meaning of the Luxembourg Banking Act 1993); (2) the denomination of which is less than €100,000; and (3) that are not distributed by way of a private placement.

11 The Law provides for a possibility to opt for certain operation rules for securitisation structures with equity financed compartments. For instance, it is possible to include in the constitutive document of a securitisation undertaking that specific financial statements are to be approved, or that profit distributions may be decided, at a compartment level.

12 A securitisation company set up as a partnership, limited partnership or special limited partnership is transparent for Luxembourg tax purposes. Accordingly, it is generally not subject to Luxembourg corporation taxes. It may become subject to municipal business tax if it carries out, or is deemed to carry out, a commercial activity, which should in principle be rare or avoidable. The tax implications for tax transparent securitisation companies are not further explored in this chapter.

13 ATAD 1 Law has introduced a grandfathering rule for loans granted before 17 June 2016.

14 Under the ATAD 1 Law, exceeding borrowing costs are defined as 'the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives'. Borrowing costs mean 'interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance, including, without being limited to: payments under profit participating loans; imputed interest on instruments such as convertible bonds and zero coupon bonds; amounts under alternative financing arrangements, such as Islamic finance; the finance cost element of finance lease payments; capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest; amounts measured by reference to a funding return under transfer pricing rules where applicable; notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings; certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds'.

15 Except for the minimum net wealth tax of €4,815 where the securitisation company's financial assets, intra-group receivables, bank deposits and cash in the bank exceed 90 per cent of its total balance sheet (which is generally the case) and €350,000. In all other cases, the securitisation company would be subject to a minimum wealth tax ranging between €535 and €32,100, depending on its balance sheet total.

16 Article 61(3) of the Securitisation Act. The Law has amended such article to allow for more flexibility in structuring a security package by enabling a securitisation undertaking to grant security interests over the securitised assets to parties that are involved in a securitisation transaction but are not direct creditors of the securitisation undertaking.

17 Article 64(1) of the Securitisation Act.

18 Article 64(1) of the Securitisation Act

Chapter 7

Norway

Markus Nilssen and Vanessa Kalvenes[1]

Summary

I OVERVIEW

The Norwegian securitisation market has historically not been substantial compared with the market in other jurisdictions in Europe. In 2004, the now-repealed Norwegian Financial Institutions Act (the FIA Act)[2] was amended to enable financial institutions to securitise their loan portfolios by way of a 'true sale' to securitisation special purpose entities (SSPE). The amendment to the FIA Act addressed traditional, 'true sale' securitisation, rather than synthetic securitisation where there is no sale of assets from the financial institution to the SSPE.

Owing to the complexity of the rules and the lack of beneficial treatment of securitisations under the Norwegian capital adequacy regime, Norway never developed a substantial securitisation market and the already minuscule market for securitisation dropped to zero when the FIA Act was replaced by the Norwegian Act on Financial Undertakings and Financial Groups (the FUA Act)[3] from 1 January 2016, as the new act did not provide for securitisation, thus making securitisation practically impossible for financial institutions in Norway.

Ordinary corporates and other non-financial institutions may securitise their loan portfolios or similar assets without regard to some of the restrictions that currently apply to financial institutions.

Following the implementation of a new framework for securitisation in the EU – consisting of the EU Securitisation Regulation,[4] the EU Securitisation Prudential Regulation amending the Capital Requirements Regulation[5] and the EU Securitisation Prudential Regulation Solvency II[6] (collectively the EU Securitisation Law), all of which are considered relevant to the European Economic Area (EEA) but are not yet implemented in the EEA Agreement – the Norwegian legislature tasked the Financial Supervisory Authority of Norway (FSAN) with establishing a working group (the Working Group) to assess a Norwegian implementation of expected EEA rules corresponding to the EU Securitisation Law. The Working Group was aided in its work by the Reference Group, which comprised representatives from the market. On 29 May 2019, the Working Group sent its final report (the Report) to the Norwegian Ministry of Finance, the Report forming the basis for a legislative proposal published by the Ministry of Finance on 4 December 2020. The final legislation for implementation of the EU Securitisation Law in Norwegian law by amending the FUA Act (the Implementing Law) was passed by Parliament on 23 April 2021 but, at the time of writing, has not yet entered into force. We expect the new legislation to take effect at the same time as the EU Securitisation Law is implemented in the EEA Agreement, the timing of which is currently unknown.

In short, the Implementing Law states that the EU Securitisation Law should be implemented by cross-reference in Norway (i.e., word for word). To the extent that certain issues are not regulated in the EU Securitisation Law, the Norwegian legislature is entitled to pass ancillary regulations in respect of those issues, provided, however, that any such Norwegian regulations are drafted to comply with the objective of the EU Securitisation Law and general EEA principles. The Implementing Law contains a limited number of such ancillary regulations; see further details in the sections below.

II REGULATION

i Licensing requirements in Norway

Lending is a regulated activity in Norway and a licence or a passport is needed. Norwegian financial undertakings without a banking licence may grant loans based on a licence as a non-banking credit institution or as a finance company. Consequently, the original lender would need a permit in Norway to grant loans.

The sale of existing loans is not a licensable activity in Norway, but the transfer of a substantial part of a financial institution's loan portfolio requires approval from the Ministry of Finance. In our opinion, which is backed by the Report,[7] the approval requirement does not apply to the transfer of loans in a securitisation context.[8] Therefore we do not believe that a sale of a loan portfolio from the original lender, originator or sponsor, as a rule of thumb, would trigger a need for an approval from the Norwegian authorities.

Pursuant to the current FUA Act, the purchase of existing loans in a traditional securitisation constitutes a licensable activity and will thus subject the SSPE to licensing requirements, capital requirements and supervision unless an exemption exists. This is also the case for SSPEs that provide credit default swap protection to the originator in a synthetic securitisation. However, the Implementing Law amends the FUA Act to clarify that securitisation SSPEs are not subject to licensing requirements as long as they do not issue bonds on a continuing basis. The SSPE must be established for the sole purpose of carrying out one or more securitisations. The EU Securitisation Regulation permits the use of SSPEs established in a third country, (i.e., not established in the EU),[9] as long as the third country is not listed as, for example, a high-risk and non-cooperative jurisdiction by the Financial Action Task Force.

Within its scope of application, the Norwegian Act on Financial Agreements (the FAA Act) grants the debtors under securitised loans certain rights.[10] The debtor's rights under the FAA Act will attach to the loan and must be respected by the SSPE that has acquired the loan. To further protect the debtors' rights under the FAA Act in cases of securitisation, the Implementing Law requires that the servicer of a securitised loan portfolio be a bank, a non-banking credit institution or a finance company. The expectation is that a Norwegian bank will normally be original lender, originator and servicer, and consequently imposing such a requirement on a securitisation servicer should not be onerous for most originators.[11]

ii Consent requirements

As a general rule, Norwegian law allows for monetary claims (e.g., receivables) to be freely assigned to third parties without the debtor's consent, provided such consent is not required by law or contract. An exception from this rule is set out in the FAA Act, which applies to loans and other credits provided by financial institutions. FAA Section 2-13 states that a financial institution may not, without the debtor's explicit consent (to be given no earlier than 30 days prior to the transfer), assign a loan to a third party, unless the assignee is a financial institution or similar entity (in which case only a notification is required). This consent requirement cannot be waived by consumer borrowers (but non-consumer borrowers may do so). However, the Implementing Law provides for an explicit derogation from the FAA Act Section 2-13 with respect to securitisation transactions, meaning that no consent of the debtors is required to transfer loans to SSPEs. Instead, the financial institution is only required to inform each individual debtor about the contemplated securitisation transaction no less than three weeks prior to closing of the transaction.

iii Simple, transparent and standardised securitisation

The EU Securitisation Law introduces a new regime for simple, transparent and standardised securitisation (STS securitisation). Subject to a legitimate designation of a securitisation as an STS securitisation pursuant to the EU Securitisation Regulation and the EU Securitisation Prudential Regulation amending the Capital Requirements Regulation, certain investors may receive more favourable capital treatment for their investment in a STS securitisation compared with a similar investment in a securitisation that does not have the STS designation.

Without going into detail, the STS designation is contingent both on the ordinary securitisation requirements being met and on special conditions related only to the STS securitisation (e.g., a sample of the underlying exposure shall be subject to external verification prior to issuance of the securities resulting from the securitisation) and there are, to some extent, different rules regarding non-asset-backed commercial paper (ABCP) securitisations compared to ABCP securitisations.

The responsibility for the assignment devolves jointly on the originator, sponsor and SSPE, but they may designate, subject to certain conditions and approval from the FSAN, a third party to attest the satisfaction of the STS criteria. This, however, will not absolve from liability the originator, sponsor and SSPE if it turns out that the assertion was incorrect.

Notification of the STS designation must be sent to the European Securities and Markets Authority (ESMA) by the originator and sponsor or, in the case of an ABCP programme, the sponsor. ESMA shall publish the STS notification on its official website and the originator and sponsor must inform the FSAN of the STS notification.

The STS designation can only be obtained when the originator, sponsor and SSPE are established in the EEA.

The EU Securitisation Regulation originally provided for STS designation only for traditional (true sale) securitisation structures. However, in April 2021 the EU passed two regulations[12] amending the EU Securitisation Regulation and the Capital Requirements Regulation to also provide an STS framework for synthetic securitisation transactions. On 7 September 2021, the Norwegian Ministry of Finance published a consultation paper on new legislation to implement these two regulations in Norway. The consultation paper was prepared by the FSAN and follows on from the Norwegian Parliament's adoption of the Implementing Law on the 23 April 2021. This legislation is expected to enter into force simultaneously with the Implementing Law, the timing of which is currently uncertain.

iv Risk retention

One of the contributing factors to the financial crisis in 2008 was the misalignment between the interests of the originators on one side and the investors on the other – securitisation transactions were often based on the 'originate-to-distribute' model, where the originators or lenders did not intend to keep the loan on their books for any longer than necessary. As a response to the unfortunate consequences that followed from this misalignment, regulators have set out certain remedial requirements intended to align the parties' interests, such as a condition that a minimum of 5 per cent of the net economic credit risk in the transaction is retained by the originator (risk retention).

It follows from Article 6 of the EU Securitisation Regulation that the risk retention requirement applies to the originator, sponsor or original lender. An entity established or that operates for the sole purpose of securitising exposures will not be deemed an originator and consequently ineligible as the retainer of risk. The interest is measured at the time of origination and shall be determined by the notional value for off-balance-sheet items. It is not allowed to split the net economic interest among different types of retainers or to perform any credit-risk mitigation or hedging related to the retained risk – this would make the risk retention requirement void.

The originator may not select assets to be transferred to the SSPE with the aim of rendering losses on the assets transferred compared to similar assets held by the originator that are not being securitised. As a starting point, the assessment is based on the assets' term, or over a maximum of four years where the life of the transaction is longer than four years.

There are five different methods by which the relevant party may comply with the risk retention requirement. We believe many parties will choose one of the less complicated methods, namely risk retention either by way of a vertical slice (retention of at least 5 per cent of the nominal value of each tranche sold or transferred to investors) or a first loss exposure (retention of a first loss exposure of not less than 5 per cent of every securitised exposure in the securitisation).

There are, however, exemptions to the risk retention requirement under the EU Securitisation Regulation. For instance, there will not be any risk retention requirement if the securities exposures are fully, unconditionally and irrevocably guaranteed by, for example, central governments or central banks.

v Reporting requirements

Pursuant to the Norwegian Act on Debt Information,[13] a financial institution has to report information to an authorised debt registry institution about a customer's unsecured debt or unused credit line for which the financial institution is a creditor. The SSPE is exempt from the licensing requirements and will consequently not be deemed a financial institution. Therefore, the Implementing Law provides that the securitisation servicer will be subject to the reporting requirement.

The EU Securitisation Regulation lays down an extensive list of requirements regarding information to be provided to a securitisation repository, or, if such a repository has not been established and subject to certain conditions, on a website, to make the transaction public. Such requirements may be reflected in Norwegian regulations passed by the Ministry of Finance after the Implementing Law has entered into force.

vi Institutional investors – due diligence requirements

Institutional investors[14] are subject to strict requirements regarding due diligence and risk assessment prior to an investment; for monitoring asset performance following the investment; and compliance by the original lender, originator and sponsor (as applicable) with certain aspects of the securitisation (e.g., that the risk retention requirement has been met – see Section II.iv). The institutional investor must be able to demonstrate to the FSAN, upon request, that the investor has a comprehensive and thorough understanding of the securitisation position and its underlying exposures and that it has implemented written policies and procedures for the risk management of the securitisation position and for maintaining records of the verifications and due diligence it is required to carry out and of any other relevant information.

vii Prohibitions

As a general rule, the underlying exposures used in a securitisation shall not contain other securitised exposures (re-securitisation). The purpose of the ban on re-securitisation is to make the securitised product more transparent – hidden risk because of re-securitisation was one of the components that led to the financial crisis in 2008. A carve-out is made for re-securitisation used for a legitimate purpose, such as where re-securitisation is in the interest of the investors because of the non-performance of the underlying exposures or for facilitation of the winding-up of a credit institution, an investment firm or a financial institution.

Originators, sponsors and original lenders must apply to the exposures being securitised the same sound and well-defined criteria for credit-granting that they apply to non-securitised exposures. The EU Securitisation Regulation also bans residential mortgage-backed securitisations that are backed by loans where the loan applicant was made aware that the information provided by the loan applicant might not be verified by the lender; this, however, is provided that the loans were made after the entry into force of the Mortgage Credit Directive.[15]

The EU Securitisation Regulation also bans the selling of securitised positions to retail clients, subject to certain carve-outs.

III SECURITY AND GUARANTEES

i Common types of security

As a prerequisite for its validity, a legal charge must be established in accordance with the terms of the Norwegian Pledge Act (the Pledge Act).[16] There are a few requirements that must be met pursuant to the Pledge Act for the charge to be valid *inter partes*. For example, a charge cannot be validly established over all the debtor's assets,[17] and it is not possible for a chargor to grant security over less than its entire ownership in the relevant asset to be charged. To obtain legal perfection, additional requirements must be met (see Section III.ii).

Pursuant to the Pledge Act, the original lender is able to secure its claim in almost every type of asset that the debtor owns; for example, autos (auto mortgage, auto mortgage floating charge or auto chattel mortgage); inventory; machinery and plant (floating charges); patents; residential home or commercial property; and monetary claims (both claims linked to a bank account held with the original lender and claims against a third party).

ii Ways to achieve legal perfection

Under Norwegian law, assignment of a non-negotiable monetary claim obtains legal perfection when the debtor has been notified about the assignment, either from the assignor (the originator or sponsor) or the assignee (the SSPE).

The establishment of a floating charge mortgage (e.g., a charge over inventory, receivables or machinery and plant) normally obtains perfection by way of registration in the Norwegian Mortgaged Movable Property Register (the Property Register). The same applies for fixed charges in autos, construction machines and railway rolling stock. The establishment of a mortgage in assets registered in a designated asset register gains perfection by registration in that asset register (e.g., the Norwegian Land Register for real estate and the Norwegian Civil Aircraft Register for aircraft).

The assignment of a mortgage with the underlying loan will, as a general rule, obtain legal perfection by way of notification to the debtor; in other words, it will follow the perfection mechanism of an assignment of a monetary claim, unless otherwise provided by contract or law. This means, for instance, that when an auto loan and a related auto chattel mortgage are collectively assigned from the originator to the SSPE by way of ownership, the assignment of both the auto loan and the auto chattel mortgage will be legally perfected once the debtor has been notified about the assignment – even though the establishment of an auto chattel mortgage obtains legal perfection through registration. Such legal perfection applies in relation to the debtor's and the originator's creditors alike.[18]

Pursuant to Norwegian law, the SSPE may grant security over its assets to the extent allowed by law and contract. The security may, as a general rule, be pledged in favour of a security trustee on behalf of the investors. The SSPE may normally also assign the mortgages to a security trustee by way of security; the trustee obtains a sub-mortgage over the mortgage. Section 1-10 of the Pledge Act states that security rights can be sub-mortgaged in favour of third parties unless prohibited by contract or other circumstances. It is not entirely clear under Norwegian law whether Section 1-10 of the Pledge Act constitutes a statutory basis for the creation of sub-mortgages in general, but we are of the opinion that it most likely does.

There is a fee for registering mortgages in the relevant register. For instance, registering a mortgage in the Property Register costs 1,051–1,516 Norwegian kroner (depending on the means of registration) and, for registration in the Land Register, the fee ranges from 540 to 585 Norwegian kroner. While electronic mass registration in the Land Register is limited to a maximum fee of 5,400 Norwegian kroner irrespective of how many mortgages are registered, the same has not been the case for mass registration in the Property Register, where there is currently no maximum fee related to mass registration. The absence of a maximum fee for mass registration in the Property Register makes true sale securitisation of certain underlying assets (such as auto loans) economically less attractive and represents an obstacle for achieving the objects of the EU Securitisation Regulation. With a view to solving this issue, the Ministry of Trade, Industry and Fisheries has put forward a proposal that, if adopted, would allow for registration of several mortgages simultaneously against a fixed fee of 483 Norwegian kroner. According to the proposal, there is a maximum limit on how many mortgages you can submit for registration at once. The maximum limit is currently expected to be set between 500 and 1,000 mortgages per submission. The proposal was subject to a public hearing in 2021 and is currently under consideration with the Ministry of Trade, Industry and Fisheries.

iii Capital requirement – significant risk transfer to the SSPE

A prerequisite for capital relief for the originator is that the securitisation has removed the significant risks associated with the underlying assets from the originator's balance sheet. The rules on significant risk transfer (SRT) are set out in the Capital Requirements Regulation,[19] which was incorporated into Norwegian law with effect from 31 December 2019. To recognise that a securitisation ('true sale' or synthetic) reduces the originator's credit risk, thus allowing a capital reduction, it must meet a qualitative test (setting out how much of the asset credit risk must be transferred) and a quantitative test (requiring the securitisation to have certain features to avoid 'fake' risk transfers). On 23 November 2020, the European Banking Authority published a report on SRT in securitisation with the aim of harmonising the current diverging approaches taken on SRT by competent authorities across the EU. It is expected that the outcome of this work will form the basis for the approach taken by the Norwegian authorities on SRT in securitisations by Norwegian originators.

iv Claw-back provisions

Regardless of legal perfection, public administration and bankruptcy proceedings (as applicable) will subject the transactions to scrutiny pursuant to Norwegian bankruptcy claw-back provisions. Essentially, the claw-back rules can be invoked by the insolvency administrator to rescind transactions deemed to be objectively unfair to the other creditors of the insolvent party.

IV PRIORITY OF PAYMENTS AND WATERFALLS

There is no established market practice for this in Norway as there is currently no active securitisation market.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

i The starting point of the insolvency estate's seizure of assets

Pursuant to the Norwegian Creditors Recovery Act,[20] the insolvency estate may seize only those assets that belong to the debtor. In this context, 'belong' refers to the debtor's actual right of ownership in the asset, which may be different from any registered or formal ownership right. Nevertheless, the insolvency estate may also seize assets:

- held by a debtor to the detriment of creditors who have not perfected their ownership interest (see Section III.ii);
- in circumstances where the estate is not bound by the transfer agreement (i.e., the assets fall back into the estate; see, for example, Section V.ii); and
- where the assets are subject to claw-back (see Section III.iv).

ii Valid contractual arrangement

A fundamental prerequisite for isolating the asset from the insolvency estate is that the transfer agreement between the original lender or originator and the SSPE is legal, valid and binding. This means, inter alia, that the insolvency estate is not bound by the agreement if it is pro forma, or if the agreement is later deemed invalid – for instance, because the agreement itself is unreasonably in favour of the debtor's contracting party (the SSPE).[21]

VI OUTLOOK

As stated in Section I, we expect that the new rules on securitisation in Norway will take effect simultaneously with the EU Securitisation Law being implemented in the EEA Agreement. At the time of writing, the timing of implementation is unknown. Following implementation, the same securitisation rules will apply in Norway as in the rest of the European Economic Area insofar as the relevant subject is regulated by the EU Securitisation Law.

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Endnotes

1 Markus Nilssen is a partner and Vanessa Kalvenes is a managing associate at Advokatfirmaet BAHR AS.
2 Act No. 40 of 10 June 1988 on Financing Activity and Financial Institutions.
3 Act No. 17 of 10 April 2015 on Financial Institutions and Financial Groups.
4 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No. 1060/2009 and (EU) No. 648/2012.
5 Regulation (EU) 2017/2401 of the European Parliament and of the Council of 12 December 2017 amending Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms.
6 Commission Delegated Regulation (EU) 2018/1221 of 1 June 2018 amending Delegated Regulation (EU) 2015/35 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertakings.
7 See the Report p. 34.
8 See also the preparatory works to the FIA Act, NOU 2001:23 p. 36.
9 Once implemented in the EEA Agreement, the EU Securitisation Regulation will recognise SSPEs established in the EEA-EFTA states (Norway, Iceland and Lichtenstein) as equivalent to EU-established SSPEs.
10 Act No. 146 of 18 December 2020 on Financial Agreements.
11 See the Report p. 56.
12 Regulation (EU) 2021/557 and Regulation (EU) 2021/558, respectively.
13 Act No. 47 of 16 June 2017 on Debt Information Related to Credit Assessment of Private Persons.
14 That is, credit institutions or investment firms as defined in the Capital Requirements Regulation; insurance and reinsurance undertakings as defined in Directive 2009/138/EC; an alternative investment fund manager (AIFM) as defined in Directive 2011/61/EU; an institution for occupational retirement provision falling within the scope of Directive (EU) 2016/2341 or an investment manager or an authorised entity appointed by an institution for occupational retirement provision pursuant to Directive (EU) 2016/2341; an undertaking for the collective investment in transferable securities (UCITS) as defined in Directive 2009/65/EC; and an internally managed UCITS, which is an investment company authorised in accordance with Directive 2009/65/EU; see also Regulation (EU) No. 575/2013 and the EU Securitisation Regulation 2(12).
15 Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No. 1093/2010.
16 Act No. 2 of 8 February 1980 regarding Pledges. See the Pledge Act Section 1-2 Subsection 2.
17 The ban is applicable for situations where all the debtor's assets are charged under one floating charge deed. The secured party can, in reality, establish a charge over all the debtor's assets by means of several deeds covering separate parts of the debtor's assets.
18 With respect to perfection against the originator's (i.e., the assignor's) creditors, the question has not been clearly answered in Norwegian legislation or jurisprudence, but the predominant view among Norwegian legal scholars seems to be that a security right, such as a chattel mortgage, obtains legal perfection in the same way the underlying claim is perfected, when it is sold together with the claim. The rationale for this view is that a security right is so closely attached to the underlying claim that it does not make sense to require for the security right a different perfection act from that of the underlying claim when both are sold together. This view is also supported by the preparatory works; see, for instance, Ot.prp.nr.39 (1977–1978) pp. 27 and 102.
19 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.
20 Act No. 59 of 8 June 1984 regarding Creditors Recovery.
21 Act No. 4 of 31 May 1918 regarding Conclusions of Agreements, the Right to Deposit an Item of Debt and Limitation of Claims Section 36. For an agreement to be deemed unreasonably in favour of one party such that the contract is invalid, the threshold is high.

Chapter 8

Singapore

Oon Thian Seng, Lim Wei-Qi and Kwong Wen Ying[1]

Summary

I OVERVIEW

In the past six years, Singapore has made great leaps and bounds in its bid to be recognised as a leading international financial centre, undergirded by a robust and reliable dispute resolution infrastructure coupled with responsive and ever-evolving business-friendly legislation.

At a domestic level, the Singapore courts' summary judgment process allows simple straightforward claims such as the enforcement of debt and guarantees to be expedited, keeping the costs of lending in Singapore low. To complement its position as a financial, legal and business hub, Singapore has aimed to strengthen its effectiveness as an international debt restructuring centre. As part of these efforts, Singapore had overhauled and consolidated its insolvency and debt restructuring regime to keep pace with regional and global developments. On 30 July 2020, the Insolvency, Restructuring and Dissolution Act 2018 (IRDA) came into force as an omnibus statute for all personal and corporate insolvency and restructuring proceedings, and it was hoped that its enactment would serve to strengthen Singapore's laws on securitisation by imbuing greater clarity to the balance between the protection of creditors and the broader interests in rehabilitating a company in financial distress.

Continued advancements in technologies such as blockchain and virtual reality have contributed to the growing popularity of new types of digital assets (e.g., non-fungible tokens) and new ways in which existing assets may be securitised (e.g., through 'tokenisation' of previously illiquid assets). The current regulatory regime in Singapore focuses on managing the risks caused by the public offering of these digital assets (for example, via the existing Securities and Futures Act 2001, the Payment and Services Act 2019 and the recently enacted Financial Services and Markets Act 2022) and the ensuing technological, anti-money laundering (AML) and countering the financing of terrorism (CFT) risks. While there remains limited regulatory guidance addressing the legal nature and ownership of these digital assets, this lacuna has recently been filled by common law, whereby the Singapore courts have held that certain digital assets can be classified as property capable of being held on trust.

II REGULATION

As a common law jurisdiction, Singapore law in the area of credit and security is largely based on English law. Concepts of common law have generally been followed and applied by the Singapore courts unless otherwise modified by local statute. Accordingly, Singapore law adopts and recognises the traditional common law forms of security interests such as mortgages, equitable charges, pledges and liens (as modified by local statute).

The regulatory regime in Singapore in respect of securitisation will largely depend on the nature of the asset being secured. Singapore does not have a central regulatory body that maintains a register of all security interests in Singapore – instead, individual statutory bodies will have oversight over particular asset classes and accordingly, any encumbrance or disposition of title in or to those assets will be registered with the appropriate statutory bodies. These statutory bodies may also prescribe forms in which the security documents must take, as well as any filing or lodgement requirements with which they must comply to perfect or otherwise give effect to the security created. Generally, any filings, lodgements or registrations in respect of securities with the relevant statutory body will incur fairly nominal registration charges. The creation or enforcement of certain securities will also attract taxes such as stamp duties, and in some cases, withholding tax.

The most common examples are charges over certain asset classes created by companies that are to be registered with the Accounting and Corporate Regulatory Authority of Singapore (ACRA), and mortgages over real property that are registrable with the Singapore Land Authority (SLA). Security over these asset classes will be dealt with in greater detail below. Security interests created over specific assets such as vessels and intellectual property rights will be dealt with by the relevant statutory body in Singapore – mortgages over vessels are required to be registered with the Maritime and Port Authority of Singapore, and security over intellectual property rights may be registered with the Intellectual Property Office of Singapore.

i Security over real property

Singapore adopted the Torrens system of land registration in 1960 with the enactment of the Land Titles Act (Chapter 157, 2004 Revised Edition) and by 31 December 2002, the process of converting all land previously registered under the Registration of Deeds Act (Chapter 269, 1989 Revised Edition) to the Torrens system was completed. The central feature of the Torrens system is the principle that the registered proprietor has indefeasible title. In essence, the registered proprietor's title to land will be paramount and cannot be defeated by a prior unregistered interest (save for certain statutorily prescribed categories). The Torrens system allows any person dealing with a registered proprietor of land to save him or herself the expense of investigating the registered proprietor's title to satisfy himself or herself that the registered proprietor has good title the land. A person dealing with a registered proprietor may therefore simply check the land register – he or she will be bound by interests stated in the register but will not be affected by any interests not reflected therein.

In Singapore, all dealings with title to registered land under the Land Titles Act 1993 are dealt with by the Land Registry under the auspices of the SLA. Under the Land Titles Act, the folios in respect of properties issued by the Registrar of the Land Registry are to be deemed conclusive evidence of the proprietor of that property, including where his or her estate or interest is subject to any encumbrances such as mortgages.

Notwithstanding that traditional mortgages involve the transfer of ownership of land by the mortgagor to the mortgagee subject to the mortgagee's right of redemption, mortgages created over land registered under the Land Titles Act 1993 differs in that there is no transfer of ownership in the property from the mortgagor to the mortgagee at the time of the creation of the mortgage. Instead, the mortgage is registered with the Singapore Land Authority, which maintains the registry of property transactions in Singapore, including the creation of any encumbrances on property in Singapore.

Unless a mortgage over real property has been registered with the SLA, it will not be effective in vesting any legal interest in the mortgagee. Upon registration, the mortgage will be reflected in any subsequent title searches conducted on the property and will be conclusive proof of the encumbrance of the property created in favour of the mortgagee.

ii Registrable charges

The creation of charges over certain asset classes granted by corporate entities may be required to be registered with ACRA, under the Companies Act 1967 of Singapore. The following charges are registrable:

- a charge to secure any issue of debentures;
- a charge on uncalled share capital of a company;
- a charge on shares of a subsidiary of a company that are owned by the company;
- a charge created or evidenced by an instrument that, if executed by an individual, would require registration as a bill of sale;
- a charge on land where situate or any interest therein but not including any charge for any rent or other periodical sum issuing out of land;
- a charge on book debts of a company;
- a floating charge on the undertaking or property of a company;
- a charge on calls made but not paid;
- a charge on a ship or aircraft or any share in a ship or aircraft; and
- a charge on goodwill, on a patent or a trademark or on a copyright or on a registered design or a licence to use any of the foregoing.

Charges created over the foregoing are to be registered with ACRA within 30 days of their creation if they are created within Singapore, or 37 days if created outside of Singapore. While a failure to register the charge does not render the charge unenforceable as between the chargor and the chargee, the charge will be unenforceable as against the liquidator and other secured creditors of the company. In essence, where a company has created a registrable charge in favour of a lender and fails to register it, the lender will be unable to enforce its rights under the charge upon the company's insolvency or against any other creditor asserting a registered security or other recognisable interest over the same assets. The assets in question will instead form part of the company's general pool of assets to be administered and distributed by the liquidator, and the lender will be considered an unsecured creditor.

iii Issues of taxation and fees involved in the creation of security

While there are no significant tax benefits or savings in creating one form of security over another, certain types of securities will attract stamp duties that, though minimal, may nevertheless be a salient consideration for parties in a securitisation transaction. Stamp duty will be chargeable on any mortgage of real property or a mortgage of shares at the rate of 0.4 per cent of the loan amount granted on the mortgage subject to a maximum duty of S$500.

Where foreign lenders extend loans to Singaporeans or hold Singapore-based security, the issue of withholding tax arises as a relevant consideration. Withholding tax at the rate of 15 per cent will be chargeable on the gross payment of any interest, commission or fees in connection with any loan or indebtedness and deducted at the source. Any Singaporean making payment of interest, commission or fee in relation to a loan or indebtedness to a foreign entity will be required to withhold 15 per cent of that gross payment before making payment to the foreign entity.

Administrative fees or lodgement charges will also be imposed where any necessary registration or filings are made with statutory bodies. Each statutory body will prescribe the relevant administrative fees to be paid for the necessary lodgement or filings made in respect of securities. For example, a lodgement fee of S$60 will be payable to ACRA when a charge is registered.

iv Digital assets

With the proliferation of blockchain technology and its myriad applications, blockchain-based digital assets such as cryptocurrencies and non-fungible tokens (NFTs) are rapidly taking prominence as new asset classes to be traded and securitised among market players.

The existing regulatory framework over digital assets primarily addresses the public offering and trading of these assets. In 2022, the Monetary Authority of Singapore (MAS) reiterated its 'tech-neutral stance' towards digital asset classes such as NFTs, and indicated that it would look through to the 'underlying characteristics' of the digital asset to determine if it falls under an asset class captured by existing regulation.[2] For example, digital assets that represent securities, such as shares or debentures, will be regulated under the Securities and Futures Act 2001, and digital assets that represent a means of payment will be regulated under the Payment and Services Act 2019. Notably, the newly gazatted Rules of Court 2021 defines movable property (in the context of enforcement of judgments and orders) to include 'cryptocurrency or other digital currency', thereby expressly recognising cryptocurrency as a form of property capable of being the subject matter of an enforcement order.

Developments in the common law of Singapore have further demonstrated the Singapore courts' increasing recognition of proprietary rights in respect of digital assets – in particular, cryptocurrency. In the case of *CLM and CLN [2022] SGHC 46 and Janesh s/o Rajakumar v. Unknown Persons* [2022] SGHC 264, the courts granted proprietary and interlocutory injunctions, respectively, after recognizing that two prominent cryptocurrencies (Bitcoin and Ethereum) and NFTs were capable of attracting proprietary relief. Notably, in the recent case of *ByBit Fintech Ltd v. Ho Kai Xin and others* [2023] SGHC 199 (*Bybit*), the High Court of Singapore held that cryptocurrencies (in reference to the cryptocurrency USDT) can be classified as property (specifically being a chose in action) capable of being held on trust. It was also clarified that while USDT also carries with it the right to redeem an equivalent in USD, this is not a feature necessary for a crypto asset to be classed as a thing in action.[3] This means that the principles elucidated in the *Bybit* case can likely be applied to the broader spectrum of cryptocurrencies and even other digital assets.

With the ever-evolving nature of digital assets globally and the rise of litigation proceedings involving digital assets, it is likely that the Singapore courts will continue to deal with an increasing number of cases involving similar legal issues for various digital assets.

III SECURITY AND GUARANTEES

The forms of security recognised under Singapore law may be broadly classified into the following categories:

- guarantees, including standby letters of credit and performance guarantees;
- charges over assets, both fixed and floating charges;
- assignment of receivables; and
- security over real assets such as mortgages and pledges.

The features of each category of security, relevant perfection requirements and the enforceability of the securities in the face of insolvency proceedings are explored in greater depth below.

i Guarantees

Personal and corporate guarantees, standby letters of credit and performance guarantees or bonds are all fairly typical forms of security in personam used commercially in Singapore. Generally speaking, there are no registration or other perfection requirements in respect of personal security, save that the guarantee be in writing and signed by the person giving the guarantee.[4]

The key feature of a guarantee is that the guarantor assumes only a secondary or collateral liability to that of the borrower, who will be primarily liable for repayment of the loan. In a true guarantee, the liability of the guarantor will depend on the validity and enforceability of the primary contract. Consequently, the liability of the guarantor will arise only when the borrower defaults. Notwithstanding this, guarantees in Singapore are often drafted as a guarantee and indemnity, thereby creating a separate and independent obligation on the part of the guarantor. The effect of this practice creates a primary obligation on the part of the guarantor that is not contingent on first looking towards the borrower under, or the validity of, the underlying contract.

Standby Letters of Credit (SBLC) are also often used in trade finance transactions. Under an SBLC, the issuing bank will undertake to pay the beneficiary upon the default of performance of obligations owed to the beneficiary of the SBLC. The prospective defaulter is usually the applicant of the SBLC. An SBLC may be contrasted with a guarantee, as it imposes a primary obligation on the issuing bank to make payment upon the beneficiary having fulfilled the terms of the credit. This is usually by way of the beneficiary producing a written demand for payment and a declaration of the performance default of the applicant. The issuing bank will be required to pay without further investigation in the absence of fraud. To maintain international comity between banks and lenders, SBLCs are usually issued subject to customary terms contained in the UCP 600 or the ISP98, which prescribe standard sets of rules and terms applicable to documentary credits or SBLCs.

Performance bonds are also common instruments used by banks. Performance bonds typically state that the bank will pay the bearer of the bond unconditionally upon demand, without any regard as to liability under the underlying contract. In essence, when the bearer of the bond calls on the performance bond, the obligation on the bank to make payment will arise without any requirement for the bank to conduct independent investigations as to whether a breach has occurred under the underlying contract.

ii Charges

Charges do not involve the transfer of either ownership or possession of the charged property to the lender and may be either fixed or floating. Fixed charges are granted over one or more specific assets, and assets subject to a fixed charge cannot be freely dealt with or sold by the chargor. In contrast, a floating charge may be taken over a class of assets generally and 'hovers' over the assets, allowing the chargor to deal with it in the ordinary course of its business. Floating charges are appropriate where security is needed to be taken over the inventory of a business, as the chargor will still be able to sell or add to its inventory in the course of its business.

The specific assets secured by a floating charge will only be determined at the point in time that the floating charge crystallises. Parties may contractually agree on the events that trigger the crystallisation of a floating charge, such as events of default, insolvency or any attempt to dispose of or encumber the charged assets in a manner inconsistent with the terms of the security. Notwithstanding any contractual provisions for events of crystallisation, a floating charge automatically crystallises if a receiver is appointed over the chargor's assets or if the chargor goes into liquidation or ceases to carry on business.[5] Upon crystallization, the floating charge will attach to the assets in the class that it hovers over, and will be a fixed charge.

As stated above, all floating charges and certain fixed charges will be registrable with ACRA within 30 days of their creation (if created within Singapore) or 37 days (if created outside of Singapore). A failure to register a registrable charge within the required time period will, in the event of the chargor's insolvency, render the charge void as against the liquidator and other creditors of the company. Priority as between two charges over the same assets will be determined by the date of creation of the charges, and not by the time of registration.

iii Assignment of receivables

Another common security taken by lenders is assignment of trade debts. The assignment of trade debts and receivables may be by way of an absolute legal assignment or an assignment by way of security.

If an assignment is to be an absolute legal assignment, it must comply with the form and procedure prescribed by Section 4(8) of the Civil Law Act 1909, namely that the assignment must be in writing and must not purport to be by way of charge only, and that notice of the assignment must be given to the third-party debtor. Notice of the assignment to the third-party debtor is required to perfect the assignment. Where an absolute assignment fails to comply in full with the requirements of Section 4(8) of the Civil Law Act 1909, the assignment will be an equitable assignment.

Although Singapore law recognises both legal and equitable assignments, the differences between them lie in the rights and remedies afforded to the lender as against the third-party debtors. These differences may be traced to the requirement for notice to be given to the third-party debtor. Absent a Notice of Assignment, any payments made by the third-party debtor to the assignor will be a good satisfaction of its debt and the third-party debtor will be treated as having discharged its underlying obligations. This is because a third-party debtor, without knowledge of the assignment, will continue to discharge its obligations in accordance with the underlying contract by making payment to the assignor and cannot be liable to the assignee for the payment of debts already paid.

iv Security over real assets

Mortgages

While traditional mortgages involve the transfer of ownership of land by the mortgagor to the mortgagee subject to the mortgagee's right of redemption, mortgages of land registered under the Land Titles Act 1993 must comply with the formalities in the Land Titles Act

1993. Land titles mortgages differ from traditional mortgages in that there is no transfer of ownership in the property from the mortgagor to the mortgagee at the time of the creation of the mortgage.

Owing to Singapore's adherence to the Torrens system, priority of land titles mortgages will not be determined by the order in which they are created – rather they will be determined by the order in which they were registered with the Land Titles Registry. This is an important differentiation because rights as to title in registered land derives from the act of registration.

Priority between legal mortgages (other than mortgages in respect of which priority is determined by registration in accordance with any applicable statute, for example, Land Titles mortgages and Singapore ship mortgages) will be determined by the order in which they are created, although mortgagees are free to regulate their respective rights and interests as between themselves. A legal mortgage will also prevail over all other mortgagees whose mortgages he or she had no notice of at the time his or her mortgage was created.

Pledges

As pledges involve the bailment of the secured assets, the key feature of a pledge is that the pledgee has actual or constructive possession of the goods. Actual delivery may take place by physically depositing the goods with the pledgee, while constructive delivery may be by way of deposit of title deeds (without which the pledgor is unable to deal with the goods) or by way of deposit of keys to the warehouse in which the goods are stored.

The pledgee should not relinquish his or her possession (whether actual or constructive) of the goods to the pledgor – doing so may bring the pledge to an end. The redelivery of the pledged goods to the pledgor may cause the pledgee to lose their rights to the pledged goods unless it is for a limited purpose and parties clearly intend for the pledgee to regain possession when that purpose has been met.[6]

v Enforcement of security in the event of insolvency

On 30 July 2020, the Insolvency, Restructuring and Dissolution Act 2018 (IRDA) came into effect. Under the IRDA, Singapore's insolvency regime was enhanced and consolidated into an omnibus act that applies to both corporate entities and individuals. Prior to the enactment of the IRDA, Singapore's insolvency regime was contained in disparate pieces of legislation such as the now-repealed Bankruptcy Act (Chapter 20 of Singapore) and Part X of the Companies Act 1967. These pieces of legislation have since been repealed in tandem with the enactment of the IRDA.

Division 3 of Part 9 of the IRDA, which applies to companies in judicial management and in liquidation, provides for the unravelling of certain transactions entered into within a certain period of the commencement of judicial management or winding-up proceedings. Division 3 of Part 9 also prescribes a 'hardening period' for floating charges wherein a floating charge created within a certain period of the commencement of a company's judicial management or winding-up may be invalid to a certain extent.

The applicable period during which transactions or floating charges entered into may be unraveled or rendered void will be determined by whether the charge or counterparty (as the case may be) was associated with the company. The definition of an 'associate' is set out in Section 217 of the IRDA and includes situations where an individual (or an individual and his or her associates) are able to control both corporations, the two corporations will be associated; or where an individual's associates are employed by a corporation, that individual and the corporation will be treated as associated.

Floating charge void upon winding-up

Section 229 of the IRDA provides that floating charges created within a certain period of the commencement or after commencement of judicial management or winding-up proceedings will be void to a certain extent. Floating charges created within two years (if the chargee and the company are associated) or one year (if the chargee and the company are not associated) of the commencement of judicial management or winding-up proceedings will be void to the extent of the consideration for the charge and any interest thereon.

However, a floating charge in favour of a non-associate created within one year of the commencement of judicial management or winding-up proceedings will not be void if the company was not insolvent at the time or was not made insolvent as a consequence of granting the charge.

Unwinding of transactions at an undervalue

Under Section 224 of the IRDA, where a company enters into a transaction for a consideration of whose value is significantly less than the value of the consideration provided by the counterparty three years prior to commencement of judicial management or winding-up proceedings, the court is empowered to make such orders as it thinks fit for restoring the position to what it would have been if the company had not entered into that transaction.

The company must have been insolvent at the time the transaction was entered into or have become insolvent as a consequence of that transaction. A presumption of insolvency of the company will apply where the transaction was entered into with an associate.

Notwithstanding that the transaction was entered into at an undervalue or that the company was insolvent at that time or made insolvent as a consequence of that transaction, the court cannot make an order in respect of the undervalue transaction if the company entered into the transaction in good faith and for the purpose of carrying on its business and if at the time the company entered into the transaction, there were reasonable grounds for believing that the transaction would benefit the company.

Unwinding of unfair preference transactions

Section 225 of the IRDA allows the court to unwind transactions occurring before the commencement of judicial management or winding-up that unfairly favour one creditor at the expense of other creditors even if the transaction does not diminish the company's assets. This provision aims to police debtor misconduct and passivity and ensures that all creditors are treated fairly.

In the case of an unfair preference that is not a transaction at an undervalue and where the preferred creditor is a director of the company or associated with the director, or is an associate of the company, the court has the power to examine and unwind such transactions made within the two-year period preceding the commencement of judicial management or winding-up of the company. In all other cases of unfair preference, the court may only examine and unwind such transactions if they were made within one year prior to the commencement of judicial management or winding-up.

The unfair preference transaction must be carried out at a time when the company was insolvent or becomes insolvent as a result of the transaction. A presumption of insolvency will apply where a transaction at an undervalue was entered into with a person connected with the company (otherwise than by reason only of being the company's employee).

A company gives an unfair preference to a person if that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities, or if the company does anything that has the effect of putting that person into a position, which, in the event of the company's winding-up, will be better than the position the person would have been had that thing not been done. The following are examples of transactions that may be construed as intending to improve the position of a particular creditor:

- payment or part payment of an old debt;
- providing security for past indebtedness; or
- transferring assets to an unsecured creditor in full or partial repayment of debt.

The court will only exercise its power to unwind such transactions if the company was influenced by a desire to produce, in relation to the creditor, the effect of putting the creditor in a better position than he or she would have been if the transaction had not been entered into. A presumption of influence will apply where the unfair preference was given to a person who, at the time the unfair preference was given, was connected with the company (otherwise than by reason only of being the company's employee).

Improper trading

Section 239 of the IRDA establishes liability for wrongful trading, which occurs when a company incurs debts (or other liabilities) that it has no reasonable prospect of meeting in full.

The wrongful trading regime established under this section is notable for its creditor-friendly nature. Under the previous regime established by the Companies Act 1967, an officer of the company in question would have to be convicted of criminal liability before a claim for wrongful trading could be brought against that officer to establish civil or personal liability. In the present IRDA regime, civil liability can be imposed without a finding of criminal liability. This removes the prior hurdle of establishing criminal liability, and thus lowers the standard of proof that claimants need to satisfy to establish a wrongful trading claim.

Notably, a declaration for wrongful trading can be made against 'any person who was a party to the company trading in that manner'; this would appear to expand the pool of possible persons beyond the directors and officers of the company.

IV PRIORITY OF PAYMENTS AND WATERFALLS

A Singapore court is likely to give effect to a contractual provision in an agreement (whether or not governed by Singapore law) distributing payments to parties in a certain order specified in the contract so long as such clauses are valid, binding and enforceable under the governing law of the agreement, but subject to any statutory priorities that may arise in the event of the insolvency of the debtor under the provisions of the Companies Act 1967.

Lenders are also free to contractually determine the distribution of payments as between themselves. This may take the form of a subordination agreement in which lenders determine the order in which they may collect repayment from the debtor, or an intercreditor *pari passu* agreement such that all lenders share equally in repayment in the respective proportions of the debts due to them. Lenders in syndicated loan transactions will often enter into agreement with the facility agent to set out the distribution of payments to each lender in default and non-default scenarios.

Certain common law rights are also available to bankers, such as the banker's lien and banker's right of set-off.

A banker's common law right of lien over securities deposited by a customer with the banker in the ordinary course of business arises whenever the customer is indebted to the banker. The banker's right of lien will not extend to the credit balance in the customer's account as this credit balance is essentially a debt owed by the bank to its customer. It is illogical for the bank to take a lien over its own indebtedness. This is instead addressed through the banker's right of set-off. In select circumstances, a banker's right of lien can arise even though the customer's account is in credit. For example, if a banker allows its customer to draw against uncleared cheques deposited by the customer with the bank, the banker will have a right over the cheques as the banker has already given credit to the customer for the value of the cheques.

The banker's equitable right of set-off arises where there are mutual credits and debits between a bank and its customer. If a customer has more than one account with the bank, the bank will be entitled to treat all the accounts as one single account unless otherwise expressly or impliedly agreed between the parties. The bank may therefore combine two or more accounts kept by the customer with it in exercising its right of set-off.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

From the borrower's perspective, relying on the concept of separate legal identity and segregating its asset-holding companies is one of the main ways a group can achieve bankruptcy remoteness. This is facilitated in Singapore by the convenience and expediency of incorporating a company. Lenders, through a mix of cross-collateralisation, cross-default clauses and non-restructuring or reorganisation undertakings, and obtaining parent–child guarantees across group companies, seek to extend the lenders' remedies and recourse to group structures.

The bankruptcy regime is particularly relevant in factoring or discounting transactions. Financers engaging in invoice discounting or factoring arrangements are exposed to the risk of having their purchase of accounts receivables from the borrower recharacterised as a secured loan transaction. If so recharacterized, the sale of receivables will be treated as an assignment by way of security, which would have been registrable as a charge within the timelines set out in Section 131 of the Companies Act 1967. In the event of the seller's insolvency, the charge over the account receivables would be void for want of registration.

Distinguishing a true sale from a secured loan in account receivables financing

In deciding whether a transaction may be properly characterised as a true sale or a secured loan transaction, the courts will look at the substance as opposed to the form of the transaction, taking into account the following factors in distinguishing a true sale from a secured loan.

Equity of redemption

The essence of a loan lies in the obligation to repay, which may be express or implied.[7] The corollary is that the borrower has an equity of redemption, that is, the right to the ownership of the charged assets free of the charge on the discharge of his obligation to repay the lender. In contrast, a seller of book debts should not have an equity of redemption.[8]

Rights on realization of book debts

In the case of a loan on security, the lender, on realising the charged assets, has to account to the borrower for any excess over the amount of the borrower's obligations to the lender. The corollary is that if the charged assets do not realise the amount of the obligations, the borrower is still liable for the shortfall. In contrast, in the case of a true sale of book debts, the buyer becomes the owner of the book debts, and any profit or loss on realization attaches to them. A sale and purchase of book debts without recourse is therefore clearly distinguishable from a loan on security.

A sale and purchase of book debts with recourse would generally not be characterised as a loan on security, provided that the protection that the buyer is seeking is the obligation of the seller to repurchase the book debts or to guarantee payment of the book debts, as opposed to the obligation to repay the money paid to the seller by the buyer to the extent that it is not recovered by the collection of debts.[9]

Discount or interest

In the case of a true sale of book debts, the profit to the buyer should be a discount on the book debts, being the difference between the amount paid for the book debts and the realisation of the same, as opposed to interest payable on the amount paid by the buyer to the seller.

If the transaction is rightfully characterised as a true sale, there will be no need for any registration or lodgement to be made with any government or regulatory authority in Singapore.

VI OUTLOOK

With blockchain technology bringing about an increasing number of avenues to securitise different asset classes, the Singapore government has recognised the need to protect retail investors and to implement additional safeguards in respect of AML/CFT. The Financial Services and Markets Act (FSMA), which was passed by Parliament on 5 April 2022, consolidates the regulatory powers of the MAS across the financial sector and improves the MAS's ability to address errant behaviour by financial institutions, including digital token service providers. The FSMA will be implemented in phases, with the first phase having commenced on 28 April 2023, and the remaining phases expected to be introduced later in 2023 and 2024.

Furthermore, given the recent spike in collapses plaguing the cryptocurrency space such as the bankruptcy of cryptocurrency exchange FTX, MAS has announced new regulatory measures applicable to Digital Payment Token (DPT) service providers to enhance investor protection and market integrity in the provision of DPT services. These measures include requirements concerning safekeeping of customer assets and restrictions from facilitating lending and staking DPT by retail customers. Currently, MAS is seeking to formalise these measures by incorporating them into the Payment Services Regulations 2019 and publishing guidelines to support consistent implementation by the industry.

i Financial Services and Markets Act 2022

Digital token service providers

The Financial Services and Markets Act 2022 (FSMA) aligns the Singapore regulatory landscape over digital token service providers with the enhanced standards promulgated by the Financial Action Task Force for virtual asset service providers in June 2019. Previously, digital token service providers (e.g., cryptocurrency exchanges) were only subject to the relevant licensing and AML/CFT regimes where digital token services were provided in Singapore. As such, digital token service providers incorporated in Singapore but providing digital token services overseas were not captured under then existing regulations. The FSMA closes this loophole by imposing licensing requirements on all entities carrying on business activities in Singapore that provide digital token services, regardless of whether the service is provided within or outside Singapore.

Furthermore, the FSMA broadens the scope of digital token services to be subject to its licensing and AML/CFT regime. These services now include, but are not limited to:

- dealing in digital tokens;
- facilitating the exchange of digital tokens;
- accepting digital tokens from one digital token account, for the purposes of transmitting, or arranging for the transmission of the digital tokens to another digital token account;
- safeguarding a digital token, where such service provider has control over the digital token; and
- carrying out customer instructions in relation to a digital token, where the service provider has control over the digital token.

In light of the above, digital token service providers who are not required to be licensed under the current regulations, such as the Payment Services Act, will need to re-evaluate their operations and consider whether they would need to be licensed under the new regulatory landscape under the FSMA.

Prohibition orders

Under the FSMA, the MAS is also vested with the sweeping authority to issue prohibition orders to prohibit any person whom it deems as not 'fit and proper' from engaging in any activity regulated by MAS and from participating in various listed roles for any financial institution. Previously, the MAS's power to issue prohibition orders resided only in certain specific Acts (i.e., the Securities and Futures Act 2001, Financial Advisers Act 2001 and the Insurance Act 1966), and then only in respect against a more limited pool of specified persons under those Acts. The consolidation of the MAS's powers under the FSMA empowers the MAS to take prohibitive action against misconduct by virtually all persons involved in MAS-regulated activities and allows the MAS to take a flexible and targeted approach in addressing errant behaviour among market players.

While the MAS's powers under the FSMA are broad, they are subject to checks and balances, in that (1) persons whom the MAS intends to issue prohibition orders against must be informed of this intention and given an opportunity to make representations to the MAS before the issuance of these orders; and (2) persons on the receiving end of a prohibition order have the right to appeal against the decision within 30 days to the Minister.

ii Regulatory measures in connection with the provision of Digital Payment Token services

On 3 July 2023, the MAS introduced new regulatory measures for licensed and exempt payment service providers that carry on a business of providing a DPT service under the Payment Services Act 2019, which aims to increase investor protection and market integrity.

Broadly, DPT service providers are required to implement the following measures:

- segregate customers' assets from its own assets under a statutory trust;
- safeguarding customers' moneys;
- conduct daily reconciliation of customers' assets and keep proper books and records;
- maintain access and operational controls to customers' DPTs in Singapore;
- ensure that the custody function is operationally independent from other business units; and
- provide clear disclosures to customers on the risks involved in having their assets held by the DPT service provider.

Furthermore, as retail customers are generally regarded as having fewer resources to analyse technical information, obtain advice, or understand the risks in a meaningful way, MAS has observed that there can be significant consumer harm that results from staking and lending activities, should they continue to be available to retail customers. As such, MAS seeks to restrict facilitating the lending and staking of retail customers' assets by the DPT service providers to mitigate the potential investment risks that could flow from such arrangements. Notably, this restriction does not apply to non-retail customers who are perceived to be more well-resourced and possess a bigger appetite for risk. Nevertheless, DPT service providers will still be required to provide a clear risk disclosure document and obtain the non-retail customers' explicit consent before proceeding with the respective staking and lending arrangement.

While these measures aim to regulate DPT trading within the Singapore context, retail and non-retail customers are not fully protected from unregulated entities that do not fall within the purview of MAS. As such, given the highly volatile nature of DPT trading and the risk of loss of assets in the event of insolvency, it is important for customers to engage in proper due diligence and engage with these DPT service providers responsibly.

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Endnotes

1 Oon Thian Seng is a partner, while Lim Wei-Qi and Kwong Wen Ying are associates at Oon & Bazul LLP.
2 https://www.mas.gov.sg/news/parliamentary-replies/2022/reply-to-parliamentary-question-on-regulation-of-nft-activities.
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Chapter 8

Switzerland

Roger Ammann, Johannes Bürgi and Thomas Meister[1]

Summary

I OVERVIEW

i Market overview and size

In Switzerland, securitisation transactions in the past have been based primarily on trade receivables, auto lease receivables and loans, credit card receivables, residential mortgage loans, commercial real estate loans and small and medium-sized enterprise loans.

In the recent past, public asset-backed security (ABS) transactions in the Swiss market have predominantly involved the securitisation of auto lease receivables and credit card receivables, with a total of nine public issuances in 2020, 2021 and 2022 and a cumulative volume of notes issued of around 2.0 billion Swiss francs. In addition, privately placed securitisation transactions are regularly implemented in Switzerland. Owing to the overall growing volume of residential and commercial mortgage loans in Switzerland, the number of residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) transactions in Switzerland is expected to increase in the future, supplementing the management of mortgage portfolios, which had in the past frequently served as collateral for covered bond transactions, rather than being securitised. However, also the number of covered bond transactions in Switzerland involving residential and commercial mortgage loans has increased in 2022 with a Swiss bank having established a new public covered bond programme and an inaugural issuance of covered bonds thereunder and is expected to continue to grow in the future.

Despite the challenges imposed by the covid-19 pandemic in the past and the overall rising interest rate environment, securitisation activity in Switzerland has remained relatively stable in the past and current year. Furthermore, the portfolios in the consumer lending space that have already been securitised in Switzerland have remained overall stable with low default rates.

ii Basic structure

Securitisations in Switzerland are usually structured as (legal) true sale transactions with one (domestic or foreign) bankruptcy remote special purpose vehicle (SPV) acting as the purchaser of a pool of income-generating assets and as the issuer of the notes. The notes are publicly placed and listed or privately placed, and the proceeds from the issuance of the notes are used by the SPV to acquire the initial pool of assets from the originator at issuance of the notes. The securitisation structures then typically provide for a revolving period during which the asset pool is replenished on a regular basis by having the SPV acquire additional assets from the originator fulfilling predefined eligibility criteria. The replenishment period is followed by an amortisation phase, during which the notes are amortised over time using the proceeds from the asset pool, unless the originator repurchases the asset pool at the end of the revolving period and the notes are repaid in full using the proceeds from the repurchase by the originator at that time.

Domestic SPVs may take the legal form of a limited liability stock corporation or a limited liability company. The SPVs are either held and controlled by shareholders unaffiliated with, and independent from, the originator and the other transaction parties (i.e., orphan SPVs) or structured as (direct or indirect) subsidiaries of the originator; in each case depending on the specific needs and goals of the originator and corresponding requirements in this respect from an accounting perspective in view of potential derecognition and deconsolidation.

In addition to the arrangers and managers who are typically involved in structuring the securitisation transaction, transaction parties in Swiss securitisation transactions regularly include asset and corporate servicers for the SPV, security and note trustees, cash managers, account banks and further third-party service providers.

As outlined above, covered bonds have historically been the preferred instrument of issuers in Switzerland to make use of their mortgage loan portfolios, rather than securitising these mortgage loan portfolios in (true sale) transactions. Covered bond transactions in Switzerland are usually structured with one bankruptcy remote SPV incorporated as a subsidiary of the issuer and acting as guarantor of the payment obligations of the issuer under the covered bonds. The collateral to cover the guarantee is provided by the issuer, which in recent transactions in the Swiss market consisted mainly of residential and commercial mortgage loans and more recently also auto lease receivables. Typically, a certain level of over-collateralisation will be required to be maintained by the issuer during the lifetime of the covered bond. Unlike in (true sale) securitisation transactions, the collateral is, however, not sold but rather transferred for security purposes to the guarantor. The covered bonds are usually issued under a programme and publicly placed and listed or privately placed, whereby the proceeds from the issuance of the covered bonds are normally used for the general business purposes of the issuer. Similarly to securitisation transactions, the arrangers and managers are normally involved in the structuring, whereby additional transaction parties include servicers for the guarantor, the note trustees, the bondholder's representative, account banks, asset monitors and further third-party service providers.

II REGULATION

Switzerland has not enacted any specific primary legislation covering securitisation (or covered bond) transactions. Instead, securitisation transactions in Switzerland have been developed and are structured under the general legal and regulatory framework available, such as the Swiss Code of Obligations (e.g., relating to the formation of the SPV and the transfer of receivables and assets), the Swiss Civil Code (e.g., relating to security interests), general capital market regulations and regulatory and tax laws.

i No risk retention rules

As a consequence, Swiss law does not provide for any risk retention rules for the originator, sponsor or other transaction parties in the context of securitisation or covered bond transactions. Furthermore, Article 6(1) of the Regulation (EU) 2017/2402, relating to simple, transparent and standardised securitisations (EU Securitisation Regulation), has been neither adopted by Switzerland nor transposed into Swiss law. Nonetheless, in the past, a number of Swiss public asset-backed security (ABS) transactions have been structured to provide for the originator to retain, on an ongoing basis, a material net economic interest in the transaction of at least 5 per cent (or any higher amount as provided for in the EU Securitisation Regulation) in order not to negatively affect a potential placement of the notes with EU investors.

ii Regulatory aspects and licensing requirements

There is no specific securitisation legislation or legislation on covered bonds in Switzerland, and therefore there are no licensing requirements per se for originators, SPVs, issuers and servicers. However, every transaction needs to be analysed and structured carefully on a case-by-case basis in view of general regulatory and licensing requirements under applicable financial market regulations, including the Swiss Federal Banking Act, the Swiss Federal Collective Investment Schemes Act and Swiss anti-money laundering regulations. Depending on the receivables and assets being securities or used as collateral for a covered bond and the regulatory status of the originator, further regulations may be of relevance, including (but not limited to) the Consumer Credit Act (e.g., credit card receivables or retail auto lease receivables being securitised), the Federal Law of 16 December 1983 on the Acquisition of Real Estate by Persons Abroad (Lex Koller) (e.g., residential mortgage loans being securitised or used as collateral for a covered bond) or the Insurance Supervisory Act (in the case of licensed insurance companies acting as transaction parties).

Regulatory treatment under the Swiss Federal Banking Act and the Swiss Federal Collective Investment Schemes Act

The unanimous view of legal doctrine supported by the practice of Swiss Financial Market Supervisory Authority (FINMA) has been that a special purpose company established for the purpose of (true sale) securitisations would not be characterised as either a bank under the

Swiss Federal Act on Banks and Savings Banks (BA), or as a collective investment scheme under the Swiss Federal Collective Investment Schemes Act (CISA). These conclusions are supported by the fact that such securitisation entities:

- refinance through the issuance of publicly or privately placed notes complying with the applicable prospectus regulations; and
- are not conducting investment activities but rather financing activities. Similarly, also, SPVs acting as guarantors under covered bond transactions are typically not required to obtain any licence under the BA or CISA.

However, this treatment needs to be carefully analysed and transactions structured accordingly on a case-by-case basis.

Anti-money laundering considerations

In general, financial intermediation undertaken by non-banks is subject to the rules of the Federal Act on Combating Money Laundering and Terrorist Financing (AMLA) and the rules, regulations and administrative guidance from time to time issued by FINMA or the responsible self-regulatory organisation (or both) in this respect.

Under the AMLA, the granting of loans (including consumer credits in the form of credit card loans and auto leasing) and mortgage loans is generally a regulated activity, unless exemptions apply. As a consequence, the originator of such loans will regularly have to comply with the Swiss anti-money laundering rules on an ongoing basis, including know-your-customer rules and the requirement to become a member of a self-regulatory organisation (SRO) in Switzerland recognised by FINMA.

The purchase of receivables, loans or other assets, which had been originated subject to compliance with anti-money laundering regulations on a limited recourse basis by a domestic SPV in the course of a (true sale) securitisation transaction, may require the SPV to itself comply with the AMLA. If compliance with the AMLA has been required for the SPV, such entity will also have to become a member of an SRO and comply on an ongoing basis with its duties under the AMLA, which will regularly be delegated to a third-party servicer (such as the originator). However, Swiss public ABS and covered bond transactions have regularly been structured in a way that the SPV is not considered to conduct financial intermediation subject to compliance with the anti-money regulations, but this needs to be analysed and structured on a case-by-case basis.

Consumer Credit Act

The granting of consumer credits (including under credit cards and auto leasing) is governed by the Consumer Credit Act (CCA) and lenders, providing consumer credits on a professional basis are generally subject to licensing requirements thereunder. Originators who are active in the consumer credit business are thus regularly licensed under the CCA, unless exemptions apply, such as for captive service providers. When a securitisation transaction involves receivables that are subject to the CCA (such as certain auto lease receivables or credit card receivables), care must be given to structure the transaction in a way that issuer will not require a respective licence.

Lex Koller

In Switzerland, equity and debt investments in non-commercial property by non-Swiss investors are in general subject to statutory limitations under Lex Koller. Transactions that are not in accordance with the Lex Koller regulations are considered null and void.

In particular, the financing of the acquisition by a foreign lender is restricted, if the purchaser or owner becomes particularly dependent on the foreign lender as a result of the following:

- the terms of the mortgage agreement or any side agreement;
- the principal amount of the loan; or
- the financial situation of the purchaser or owner.

A financing is generally regarded as creating a particular dependency from the lender if it is clearly not in line with Swiss market standards.

In securitisation and covered bond transactions involving residential mortgage loans and non-Swiss transaction parties or investors, particular care must be given to structure the transaction in a way that is compliant with the requirements of Lex Koller.

Regulatory confirmations

It is recommended to seek confirmation from FINMA on certain regulatory aspects of a securitisation or a covered bond transaction and the transaction parties involved prior to implementing the transaction (such as confirmation of non-licensing requirement, confirmation that anti-money laundering regulations do not apply, non-consolidation of SPVs, as relevant and applicable).

Similarly, depending on the assets being securitised or used as collateral in a covered bond transaction, further regulatory confirmations may be sought, such as from the competent cantonal authorities in relation to non-licensing requirements under the Consumer Credit Act (e.g., credit card receivables or retail auto lease receivables being securitised) or the exemption from Lex Koller from competent cantonal or communal authorities.

iii Investors

Under Swiss law, there are, in principle, no restrictions for the type of investors that may invest in (publicly or privately placed) ABS notes or covered bonds. However, the financial intermediaries who are involved in the placement of the notes will need to comply with their duties under financial market laws (such as the Financial Services Act (FinSA)), including in relation to the assessment of appropriateness and suitability of such products for the investors, as applicable. Further restrictions apply with respect to the targeting of non-Swiss investors and foreign capital market regulations with which compliance is required, if the notes will also be placed outside Switzerland.

iv Prospectus rules

Under the FinSA that came into force on 1 December 2020, any person offering securities for sale or subscription in a public offering in Switzerland or any person seeking the admission of securities for trading in a trading venue (as defined in the Financial Institutions Act (FinIA)) must first publish a prospectus. Exemptions are available depending on the type of offer, the type of securities being offered and in connection with the admission to trading. The FinSA and the corresponding ordinance (FinSO) have also introduced specific minimal contents for prospectuses depending on the financial instrument being offered or for which admission to trading is sought (including for notes issued in securitisation transactions and for programmes) as well as a new prospectus pre-approval regime, providing for the mandatory pre-approval of a prospectus by a FINMA licensed prospectus review body. Currently, the only two prospectus review bodies licensed by FINMA are BX Swiss AG (the Berne Stock Exchange) and SIX Exchange Regulation AG. Exemptions are available from the requirement to have the prospectus pre-approved before making the public offering, such as in the case of certain debt instruments, where the prospectus may also be approved post-public offering or admission to trading, or both, provided that certain requirements are met (including that a bank, as defined in the Banking Act, or a securities firm, as defined in the FinIA, issues a confirmation that, at the time of publication of the (preliminary) prospectus, the most important information on the issuer and the securities had been known).

v Tax aspects

Bonds and notes issued by a Swiss issuing SPV (or by the Swiss originator in case of a covered bond) qualify as instruments of collective fund raising for Swiss federal withholding tax purposes. Accordingly, interest payments on such instruments, be they periodic or by original issue discount or premium, are subject to the 35 per cent Swiss federal withholding tax. If bonds or notes are issued by a foreign issuing SPV, care must be taken that such issuance is not attributed to the Swiss originator of the assets serving as security of such issuance. Typically, affirmative advance tax ruling confirmations will be sought as to the Swiss federal withholding tax.

If Swiss mortgages serve as cover stock for Covered Bond, RMBS or CMBS transactions, a missing legal link in the security structure needs to be implemented to avoid the interest payments on the bonds and notes issued becoming subject to special cantonal and federal withholding taxes. However, because of ring-fencing of the cover stock and bankruptcy remoteness of the SPV holding the mortgage security, rating agencies have accepted this structure in rated transactions.

There are no specific securitisation rules in Swiss taxation, and therefore transfer pricing should be reviewed carefully, in particular if a Swiss SPV serves as holder of the cover stock or issuer of bonds and notes and if asset servicing remains with the originator. However, the range of income to be earned by a Swiss SPV is quite settled in practice and the competent tax authorities are willing to confirm this in advance of tax ruling confirmations.

Swiss VAT, although the rate is currently only at 7.7 per cent (and will increase to 8.1 per cent as per 1 January 2024), is a concern in several respects that should be looked at carefully. In general, asset servicing triggers Swiss VAT. If the Swiss SPV holding the cover assets is not registered for VAT purposes (and is not part of the VAT group of the Originator), which is the usual set-up, such VAT charge comes as a leakage and extra cost factor. If VAT-charged receivables are transferred to an SPV, such transfer may trigger an acceleration of the tax point for VAT purposes. Furthermore, the originator may be denied bad debt relief for non-performing receivables transferred. If future receivables are transferred at a time when the tax point for VAT purposes has not yet been reached, a potential secondary joint liability of the acquiring SPV with the transferring originator may arise. If planned and arranged carefully, these traps can be avoided and comfort can be sought by affirmative advance tax ruling confirmations from the competent tax authorities. Accordingly, although there is no specific securitisation legislation in the tax field in place, comfort can be sought and is available if structured carefully.

III SECURITY AND GUARANTEES

In securitisation transactions in Switzerland, it is common that the SPV grants a comprehensive security package over its assets, in addition to the (exclusive) indirect access that the investors have to the assets held by the SPV based on the bankruptcy remoteness analysis applicable to the SPV. Such a security package regularly includes the underlying receivables, the claims under the transaction agreements and the bank account claims. By contrast, covered bond transactions are typically structured in a way that the cover pool assets are already provided to the guarantor for security purposes only, so that no additional security will be created over these in favour of a security agent.

i Typical security interests

Security over the underlying receivables and claims under the transaction agreements is typically created by way of an assignment for security purposes. To perfect such an assignment, a written security assignment agreement and a written assignment declaration is required, detailing the receivables and claims to be assigned. Notification of the underlying debtors is not a perfection requirement under Swiss law. However, as long as the underlying debtors have not been notified of the assignment, they may continue to validly discharge their obligations towards the assignor and, in the event of a bankruptcy of the assignor, such payments will fall into the bankruptcy estate of the assignor until the underlying debtors have been notified. Furthermore, it is not required to register the assignment in any sort of (public) register in order for perfection of the security assignment over the receivables and claims that are typically assigned in securitisation transactions.

Bank account claims are treated under Swiss law as claims from the bank account holder against the account bank, and security interests over these bank account claims are created either by way of an assignment for security purpose or a pledge, requiring in each case a written security agreement. Notification of the account bank is not a perfection requirement under Swiss law for an assignment for security purposes, but it is regularly required for the perfection of a pledge because of the priority liens that account banks in Switzerland customarily have over the bank accounts under their general terms and conditions. However, for security assignments it is also standard procedure to notify the account banks of the assignment. Furthermore, the security agreements relating to the bank accounts are typically supplemented by cash control agreements entered into between the account bank, the issuer, the cash manager and the security trustee, to further detail the operational aspects of managing the issuer's bank accounts.

When mortgage claims form part of the assets to be securitised (or of the cover pool for a covered bond), particular care must be given in analysing and structuring potential security interests on a case-by-case basis, given that interest payments, which are secured by Swiss real estate to creditors outside Switzerland, may be subject to cantonal and federal withholding taxes. In addition, the transfer of security interests securing such mortgage claims from the originator to the SPV may require additional perfection steps, such as the transfer of possession of mortgage notes (for paper mortgage notes) or the registration of the acquirer in the competent public land register (for a transfer of full legal title in paperless mortgage certificates).

ii Role of the security trustee

As Swiss law does not provide for the concept of a security trust and, to mitigate potential insolvency risks in connection with the security agent or trustee, the security structure for securitisation transactions normally provides for a security trustee who holds the security under an English law-governed trust in favour of the noteholders and the other secured parties, as well as if the assets and the security agreements are governed by Swiss law. Depending on whether a Swiss law security interest is considered to be accessory in nature, the security trustee will then hold such security interest either as direct representative in the name and for the account of the noteholders and the other secured parties (in case of Swiss law accessory security interests, such as pledges), or as fiduciary in his or her own name but for the benefit of the noteholders and the other secured parties (in the case of non-accessory Swiss law security interests, such as security assignments).

iii Claw-back provisions

The general claw-back regime provided under Swiss insolvency laws also applies to domestic securitisation structures. As a consequence, in the case of the Swiss SPV being adjudicated bankrupt or being liquidated (except on a voluntary basis), the insolvency official or, under certain conditions, creditors of the Swiss SPV, may challenge the entering into of the relevant agreements and the performance of any obligation thereunder by the Swiss SPV, subject to the conditions of Articles 285 et seqq. of the Swiss Debt Enforcement and Bankruptcy Act (DEBA) being satisfied. Articles 285 et seqq. DEBA provide that a transaction may be subject to challenge:

- if no consideration, or its equivalent, is given ('transaction at an undervalue' as described in Article 286 of the DEBA);
- if the party granting security or discharging a debt was over-indebted ('voidability for over-indebtedness' as described in Article 287 of the DEBA); or
- if a party had the intention to disfavour or favour certain of its creditors or should reasonably have foreseen such a result and this intention was or must have been known to the receiving party ('preference' as described in Article of the 288 DEBA).

With respect to (a) and (c) for transactions with related parties, such as group companies, the burden of proof is reversed and the challenged parties have to prove the adequacy of the challenged transaction.

IV PRIORITY OF PAYMENTS AND WATERFALLS

In Swiss securitisation transactions, the priorities of payments are contractually agreed among the transaction parties, which create a contractual subordination, leading to tranching on the level of the different classes of notes issued by the issuer. Swiss securitisation transactions typically include a pre-enforcement and a post-enforcement waterfall, whereby the transaction documents specify the trigger events, leading to the application of the post-enforcement priority of payments. The administration and management of the cash receipts and the periodic payments in accordance with the applicable waterfall are then typically delegated by the issuer to a third-party cash manager.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

In Swiss (legal) true sale securitisation and covered bond transactions, isolation of assets is achieved by legally transferring the assets to be securitised (or that serve as collateral for the covered bond) from the originator to a bankruptcy remote SPV. The means of perfecting the transfer depends on the specific nature of the receivables and assets, whereby in certain cases not only the receivables, but also the underlying agreements giving rise to the receivables, are transferred to the SPV, in light of the jurisdiction of the Swiss Federal Supreme Court on the bankruptcy remoteness of the transfer and assignment of future receivables.

i SPV bankruptcy remoteness

Bankruptcy remoteness for Swiss SPVs is generally achieved by a combination of limiting the corporate purpose of the SPV, limited recourse and non-petition provisions that are included in the transaction documents to which the counterparties to the SPV are bound and supporting covenants, representations and warranties of the SPV in the transaction documents. The limitation of the corporate purpose is achieved by implementing certain restrictions on the SPV's corporate purpose in its articles of incorporation, such that any action not related to the scope of the specific transaction under the transaction documents would be *ultra vires*. Furthermore, all counterparties to the SPV are asked to sign up to the waiver of set-off provisions.

Given the set-up, structuring and operation of the SPV as a special purpose vehicle, it is expected that there will regularly be no relevant creditors other than the transaction parties (who have signed-up to the limited recourse, non-petition and waiver of set-off provisions in the transaction documents) and the tax authorities (from which typically affirmative advance tax ruling confirmations will be sought as to the taxation of the SPVs).

Furthermore, under Swiss corporate and bankruptcy laws, the bankruptcy of a shareholder of the SPV will not lead to the bankruptcy of the SPV, but such shares will be part of the shareholder's bankruptcy estate. Thus, a bankruptcy of a shareholder of the SPV (in its capacity as shareholder) would not legally affect the SPV's contractual obligations under the transaction documents. In addition, a bankruptcy of a shareholder of the SPV would not result in the consolidation of the shareholders' and the SPV's assets and liabilities, as there is no concept of substantive consolidation under Swiss law (subject to exceptional cases, including fraud or abuse of rights).

ii Commingling risk

Commingling of the collections under the securitised receivables is regularly considered to be a risk in Swiss securitisation transactions because of Swiss bankruptcy laws, under which collections that are held in the bank account of the originator or servicer would form part of the originator's or servicer's bankruptcy estate, unless such collections had been previously swept into the SPV. Commingling risk in Swiss securitisation transactions is typically addressed by providing for short time periods for sweeping the collections to the collection account of the SPV and implementing notification triggers that provide for the notification of the debtors to pay directly to the collection account of the SPV well ahead of a potential bankruptcy of the originator. Further risk mitigators for commingling risk may include the appointment of a servicer facilitator or a back-up servicer and the implementation of commingling reserves.

VI OUTLOOK

i Specific legislation

No legislation or regulatory projects specifically related to securitisation or covered bond transactions have been publicly announced in Switzerland for the coming year.

ii Securitisation market in general

Overall, the securitisation market in Switzerland is expected to remain stable with respect to traditionally securitised asset classes. In addition, given the overall growing volume of residential and commercial mortgage loans in Switzerland, it is expected that the number of securitisation transactions in Switzerland involving mortgage loans will also increase and supplement the growing number of covered bond transactions in this field.

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Chapter 9

United Arab Emirates

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Summary

I OVERVIEW

Securitisations are a viable alternative source of funding for financial institutions and corporates in the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (Saudi Arabia), but the take-up remains slow. The scarcity of securitisations in the region is driven by a number of factors, including:

- the existing legal environment (e.g., a lack of legal certainty with respect to enforcement of contracts and security);
- plentiful liquidity within many financial institutions (e.g., banks in Saudi Arabia have good liquidity – typically funded by current account deposits on which they pay little or no return to customers – and they hold to maturity the financial products they originate rather than securitising them);
- financial institutions are smaller and do not face the same concentration risk issues compared with the larger international financial institutions;
- the investor base is more focused on sponsor creditworthiness (rather than the creditworthiness of a segregated pool of assets and related cash flows);
- that same investor base has a need to acquire *shariah*-compliant (and not conventional) securitised products, which can be more complicated and expensive to structure; and
- the requirement for any person who wishes to provide financing to be licensed (i.e., the activity of lending is in general prohibited unless the person doing the lending has the requisite licence).

Instances where material securitisations have been successfully bought to market in the UAE and Saudi Arabia include HANCO Rent A Car (Saudi Arabia 2004), Tamweel ABS Sukuk (2005), Kingdom Instalment Company (Saudi Arabia 2006), Tamweel ABS Sukuk (UAE 2007), Sun Finance Sukuk (UAE 2009), such securitisations taking place either before or shortly after the global financial crisis and, since that time, few large-scale securitisations have come to market. More recently, the Tata Group securitised receivables from 11 African subsidiaries of Tata International Limited (India) and Tata International Singapore Pte Ltd through a special purpose vehicle established in the ADGM (defined in Section II) and in 2023, Goldman Sachs backed Saudi Arabian buy-now pay-later business Tamara with a receivables warehouse facility. The impact of the covid-19 pandemic forced companies in the UAE and Saudi Arabia to look again at how they finance their working capital. Monetising receivables whether by way of a securitisation or a more traditional receivables purchase agreement (with or without recourse) is a viable way to raise liquidity as proven by the Tata Group securitisation and the Goldman Sachs financing. The rise of (1) buy-now-pay-later companies in the Middle East and (2) other providers of alternative credit has resulted in further interest in securitisation as such businesses look for ways to finance themselves. The rise of alternative financing has been driven in part by changes to the regulatory environment, including access to fintech sandboxes and new private credit regimes in the DIFC (as defined below), the ADGM and Saudi Arabia.

The securitisations that are currently being undertaken in the UAE and Saudi Arabia are on a smaller scale (US$10 million to US$50 million) and are typically being privately placed. Examples include financial institutions securitising pools of financial products they have originated, with the notes (which are called *sukuk*) placed privately, in many instances with high-net-worth individuals who are customers of the financial institutions' private wealth management arms. The privately placed notes (or *sukuk*) are not rated and the financial products (that have been securitised) will typically continue to be serviced by the financial institutions that originated them.

It is also not uncommon for financial institutions in the UAE and Saudi Arabia (in particular banks) to acquire receivables from the originators of those receivables (e.g., automobile lease receivables). A leasing company will originate lease receivables, which are then acquired by a bank (often on a non-recourse basis). Because banks are prepared to acquire such receivables, there is no business case for setting up securitisation programmes.

Because many of the financial institutions in the UAE and Saudi Arabia operate on a *shariah*-compliant basis and because those same financial institutions are often the investors who participate in regional securitisations, most securitisations in the region are structured on a *shariah*-compliant basis. This requires the issuer of the notes (or *sukuk*) to own a pool of tangible assets (not intangible assets, such as receivables). The holders of the *sukuk* own an undivided interest in that pool of tangible assets with returns generated by that pool of tangible assets funding coupon and principal payments to the *sukuk* holders. To understand the material difference between a *sukuk* offering and the offering of notes in a conventional securitisation programme, take as an example the securitisation of a pool of residential mortgages. Many residential mortgage programmes in the UAE and Saudi Arabia are structured on a lease-to-own basis: the financial institution owns the property, which it leases to its customer; the rent payable under the lease provides the financial institution with the repayment of its capital (equivalent to loan principal) plus a financing return (equivalent to interest); and upon the final capital payment, the financial institution transfers the property to its customer. To securitise such a residential mortgage programme in accordance with *shariah* principles, the entity that issues the *sukuk* must own the properties that are the subject of the leases (therefore the financial institution has to transfer the properties to the issuer as part of the securitisation). The *sukuk* holders then own an undivided share in the properties and the returns generated from leasing the properties are used to fund payments under the *sukuk*. Payments to *sukuk* holders are generated by tangible assets, which distinguishes a *sukuk* offering from an offering of conventional notes (which typically rely on a pool of receivables to fund payments to noteholders).

There have been some recent legal developments in the UAE and Saudi Arabia that should make it easier to structure securitisations in that the procedure for taking, perfecting and enforcing security has seen some recent positive developments and new laws on insolvency have been enacted in both the UAE and Saudi Arabia.

Finally, while the issuance of *sukuk* in Saudi Arabia and the UAE remains robust, nearly without exception those *sukuk* issuances are asset based and not asset backed and therefore those issuances do not involve the securitisation of pools of assets (i.e., securitisations may involve the issuance of *sukuk*, but not all *sukuk* issuances are securitisations). In an asset-based *sukuk* issuance, the holders of the *sukuk* are ultimately looking to the originator of the *sukuk* for repayment, and not to the assets of the underlying *sukuk* programmes. Of the more than 60 *sukuk* traded on Nasdaq Dubai, all are asset based (and not asset backed) and most include provisions that restrict *sukuk* holders from enforcing rights against specific assets of the originator. Enforcement rights are limited to enforcing contractual rights. Therefore, if *sukuk* holders wanted to enforce against the assets of the originator, they would first have to obtain a judgment for damages, resulting from a breach of contract by the originator, and then use that judgment to attach the assets of the originator.

II REGULATION

A majority of the large-scale securitisations in the region (specifically transactions seeking to attract investors from outside the region) have been structured, in part, through either the Dubai International Financial Centre (DIFC) or the Abu Dhabi Global Market (ADGM), and the issuing vehicles have typically been incorporated in the Cayman Islands (the issuing vehicle for the Tata Group securitisation was set up in the ADGM, see Section I).

The DIFC and the ADGM are free zones within the UAE that have adopted laws aligned with English common law and whose courts have their own jurisdiction. The DIFC and ADGM are commonly referred to as offshore jurisdictions (notwithstanding the fact that they sit within the UAE).

The driver behind structuring as much of a securitisation transaction as is possible in the DIFC or the ADGM is to gain access to legal systems that international investors are more familiar with (i.e., the English common law system). Having transactions governed by laws aligned with English law provides greater certainty and makes it more straightforward for clear legal opinions to be provided (e.g., with respect to the true sale of an asset and the enforcement of security), which in turn provides the necessary comfort to rating agencies and international investors.

However, moving transactions into the DIFC or the ADGM does in some cases lead to tax issues, specifically in relation to withholding tax. For example, incorporating an issuing vehicle in the DIFC that is reliant on an income stream from Saudi Arabia to fund payments to *sukuk* holders will trigger a 5 per cent withholding tax on certain types of payments made from Saudi Arabia to the DIFC, and this has to be priced into any transaction. Similarly, in the case of transfer taxes, if assets such as real estate have to be transferred as part of the securitisation programme (which is often the case with any *shariah*-compliant securitisation programme), that may result in transfer taxes.

A further issue that has to be factored into securitisations in the region is that if they are to be structured on a *shariah*-compliant basis, the issuing vehicle must have an ownership interest in the underlying assets (tangible assets) (see Section I). Both the UAE and Saudi Arabia have laws restricting foreigners from owning certain assets (e.g., land unless it is in a designated area), which means any assets transferred to the issuing vehicle may not be able to be owned by foreigners (either non-nationals of a particular country, such as the UAE, or non-nationals of a Gulf Cooperation Council country). Therefore, unless the securitisation transaction is structured in a particular manner (or the assets owned by the issuer are not subject to foreign-ownership restrictions), the persons able to acquire the *sukuk* will be limited (i.e., the owners of the *sukuk* are deemed to own an undivided share in the assets of the issuing vehicle, but if the assets are of a type whose ownership is restricted to a certain class of persons, only persons of that restricted class will be able to own the *sukuk* – unless the *sukuk* is properly structured).

One final issue to be considered with any securitisation programme in the region is whether the issuing vehicle will require a special licence to be able to acquire the financial products being securitised. In the UAE and Saudi Arabia, both the lending of money and the taking of deposits are regulated activities, and therefore if the issuing vehicle is held to be in the business of lending (because it owns a portfolio of residential mortgages), it may have to be licensed to be able to conduct that activity. In practice, however, that does not appear to be the case (e.g., the issuing vehicle in the recent Tata Group securitisation, which acquired receivables, was not required to be licensed). Because of the regulatory regime in the UAE and Saudi that, as a general rule, restricts lending to entities that have the requisite licence, structured finance solutions may provide an alternative. For example, notes or *sukuk* issued by a special purchase vehicle that uses the proceeds to acquire a pool of receivables originated by a third party, such an arrangement (provided it was approved by the applicable regulatory authority in the UAE or Saudi Arabia) should enable the issuer to become the owner of the receivables but without the requirement to have a lending licence. The regulatory landscape with respect to the lending of money is changing, however. The DIFC, the ADGM and Saudi Arabia now have their own private credit regimes which enable funds established in those jurisdictions to enter into financing transactions subject to the conditions of the new regimes. A recent development in Saudi Arabia has been the introduction of the Rules for Special Purpose Entities issued by the Board of the Saudi Capital Market Authority. Capital Market Institutions (persons authorised by the Saudi Capital Market Authority) are now able to apply to set up a special purpose entity which can be used for amongst other matters to issue *sukuk*. The special purpose entity is likely to become a more common vehicle for issuing *sukuk* that have a Saudi Arabian originator (i.e., some of the drivers to set up an issuer in say the Cayman Islands or the ADGM have become less obvious because it is now possible to set up an entity in Saudi Arabia which can issue *sukuk*).

III SECURITY AND GUARANTEES

Historically the taking of security and the provision of guarantees in the UAE and Saudi Arabia has not been straight forward and security packages have typically been limited to mortgages over land and personal guarantees (with security over other types of assets and corporate guarantees having been viewed as being of limited value). Until recently most security had to be granted in favour of a financial institution licensed in the jurisdiction of the *situs* of the asset subject to the security, and enforcement of security was a court-sanctioned process (i.e., self-help remedies, such as a sale at a public auction arranged by lender or its nominee outside court, were not available). Further issues that have caused problems have included the inability to take security over a floating pool of assets (such as cash in a bank account, receivables and inventory) and the lack of any procedure for perfecting security.

Because of the issues around taking a robust security package, it has not been uncommon for lenders to require all or a part of a transaction to be structured through the DIFC or the ADGM to obtain access to a better security package. For example, take the case of a limited liability company incorporated in onshore UAE or Saudi Arabia (Opco) that requires financing. The lender, as a condition to providing the financing, may require the owners of the business to swap their shares in the Opco for shares in a DIFC holding company (with the DIFC holding company then acquiring the shares in the Opco). The lender will then require the owners of the business to grant English law security over their shares in the DIFC holding company. Following the restructuring, the lender will have a good security package over the shares in the DIFC holding company (which can be enforced outside a court-sanctioned process) even if its onshore security package (such as a pledge over the shares in the Opco) contains some weaknesses.

However, some of the perceived weakness of UAE and Saudi Arabian onshore security packages (specifically in relation to taking security over moveable property) have been addressed through Federal Law No. 4/2020 on Guaranteeing Rights Related to Movables (which replaced and repealed UAE Federal Law No. 20/2106 on Mortgaging of Movable Assets as Security for Debt) (the UAE Mortgage Law) and Saudi Arabia Royal Decree No. M/86 (as amended in 2019 and April 2020) and the Law on Securing Rights with Moveable Assets and implementing regulations of April 2020 (together the Saudi Mortgage Law).

The UAE Mortgage Law and the Saudi Mortgage Law now make it possible to take security over fluctuating pools of assets, and security can be granted in favour of unlicensed financial institutions. The UAE Mortgage Law and Saudi Mortgage Law also set out a process for enforcing security outside a court-sanctioned process; for example, in the UAE it is now possible to enforce security over a bank account without having to resort to a court-sanctioned process. While a lender could exercise a right of set-off, there had always been some doubt as to whether exercising such a right was a self-help remedy and therefore prohibited, but that doubt has now been removed by the UAE Mortgage Law.

Both the UAE Mortgage Law and the Saudi Mortgage Law provide a procedure for perfecting security interests (by registering the security in a public register). The registration (perfection) of security has become more important following the implementation of new insolvency laws in both the UAE and Saudi Arabia, as failure to perfect security will now mean that the security will be void against the bankruptcy trustee in any insolvency process.

The developments in the area of taking security over fluctuating pools of assets (such as cash in a bank account and receivables) can only help with structuring securitisation transactions provided such security is consistently upheld by the courts in an insolvency.

Trusts are not recognised in Saudi Arabia or the UAE, and, therefore, it is not possible to grant security over assets in favour of a trustee who would then hold those assets on trust for a group of beneficiaries (such as a group of lenders or *sukuk* holders). Instead of a trustee being appointed to hold such assets, a lending syndicate will typically appoint an agent to hold those assets and communicate with the borrower. However, what remains unclear in both the UAE and Saudi Arabia is whether that agent can prove in the insolvency of the borrower. Because the agent is not actually owed any money by the borrower, what right does it have to prove in the insolvency of the borrower? It is therefore not uncommon to see parallel debt language in UAE and Saudi Arabian financing documents. This language states that the borrower owes a debt to both the lending syndicate and the agent; as the debt to the lending syndicate is paid down, the debt owed to the agent is automatically deemed to be paid down and vice versa. If the agent had to prove in the insolvency of the borrower, it could point to the fact it is owed an independent debt and on that basis argue that it has a right to prove in the insolvency of the borrower (any amounts paid to the agent as part of the insolvency process would automatically discharge a corresponding amount of the debt owed by the borrower to the lending syndicate, therefore the borrower would never be in a position of having to pay the debt twice – once to the agent and once to the lending syndicate).

IV PRIORITY OF PAYMENTS AND WATERFALLS

New insolvency laws have recently come into force in the UAE and Saudi Arabia. Federal Decree-Law No. 9/2016 (the UAE Insolvency Law) and Saudi Royal Decree No. M16/1416 H (the Saudi Arabia Insolvency Law) have both made material changes to the corporate insolvency regime.

The Saudi Arabia Insolvency Law is being used by distressed debtors to restructure their businesses and a number of insolvency cases are now being heard by the Saudi courts. The uptake in the use of the UAE Insolvency Law by debtors in the UAE has been slower (this may be due to many businesses in the UAE being owned by expatriates, often such business owners will leave the UAE (because they may have written cheques, which, if dishonoured, enables the beneficiary of the cheque to file a criminal complaint) rather than work through a restructuring). However, the recent approval of a restructuring plan under the UAE Insolvency Law for the KBBO Group overseen by the UAE courts will hopefully serve as a useful road map for further successful restructurings in the UAE. The primary purpose of both the UAE Insolvency Law and the Saudi Arabia Insolvency Law is to provide a debtor facing financial distress with a period in which to restructure its business and put it on a more secure footing. These laws provide for a moratorium during which time creditors are unable to take enforcement action against the debtor (including a moratorium on secured creditors taking enforcement action without the consent of the courts). The Saudi Arabia Insolvency Law and the UAE Insolvency Law do not apply in the DIFC or the ADGM, which have their own insolvency laws. NMC Healthcare (a London-listed healthcare provider whose principal business is in the UAE and Saudi) successfully applied for an administration order that covers its UAE business. Notwithstanding the companies that went into the ADGM administration were not established in the ADGM, the ADGM courts accepted the administration application after the companies continued as ADGM companies following an application to the ADGM Companies Registrar. The NMC administration has proved to be a success and may set a precedent for restructuring UAE businesses facing financial difficulty (it is likely NMC chose the ADGM as the jurisdiction to handle its restructuring because it saw the insolvency regime in the ADGM as being more favourable to it, which in turn led to a more successful outcome for the business).

The importance of taking security and ensuring it has been perfected has now become more important because the new insolvency laws, as you would expect, protect the interests of secured creditors, with secured creditors ranking ahead of all other creditors under both insolvency regimes. The Saudi Arabia Insolvency Law and the UAE Insolvency Law both contain provisions to deal with transactions entered into by a debtor prior to the onset of insolvency, with the courts having the power to unwind certain transactions (such as transactions at an undervalue and the granting of security during a time when the grantor was insolvent). Therefore, transactions entered into by a debtor and an issuing vehicle as part of any securitisation transaction will be subject to the provisions in the new insolvency laws and the provisions relating to the unwinding of transactions.

While it is common to structure all or part of a transaction in the DIFC and ADGM (because of the legal certainty that brings, including in connection with matters relating to insolvency and in what circumstances a transaction can be unwound), that is not always going to be possible, and it adds cost and complexity to a transaction. Furthermore, it will not be possible in all circumstances to structure transactions through the DIFC or ADGM. For example, if assets are to be sold by an onshore UAE limited liability company (the originator) to a DIFC company (the issuer) as part of a securitisation programme, the sale agreement will typically be governed by UAE law and will be subject to the laws of the UAE (including the UAE Insolvency Law as it relates to unwinding transactions).

The new insolvency laws in the UAE and Saudi Arabia, the new laws relating to the taking of security and the Saudi Arabia Civil Transactions Law due to come into force later in

2023 (which provides some clarity with respect to the transfer of rights) provide more certainty when structuring transactions in onshore UAE and Saudi Arabia (including securitisation programmes).

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

One of the critical components of any securitisation programme is ensuring that the pool of assets that will be used to fund payments to note holders (or, as the case may be, *sukuk* holders) will not form part of the estate of the originator of the securitisation programme in the event of insolvency. Following the introduction of new laws relating to insolvency and the taking of security in both the UAE and Saudi Arabia, there is now much greater certainty around what will and what will not form part of the estate of an insolvent entity.

In the UAE and Saudi Arabia, the most robust method of transferring rights or assets from one person to another person is a tripartite agreement. For example, an assignment of rights (such as a right to receive payment from a debtor under a contract) is typically documented under a tripartite agreement between seller, buyer and debtor. If the underlying agreement (governing the rights being assigned) does not contain a prohibition on assignment, then the consent of the debtor will not be required and, provided the debtor is not required to pay to the buyer (i.e., the seller continues to service the agreement that is the subject of the assignment), then no notice will have to be served on the debtor.

Notwithstanding the passing of new laws in the UAE and Saudi Arabia with respect to insolvency and security, it remains common for issuing vehicles to be incorporated in the DIFC, ADGM or the Cayman Islands. While it is certainly possible to incorporate bankruptcy-remote vehicles in onshore UAE and Saudi Arabia, there are challenges; the most obvious one being that for a UAE limited liability company, 51 per cent of the shares in such an entity must be owned by a UAE national; however, recent changes to the law in the UAE mean that it is now possible for many UAE entities (subject to the sector in which the entity is operating) to be 100 per cent foreign owned. Similar restrictions apply in Saudi Arabia. For that reason, setting up an entity owned by a purpose trust or charitable trust (the typical shareholder of an issuing vehicle in a securitisation programme) will not be possible. It is for that reason that issuing vehicles are set up offshore (i.e., in the DIFC, ADGM or the Cayman Islands). The other advantage of having the issuing vehicle incorporated in a common law jurisdiction is that a trust can be created over the assets of that vehicle for the holders of the notes (or, as the case may be, the *sukuk*). But note the comments above with respect to special purpose entities in Saudi Arabia; these entities will now be able to serve as ***sukuk*** issuers (the SPE regime was originally established because it was not possible for a Saudi Arabian company to issue debt instruments; however, that is now possible following the coming into force of the new Companies Law, notwithstanding this change, it is likely SPEs will be used for ***sukuk*** issuances).

Therefore, a typical securitisation structure in the UAE involves assets being transferred by an originator (in onshore UAE) to an entity incorporated in the DIFC or the ADGM (in offshore UAE). That transfer would typically be documented under a sale and purchase agreement (or an absolute assignment). That sale and purchase agreement (or assignment, as applicable) will now be subject to the UAE Insolvency Law (see Section IV).

A similar structure would also be possible for a Saudi Arabian securitisation (i.e., a sale of assets by a Saudi originator to a DIFC or ADGM issuing vehicle); however, the issue of withholding tax would have to be considered. Certain payments made from Saudi Arabia to the DIFC or the ADGM will be subject to withholding tax (unless the issuing vehicle can obtain Saudi Arabian tax residency, in which case the withholding tax would not apply).

Jurisdiction

It has become common for all or parts of a transaction in the UAE and Saudi Arabia to be structured in the DIFC or the ADGM for the reasons that have been set out in this chapter.

Because the assets that back a securitisation will typically have been originated onshore (i.e., outside the DIFC and ADGM), there is always going to be onshore risk factored into any securitisation programme. For example, any residential mortgage programme that is securitised will have customers (borrowers) who are onshore and the property (over which the mortgage is granted) will also be onshore. Therefore, any enforcement of security and related recoveries will be subject to the laws of the UAE (or Saudi Arabia, as the case may be).

Local investors have a better appetite for securitisation structures where local law risk is more pronounced (i.e., they are more comfortable with the onshore risk). However, that mentality is often driven by the perceived creditworthiness of the originator of the securitisation programme. For example, where a financial institution securitises financial products and sells the resulting notes (or *sukuk*, as applicable) to high-net-worth individuals who are customers of that financial institution, the high-net-worth individuals are likely to be looking at the creditworthiness of the originator with whom they have a relationship (even if they are going to get repaid solely from the financial products that have been securitised). Privately placed securitised products are also bought up by regional banks and, again, those banks are less inclined to have an adverse reaction to the local law risk because they operate in the local market and understand the risks better. What looks acceptable to a local investor may not be acceptable to an international investor.

While the DIFC and ADGM remain important jurisdictions for structuring securitisation programmes, the new insolvency and security laws in the UAE and Saudi Arabia, and the new special purpose entities law in Saudi Arabia, should make it more straightforward to structure onshore securitisations that are understood by and acceptable to international investors.

To bring greater certainty in the enforcement of financial transactions, Saudi Arabia has established a number of specialised committees to hear disputes regarding financial transactions. One such committee is the Committee for the Resolution of Securities Disputes and the Appeal Committee for Securities Disputes (the Securities Disputes Committee). The Securities Disputes Committee has been set up to settle disputes relating to the offering of securities. In the event that a dispute relating to the offering of securities comes before the courts in Saudi Arabia, the courts are required to refer the matter to the Securities Disputes Committee. The purpose of these specialised committees (including the Securities Disputes Committee) is to ensure that disputes are settled by judges who have specialised knowledge, disputes are settled quickly and efficiently, and the outcome of disputes become more predictable (i.e., the specialised committees are not going to serve up surprising decisions, which can sometimes occur when a matter is bought before the general courts in Saudi Arabia).

VI OUTLOOK

The legal framework to structure securitisation programmes exists in the UAE and Saudi Arabia.

Recent changes to insolvency and security laws in the UAE and Saudi Arabia, the new special purpose entities regime in Saudi Arabia, together with access to specialised committees in Saudi Arabia (such as the Securities Disputes Committee) to hear disputes related to financial transactions and access to the courts of the DIFC and ADGM, create a positive environment in which to structure the more complicated financial products (such as securitisation programmes).

It is an obvious statement, but a market for securitised products will start to emerge once there is an obvious business case for putting securitisation programmes in place. Specifically, the financing return payable on the securitised notes must be lower than the financing return the originator has to pay to its investors or financiers or there must be some other benefit to the originator.

The covid-19 pandemic has required companies in the UAE and Saudi to look at how they finance their working capital. Receivables financing (including securitisation) is one way for a business to fund its working capital and businesses in the UAE, and Saudi is looking into such financing resolutions. There has also been a rise in buy-now-pay-later lenders and other alternative credit providers who are looking at ways to finance themselves, securitisation being one option.

Another example of a specific sector that may look to securitisation as an alternative form of financing is the sector providing financing for middle-income housing in Saudi Arabia. There is a shortage of housing for middle-income families in Saudi Arabia, and securitisation may have a role in providing financing for building programmes. Finance companies (rather than the banks) could take on the role of providing mortgage finance (perhaps backed by guarantees from the Ministry of Housing), and, in originating loans of this kind, the finance companies might then look to tap into the securitisation market. A set of new laws that came into force in Saudi Arabia in 2012 was intended to promote the growth of the real estate financing sector. These laws provided for the establishment of real estate finance companies, the promotion of a secondary market for real estate loans (including the use of the capital markets to securitise real estate loans) and the option for banks and real estate finance companies to register mortgages over real estate assets. Historically, notaries in Saudi Arabia were reluctant to register mortgages over properties because the registration of a mortgage had connotations of interest-based financing; the notaries, therefore, took the view that registering a mortgage would be in breach of *shariah* principles and did not register mortgages. As a result, banks had to take title to real estate assets to secure any financing. The new law has clarified the position, with mortgages now able to be registered. The new laws have not led to a growth in residential real estate financing. However, with the Saudi Arabian government focused on delivering middle-income housing as part of Vision 2030, this market may start to grow, particularly if the Saudi government (through the Ministry of Housing) is prepared to provide financial incentives to real estate finance companies (such as underwriting a percentage of the financing provided by finance companies).

Other businesses that may in the near future look to securitisation as a form of financing are leasing companies (automobile and aircraft leasing) and toll roads (for which a benchmark has already been set by the Salik Sukuk (UAE 2009)). However, while the banks in the region have liquidity and are prepared to acquire receivables originated by finance companies (such as automobile lease receivables) the incentive to create securitisation programmes will be limited. The market for financial products has to grow such that, in turn, alternative sources of liquidity have to be sourced. At that point, securitisation may become an option for banks and corporates in the UAE and Saudi Arabia.

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Endnotes

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Chapter 10

United Kingdom

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Summary

I OVERVIEW

i Market size

According to publicly available market data, securitisation of assets originated in the United Kingdom (the UK) accounts for a sizable proportion of both European placed and outstanding securitisation issuance, with residential mortgage-backed securities (RMBS) being the most prevalent asset class in both cases.

In reality, the UK securitisation market is wider than the market for securitisation of UK-originated assets described above, as it is common for assets originated in other jurisdictions to be securitised using English law governed structures (as is often the case for pan-European trade receivables and collateralised loan obligations (CLO) transactions) or for securitisation transactions to have some form of UK nexus, for instance through one or more parties being incorporated in England or bank accounts being held in England. Additionally, the UK market has, particularly over the past few years, seen high levels of retained and privately placed securitisation transactions that may not be fully captured in publicly available data.

Despite the challenging macroeconomic backdrop, securitisation activity in the UK has remained at relatively stable levels, in contrast to the market shock caused by the 2008 financial crisis, which resulted in an almost immediate and abrupt drop in the level of new issuance. In fact, many companies are now looking to securitisation and other similar techniques as regular financing tools as part of their funding strategies.

ii Asset classes

The UK securitisation market has been characterised by the continued existence of certain traditional settled transaction structures alongside periods of intermittent activity across various other product classes.

The UK RMBS market is very well established and is built on market practice consolidated over the years. Other product classes, such as consumer finance securitisation (including securitisation of credit card and auto receivables), trade receivables securitisation and commercial mortgage-backed securitisation (CMBS) are also well established.

There has also been a steady level of activity in other specialist product classes over recent years. These include loan portfolio acquisitions, student loan securitisations, whole business securitisations, mobile phone receivables securitisations, intellectual property rights and capital relief trades.

Fintech and the increasing digitalisation of financial services have opened up new opportunities for securitisation, with securitisation of peer-to-peer loans and the establishment of digital origination platforms associated with securitisation programmes now being relatively common.

iii Basic structure

Securitisation usually entails the transfer of a pool of income-generating underlying assets to a special purpose vehicle (SPV) incorporated in England or in another jurisdiction (often in Ireland, Luxembourg, Jersey, the Netherlands or the Cayman Islands) that in turn issues securities to investors, using the issuance proceeds to pay the purchase price for the underlying assets. Effectively, securitisation is a way of monetising the cash flows generated by the underlying assets.

Under English law,[2] the transfer of the underlying assets is usually made using one of the following methods:

- equitable assignment;
- legal assignment; or
- novation.

Other structures reach an effect similar to a transfer of underlying assets through the use of other techniques (e.g., declarations of trust, sub-participation and, in synthetic transactions, guarantees and credit derivatives).

In UK securitisation transactions, provided that there are no contractual restrictions affecting the transfer of the underlying assets, the most common method of transfer is through an equitable assignment of the underlying assets from the seller to the SPV. This method has various advantages, including the fact that the debtor of the underlying asset does not need to be notified of the transfer in ownership (and will typically only be notified after the occurrence of certain events specified in the transaction documentation, which would usually include the insolvency of the seller) and the possibility of transferring any security associated with the underlying receivables without the need to comply with further formalities. This latter point is particularly useful in the transfer of residential mortgage loans, as transfer of the legal title to the residential mortgage loans through a legal assignment would require the transfer of the mortgage collateral securing the residential mortgage loan to be registered with the HM Land Registry and could trigger potential tax liabilities.

II REGULATION

i General regulatory framework

Domestic legislation and regulation

Securitisation transactions governed by English law are subject to specific domestic legislation, including a taxation regime specifically designed to allow securitisation SPVs to achieve a certain degree of tax neutrality.

Moreover, the environment in which most UK securitisations are set is highly regulated, both in terms of its participants (which frequently include regulated financial institutions), the activities performed by parties to the transactions (for instance, servicing activities that are subject to certain regulatory permissions and to specific regulatory regimes applicable to the underlying assets serviced) and the requirements applicable to the issuance of securities or granting of financing.

Additionally, the insolvency regime is of particular relevance to the structuring of securitisation transactions (see Section V). Changes to the UK corporate insolvency regime in 2020[3] had no impact on the majority of UK securitisation structures but have proved to be relevant in relation to the wider universe of corporate entities within a transaction structure.

Securitisation regulation in the European Union and in the UK

Until 31 December 2020 (the date on which the Brexit transition period concluded), securitisation activity in the UK was governed by Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 (the EU Securitisation Regulation). From 1 January 2021, the 'on-shored' version of the EU Securitisation Regulation[4] (the UK Securitisation Regulation) has applied to securitisation activity with a UK nexus.

Although the UK Securitisation Regulation adapted the EU Securitisation Regulation for domestic application in the UK, the changes introduced have been identified as creating a slightly different regime, including: the widening of the definition of 'sponsor' to include both entities located in the EU and outside the EU, the expansion of the jurisdictional scope of the due diligence requirements imposed on institutional investors and the introduction of a parallel simple, transparent and standardised (STS) regime for UK securitisations. In transactions with a cross-border element, some regulatory uncertainties subsist because of overlapping regulation and unclear scope of application.

Securitisation transactions are required to include an element of 'risk retention' – the idea being that a key stakeholder (such as an originator or sponsor) retains at least a 5 per cent interest in the transaction, using one of the methods prescribed in the applicable legislation – the 'skin in the game'. In terms of risk retention structures, the risk retention in UK transactions has, so far, been aligned with the risk retention structures compliant with the

EU Securitisation Regulation. However, divergence may ensue, as final Regulatory Technical Standards on risk retention under the EU Securitisation Regulation will shortly come into force following the European Commission adopting these on 7 July 2023, entailing changes to the EU Securitisation Regulation regime. The Financial Conduct Authority is currently consulting on the required onshoring changes to the final Regulatory Technical Standards which will become part of UK domestic law once enacted by the UK. The FCA consultation paper contains a number of deviations from the final Regulatory Technical Standards such as amendments to facilitate securitisations of non-performing exposures, transfer of risk retention on insolvency and interpretation of the sole purpose test.

The main risk retention structures under the relevant regulations can be summarised as follows:

- retention of a 'vertical slice' of at least 5 per cent of the nominal value of each class of notes issued;
- in revolving pools, retention of an interest equivalent to at least 5 per cent of the nominal value of the underlying assets comprising the revolving pool;
- retention of at least 5 per cent of randomly selected underlying assets;
- retention of a 'first loss tranche' in the transaction, corresponding to the most subordinated class of exposures in the structure amounting to at least 5 per cent of the securitised exposures; and
- retention of a 'first loss exposure' of not less than 5 per cent of every securitised exposure in the securitisation.

The retained material net economic interest should not be split among different types of retainers and should not be subject to any credit-risk mitigation or hedging (although limited carve-outs are available to allow for the financing of the retention piece).

Market practice has developed specific solutions for allowing risk retention in accordance with the above methods and for ensuring dual compliance with US credit risk retention requirements, where applicable. This is typically achieved through retention of an 'eligible vertical interest' corresponding to at least 5 per cent of the nominal value of each class of notes issued and structured as a 'VRR note' or 'VRR loan interest'.

On 11 July 2023, HM Treasury published a near-final version of The Securitisation Regulations 2023 as part of the Edinburgh Reforms which seek to drive growth and increase competitiveness in the UK financial services sector. The draft of The Securitisation Regulations 2023 does not cover a number of topics including due diligence, risk retention disclosure, credit granting and STS securitisations – these areas will be covered under separate rules to be published by the Financial Conduct Authority and the Prudential Regulation Authority, following a series of consultations. We expect further divergence between the UK securitisation regime and the EU securitisation regime in the future as the consultation papers published thus far indicate further consultations planned, in particular with respect to disclosure requirements.

ii Taxation

For most securitisation transactions, it is possible to achieve considerable tax neutrality as significant tax exemptions can be relied on for transactions that present certain typical features. However, a case-by-case analysis is required, particularly in more complex structures or where a strong cross-border element is present.

Corporate income tax

While securitisation transactions are usually structured to achieve tax neutrality, certain taxation considerations apply in the UK, including in relation to structuring the SPV in a manner that minimises the liability of the SPV for corporate income tax.

There is a special corporation tax regime for 'securitisation companies' in the United Kingdom. The Taxation of Securitisation Companies Regulations 2006 (SI 2006/3296) (the 2006 Regulations) was introduced to tax securitisation companies on their actual cash profit, rather than on the accounting profit (to address potential distortions in accounting and tax reporting arising from accounting changes in 2005), ensuring minimal tax leakage from a structure where an SPV incorporated in England is used.

For an SPV to be a 'securitisation company' for the purposes of the 2006 Regulations (as amended by the 2018 Regulations and the 2022 Regulations, each as defined below), certain conditions need to be met, including:

- the securitised assets being considered financial assets for accounting purposes;
- all the cash received by the SPV within an 18-month time period being distributed (except where reserves of cash are required to be retained, for example for credit enhancement purposes); and
- the SPV satisfying certain requirements in relation to the issuance of securities and its status under UK insolvency law.

The Taxation of Securitisation Companies (Amendment) Regulations 2018 (the 2018 Regulations, jointly with the 2006 Regulations, the UK Taxation Regulations) has updated and amended the 2006 Regulations to address the uncertainty regarding the application of certain tax rules to securitisation companies. The changes introduced by the 2018 Regulations include:

- removal of the obligation to withhold income tax in respect of residual payments; and
- revisions to the definition of 'financial assets' (for arrangements made after 6 February 2018) to (among other things):
  - clarify that derivatives whose underlying subject matters include land or shares and loan relationships with embedded derivatives relating to shares or land are included;
  - disregard a small and insignificant proportion of non-financial assets inadvertently included in a portfolio of otherwise qualifying financial assets;
  - exclude securitisation companies from the recovery of unpaid corporation tax provisions; and
  - revise the definition of a 'warehouse company' to allow a warehouse securitisation company to transfer assets indirectly to a note-issuing company or asset-holding company on a securitisation.

A recent reform of the UK Taxation Regulations in 2022 (the 2022 Regulations) has introduced provisions to facilitate 'retained securitisation transactions' (i.e., those in which the securities issued are not placed with third-party investors but acquired by the originator instead) and has amended the requirements that securitisation SPVs only hold financial assets and lower the thresholds required for an SPV to qualify as a 'securitisation company' for the purposes of the UK Taxation Regulations.

General taxation issues, such as potential stamp duty and stamp duty reserve tax on issue or transfer of issued notes and withholding tax and VAT, are also relevant in the context of UK securitisations and should always be considered.

Withholding tax

In the UK, withholding tax generally applies to payments of interest (as at the date of this article, withholding tax is levied at the rate of 20 per cent). It is therefore important to ensure that appropriate withholding tax exemptions apply to all payments within the securitisation structure to avoid tax leakage.

Generally, payments of interest with a UK source may be paid without UK withholding tax where the recipient is either a UK resident company or a non-resident carrying on business in the UK through a branch or agency to which the payment of interest is attributable.

Therefore, if the SPV is located in England, there is generally no UK withholding in respect of the underlying assets. Where payments of interest that arise in the UK are made to a non-UK resident company (including a securitisation SPV), these payments are usually subject to withholding and the SPV will generally have to apply for relief under an applicable double tax treaty. Non-UK resident SPVs that purchase English assets are generally located in Ireland, Luxembourg or the Netherlands, as each of these jurisdictions has a double tax treaty with the UK.

Payments of interest made by an English SPV to non-UK residents can generally (and subject to certain exceptions) only be paid without withholding UK tax where the SPV's securities are listed on a 'recognised' stock exchange and are therefore entitled to benefit from the UK 'quoted Eurobond' exemption.

Stamp duty

Generally, UK transfer taxes (stamp duty, stamp duty reserve tax and stamp duty land tax) are levied only on transfers of shares, real estate and non-standard loans carrying characteristics that the UK legislation has deemed equivalent to equity. There are currently no other stamp duties or transfer taxes applicable to the issue of notes or transfers of receivables in the UK.

iii Other regulatory regimes

Specific regulatory regimes apply to many underlying assets that are securitised. These regimes will continue to apply during the life of the securitisation and will often have a significant impact on the structuring of the transaction and on the ongoing obligations of the parties. Among the most significant regulatory frameworks to take into account are the FCA Mortgage Conduct of Business (MCOB) rules, applying to mortgage loans and the Consumer Credit Act 1974, the Consumer Rights Act 2015 and the rules and guidance contained in the FCA Handbook, notably the Consumer Credit sourcebook (CONC) and, as of 31 July 2023, the Consumer Duty. It is also important to consider data protection legislation, including the Data Protection Act 2018.

Certain transaction parties will also be subject to regulatory requirements set out in the Financial Services and Markets Act 2000 and in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544), such as the requirement for an entity seeking to grant further advances in relation to a mortgage loan to have the appropriate regulatory permissions (although most transactions will effectively deal with this issue by requiring another party in the transaction in possession of all required permissions to make any further advances required under the documentation governing the underlying assets) or, for instance, the potential requirement for the servicer in certain RMBS transactions to be an entity authorised to administer regulated mortgage contracts.

iv Other regulatory concerns

Securitisation transactions involve a significant number of parties and components, often with a cross-border nexus. Therefore, changes in domestic or international regulation relating to commercial transactions in general (or in the interpretation thereof), including data protection and taxation, will potentially impact securitisation transactions.

Securitisation transactions have also been impacted by other market and industry-driven events, such as benchmark reforms, including the reform of the Interbank Offered Rates (IBOR).

From 31 December 2021, no new contracts should reference the GBP London Interbank Offered Rate (GBP LIBOR). In the UK market, the Sterling Overnight Index Average (SONIA) is typically used as the risk-free rate replacing GBP LIBOR.

III SECURITY AND GUARANTEES

In a typical 'true sale' securitisation transaction, the SPV will grant security over all of its assets, including:

- a purported fixed charge over the underlying assets it has acquired from the seller and their related security;
- assignment of its rights under the transaction documents;
- security over its bank accounts; and
- a floating charge, which will extend to all the assets of the SPV and crystallise upon the occurrence of certain events as set out in the documentation (typically following occurrence of an event of default under the transaction documents).

The formalities for creation and perfection of security under English law will depend on the nature of the assets over which security is created.

For most assets other than financial collateral,[5] security granted by an English company[6] requires registration with Companies House. Lack of registration will cause such security to be void and unenforceable against a secured creditor of the company or a liquidator or administrator in the context of the company's insolvency. When creating fixed security over receivables or deposits in a bank account, sufficient control over such receivables or deposits is required, otherwise there is a risk that the relevant security may be re-characterised as floating security.[7]

In English securitisations, security is typically granted in favour of a corporate trustee acting on behalf and holding security on trust for the SPV's secured creditors (i.e., the noteholders and other transaction parties). If the security needs to be enforced, the security trustee will enforce the security on behalf of secured creditors and in accordance with the provisions of the transaction documentation. Occasionally, security trustees will be required to exercise their discretion in relation to certain matters not provided for in the transaction documents or in relation to waivers or consents required under the transaction documentation. This will inevitably involve discussions with the transaction parties and is potentially a time-consuming and costly exercise (the security trustee would typically expect to be prefunded or indemnified in relation to any costs, expenses and potential liabilities relating to these processes).

Unlike in some other jurisdictions, English law receivables sales are not registered as security interests, and generally security will not be taken over assets of the seller. It is common for the seller to grant declarations of trust over collection accounts in favour of the SPV.

IV PRIORITY OF PAYMENTS AND WATERFALLS

Priorities of payments in securitisation transactions will typically include a pre-enforcement waterfall and a post-enforcement waterfall. This allows transaction receipts to be applied differently when the transaction is performing and following acceleration of the notes or enforcement of the transaction security (the post-enforcement waterfall is designed to work as a close-out priority of payments). While there is usually a single post-enforcement waterfall, it is relatively normal (depending on underlying asset class) to split pre-enforcement priorities of payment into two separate interest and principal waterfalls for separate application such that revenue receipts are used to satisfy interest and expense payments under the notes, and principal receipts are used to repay principal under the notes. However, the transaction documentation may specify additional trigger events that lead to application of other priorities of payment (by way of an example, on CMBS transactions, where the occurrence of certain loan failure events may trigger the application of a slightly modified pre-enforcement priority of payments).

The priority of payment provisions in securitisation transactions create contractual subordination at note level, which corresponds to the concept of 'tranching', which the UK Securitisation Regulation (as well as the EU Securitisation Regulation) has adopted as the central defining feature of a securitisation transaction. Tranching requires the existence of subordination, and therefore if a priority of payments only provides for *pari passu* payments under the various classes of notes issued (as opposed to payments in sequential or reverse sequential order), the transaction may not be considered a securitisation for regulatory purposes (and consequently certain requirements such as risk retention may not be applicable). The priorities of payment also serve the key purpose of identifying the universe of secured creditors of the SPV and determining the order in which the amounts due to them by the SPV are paid during the transaction and upon enforcement of security. One of the typical issues that arises in this respect is the existence of 'flip clauses' in priorities of payments, whereby a swap provider's right of payment will rank subordinated to the payment rights of noteholders upon default by the swap provider. These provisions, once held unenforceable under New York law (although recent court decisions have shown a departure from this position), have been upheld by the English courts as enforceable under English law.[8] While the priorities of payments will be transaction-specific, an example of a few of the key items to be found in priorities of payments is set out in the table below.

Pre-enforcement priority of payments		Post-enforcement priority of payments
Interest	Principal	
Fees, expenses and amounts due to third parties providing services to the SPV (trustees, agents, cash manager, corporate services provider, etc.)	Principal due under the notes	Fees, expenses and amounts due to third parties providing services to the SPV (trustees and their appointees and receivers, agents, cash manager, corporate services provider, etc.)
Interest due under the notes	Excess to be re-applied through the revenue pre-enforcement priority of payments as available revenue receipts in the next interest payment date	Interest and principal due under the notes
Top-up of reserves		SPV profit amount*
SPV profit amount*		Surplus (deferred consideration to seller, residual certificate payments to residual certificate holders, etc.)
Surplus (deferred consideration to seller, residual certificate payments to residual certificate holders, etc.)		
* Priorities of payment relating to transactions where an SPV is structured in accordance with the UK Taxation Regulations will normally contain an item corresponding to the SPV profit amount, which will correspond to the taxable corporate income of the SPV for corporate income tax purposes.		

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

Securitisation transactions typically require the underlying assets to be insulated from insolvency risks associated with the relevant seller and the SPV to which the underlying assets have been transferred. These risks will arise if the sale of assets can be challenged or set aside upon insolvency of the seller or if the SPV is declared insolvent, respectively.

i Seller insolvency risks

In typical UK securitisation structures, the transfer of the underlying assets from the relevant seller to the SPV is structured so that it should not, upon insolvency of the seller, be re-characterised by a court as a secured loan (in relation to which security would be unenforceable because of lack of compliance with registration requirements); this corresponds to what parties in the market tend to call a 'true sale' (often resulting in the de-recognition of such assets from the balance sheet for the relevant seller for accounting purposes).

There is not a defined set of rules prescribing the requirements of a 'true sale'. However, market practice and case law have firmed up a set of key principles that can be distilled to a single requirement: the transfer of the risk of the beneficial title to the assets from the seller to the purchaser should put the purchaser in the position of owner of such assets. Unlike in other jurisdictions, English courts tend to place great emphasis on the intention of the parties, often allowing certain pockets of asset risk to be retained by the seller (for instance, in relation to repurchase obligations arising in relation to assets that breach certain 'eligibility' representations and warranties given on the date of transfer). The interpretation of 'true sale' principles is very fact specific and requires detailed analysis.

ii SPV insolvency risks

Bankruptcy remoteness in UK securitisation is typically achieved through use of an SPV. In typical 'true sale' transaction structures, the beneficial title to underlying assets is assigned to a newly incorporated SPV structured as an 'orphan company'. To achieve this result, the share capital of the SPV is, directly or indirectly, held by a corporate entity unconnected to the transaction parties (usually a corporate services provider) on trust for discretionary purposes. Additionally, transaction documentation usually contains a number of provisions limiting the risk of SPV insolvency and the risk of consolidation with the seller, such as (but not limited to):

- covenants restricting the future activities of the SPV to those contemplated in the transaction documents, including restrictions on ownership of assets or on having employees;
- covenants requiring the SPV to be owned by a party unconnected with the transaction and independently managed;
- representations and warranties to ensure the SPV has not previously been engaged in any activities or owned any assets; and
- limited recourse and non-petition provisions designed to prevent SPV creditors from filing insolvency petitions against the SPV.

In certain types of transactions, particularly whole business securitisation, the above principles may require some adjustment, although it is usual to have a certain degree of bankruptcy remoteness at issuer level. Securitisation of English underlying assets may be structured with an international element, which will require consideration of the laws and market practice of other jurisdictions.

If a transaction is rated, rating agencies tend to analyse isolation of assets and bankruptcy remoteness very closely, as an effective isolation of assets and bankruptcy remoteness may allow for the credit rating of the relevant notes issued (or loans, as applicable) to be higher than the seller's credit rating as a result of the dissociation of risk from the seller and the limited scope for any creditors to seek recourse against the issuer. Any cross-border elements or deviations from the standard structure or issuer covenant package may introduce considerable complexity and risk and will require detailed analysis.

VI OUTLOOK

In financial year 2022, €203.3 billion of securitised products were issued in Europe, a decrease of 12.8 per cent year-on-year. Despite this overall decrease in Europe, UK RMBS issuances increased by 21.2 per cent which was mainly driven by high volumes issued in the first quarter of 2022.[9] We expect the Edinburgh Reforms which aim to build a smarter regulatory framework for the UK and will reform the securitisation regulation in the UK to have a positive effect on the UK securitisation market. There are early signs that such reforms will make securitisation transactions easier for market participants including, for example, reducing what some participants view as onerous disclosure and due diligence requirements.

Securitisation is seen as a robust funding source, and although the appetite for securitised products may be tested by challenging and ever shifting market conditions, the attractiveness of securitisation as a flexible funding tool is expected to continue.

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Endnotes

1 Jeremy Levy and Sarah Porter are partners and Adam Gardener is a senior associate at Baker McKenzie LLP.
2 This chapter primarily focuses on English law. However, for assets subject to Scottish or Northern Irish law, specific requirements may apply and, therefore, input from Scottish or Northern Irish counsel will be required in relation to such matters.
3 Introduced by the Corporate Insolvency and Governance Act 2020.
4 The Securitisation (Amendment) (EU Exit) Regulations 2019.
5 Creation of security over financial collateral (i.e., cash, financial instruments or certain types of monetary claims) is governed by the Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226) and is subject to specific requirements. One of the key distinguishing traits of the financial collateral regime is that appropriation of the relevant financial collateral may be allowed in certain circumstances, unlike other types of security.
6 The requirements for registration of security granted by an overseas company ceased to apply from 1 October 2011.
7 Case law has developed various tests for determining whether sufficient control exists to avoid recharacterisation of fixed security as floating security (*Re Spectrum Plus* [2005] UKHL 41).
8 *Belmont Park Investments PTY Ltd v. BNY Corporate Trustee Services Ltd* [2011] UKSC 38.
9 Securitisation Data Report Q4 2022 and 2022 Full Year published by AFME published on 14 March 2023.

Chapter 11

United States

Michael Urschel, Kathryn Weiss and Charlene Yin[1]

Summary

I OVERVIEW

i Background

The modern US securitisation market is widely considered to have emerged as a product of the federal government's involvement in the housing market following the Great Depression. The US federal government adopted the National Housing Act of 1934 and established the Federal National Mortgage Association (FNMA, or Fannie Mae) in 1938. Fannie Mae's purpose was to 'establish secondary market facilities for residential mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible',[2] which it did by purchasing mortgage loans from lenders, thereby freeing capital that could be used to make more loans. By 1970, in addition to Fannie Mae, the US federal government had established other government-sponsored enterprises (GSEs) that were critical to the rise of modern securitisation in the United States: the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac), the Federal Home Loan Bank System, and the Government National Mortgage Association (GNMA, or Ginnie Mae). It was Ginnie Mae that issued the first asset-backed security, pooling the individual mortgage loans together and in 1970, selling securities backed by the mortgaged properties (mortgage-backed securities, or MBSs).[3]

After 1970, the securitisation market expanded rapidly alongside the housing market. More complex securitisation structures were introduced, and while 'GSEs dominated the MBS market for nearly twenty years'[4] from the first issuance in 1970 to around 1990, the 1990s saw the introduction of private actors into the securitisation market and the first offerings of 'private-label' or 'non-agency' MBSs (those offered by private institutions, as opposed to those issued and guaranteed by GSEs and known as 'agency' MBSs). This expansion was another critical aspect of the development of securitisation in the United States. By their peak in 2006, private-label MBS issuances were valued at approximately US$900 billion,[5] and the value of the MBS market as a whole was in the trillions of dollars.

While MBSs dominated the securitisation market from its inception until the early 2000s, during that period in the United States, other forms of securitisation developed and continued to expand. The mid-1980s saw the introduction of the first 'asset-backed securities' (ABSs), a term used generally to refer to the securities issued in a securitisation of asset pools consisting of loans and debt obligations other than mortgages.[6] While initially a smaller portion of the market than MBSs, ABS issuance did increase markedly after its inception in the 1980s and grew rapidly, along with the rest of the securitisation market, in the early 2000s.

Despite the setbacks resulting from the financial crisis in 2008, securitisation in the United States remains an attractive form of financing for borrowers in various industries, as the cost of gaining liquidity is often lower than that of traditional lending. Both investor concerns and the post-crisis regulatory framework in the United States have required parties to continue to develop new structural features. Nonetheless, issuers and underwriters continue to develop new structures to apply to novel asset classes, as well as applying modified versions of pre-existing structures to traditional ABS assets, such as mortgage, auto and credit card loans. In 2020, important developments in the market occurred as a result of the effects of the covid-19 pandemic, but the securitisation market has shown significant resiliency and continued to operate effectively throughout 2020 and 2021, with 2021 being a record year in recent years in terms of deal volume and innovation. In addition to the ongoing effects of the pandemic, the US securitisation market is also currently reacting to several macroeconomic events, including inflation and significant strains in the supply chain, that have resulted in market volatility.

ii Common structures

There are two main structures employed in securitisations. The first structure is commonly used in MBSs, though some other asset classes also employ this method. In this structure, a wholly owned subsidiary of the sponsor[7] or originator of the assets, known as a depositor,[8] acquires or receives the assets that will be securitised. The depositor transfers the assets to a trust that is also a wholly owned subsidiary of the sponsor or originator, and the trust then issues notes[9] backed by the assets.

The second structure is more likely to be found in the securitisation of 'esoteric'[10] assets and is gaining increased use across the market. The key difference between the two structures is that the latter does not include the intermediate step of transferring to a depositor. Instead, the issuer of the notes is a wholly owned subsidiary of an entity that manages the assets on behalf of the owners of the assets (typically, the manager or parent). The owners of the assets, known as asset entities, are typically wholly owned subsidiaries of the issuer. The notes issued then are backed not by the assets themselves, but by the equity of the asset entities that own the assets. Some transactions also have a guarantor that is a direct subsidiary of the manager and direct owner of the issuer. The guarantor grants a security interest in its equity interest in the issuer and guarantees the issuer's and asset entities' obligations under the transaction documents.

In both structures, one or more financial institutions will typically purchase securitisation notes with the intention of reselling these notes on the secondary market.[11]

iii Notes issued

In many esoteric structures, in addition to issuing securitsation notes as term notes, issuers also issue variable funding notes (VFNs). Term notes are fixed-rate notes that are fully funded when the transaction closes, providing liquidity only at closing, whereas, VFNs act as a revolving credit facility in that the issuer may access funds (up to a set maximum amount) which can be borrowed or drawn, repaid and re-borrowed at variable interest rates throughout the term of the VFNs. In certain circumstances, variable funding notes are also issued as delayed-draw term notes, which have a variable rate of interest, but which cannot be repaid and reborrowed. Unlike term notes which are traded on the secondary market, VFNs are typically held by a bank or syndicate of banks. If VFNs are outstanding at the same time as term notes, they are often paid on a super-priority basis, before any other securitisation indebtedness; however, if an event of default occurs, they are typically paid collateral proceeds *pari passu* with other senior notes. This payment priority structure is particularly common in whole business and digital infrastructure securitisations, though revolving notes can be issued at different priorities depending on structure. For a borrower, the issuance of VFNs as part of a broader term note securitisation can allow for lower borrowing costs, greater liquidity, and more flexibility than the term notes. The use of securitisations to issue VFNs also provides for the same bankruptcy and securitisation protections that the term notes are afforded. Many VFN facilities include a letter of credit facility pursuant to which the borrower can obtain letters of credit for various purposes, including the funding of interest reserve accounts.

II REGULATION

i Disclosure

In a typical securitisation, initial purchasers or underwriters will offer securitisation notes to potential investors on the secondary market and will provide such potential investors a preliminary offering memorandum (the POM) that contains transaction terms and disclosures regarding certain risks to the collateral and to the notes. Because potential investors make investment decisions in reliance on the information contained in the POM, once the POM is distributed to potential investors, liability under the Securities and Exchange Commission's Rule 10b-5[12] attaches to the issuer and the initial purchasers or underwriters. In response to recent market volatility, initial purchasers are increasingly engaging in the 'pre-marketing' of transactions as a way to gauge market interest prior to officially offering the notes. Often, pre-marketing includes distribution of a POM, in which case liability under SEC Rule 10b-5 may attach during pre-marketing even though the notes have not been officially offered. Note that generally only term notes are offered through a POM, though VFNs may be issued contemporaneously with the offering of term notes.

Another evolving trend is increased reliance on Section 4(a)(2) of the Securities Act of 1933 (the 33 Act) for exemption from certain registration requirements under the 33 Act for privately placed (as opposed to publicly offered) securitisation notes. In general, private placements can be exempt from registration under Rule 506 of Regulation D[13] or Section 4(a)(2). To be exempt under Section 4(a)(2), an issuer must provide potential investors with access to the same kind of information that would be provided in a registration statement and each potential investor should be sufficiently financially sophisticated such that it can 'fend for itself without a registration statement'.[14] In practice, this means that typically no POM is prepared, but direct investors are more active in the process, conduct their own diligence, and often substantially negotiate deal terms.

ii Risk retention

In response to the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)[15] was enacted in the United States in July 2010. The Dodd-Frank Act increased regulation of the securitisation market in many respects, including the implementation of new credit risk retention rules in Regulation RR, 17 CFR Part 246. The rules were intended to promote alignment of the interests of sponsors and investors by requiring the sponsor to maintain 'skin in the game'; that is, the sponsor must retain an economic interest in the credit risk of the securitised assets for a certain period. In 2014, the Securities and Exchange Commission (SEC) and five other federal agencies jointly adopted the final rules, requiring the sponsors of ABSs to retain not less than 5 per cent of the aggregate credit risk of the assets being securitised (the US Risk Retention Rules).[16] The US Risk Retention Rules became effective with respect to residential MBSs on 24 December 2015 and with respect to all other asset classes on 24 December 2016. The Rules were described as the 'single most important part of the bill',[17] and were designed to be a fix for certain perceived flaws in MBSs prior to the financial crisis. In February 2018, the US Court of Appeals for the District of Columbia Circuit ruled that an open-market CLO manager is not a 'securitiser', and, therefore, the Dodd-Frank Act does not require CLO managers of open-market CLOs to comply with the US Risk Retention Rules.[18]

An ABS is defined in Section 3(a)(79) of the US Securities Exchange Act of 1934 as 'a fixed-income or other security collateralised by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset'.[19] This definition is broad enough to encompass some securities that may not have traditionally been considered ABSs, but narrow enough to exclude certain types of securitisation transactions, including many that rely on how actively the underlying assets are managed and commercialised rather than a static pool of self-liquidating assets.[20]

Because of the difference in interpretation and lack of case studies, considerable uncertainty exists as to whether certain securities constitute ABSs for the purpose of the US Risk Retention Rules, in particular as regards more esoteric asset classes. When compliance is required (or undertaken in the absence of certainty as to the requirement for compliance), the US Risk Retention Rules provide that the retained interest may be held as an 'eligible horizontal residual interest'[21] or 'eligible vertical interest'.[22] The risk retention requirement may also be satisfied by a combination of both horizontal and vertical interest.[23] Each method requires retention of at least 5 per cent of the nominal value of the interests in the securitisation.[24] The US Risk Retention Rules also require certain disclosures regarding the value of the retained interests and, in the case of an eligible horizontal residual interest, the sponsor's methods of valuation, including the default and payment rate assumptions.[25] An eligible horizontal interest is the more attractive option when the credit enhancement required to be maintained to support the rating of the securities requires the sponsor, through the issuer, to retain an interest that is already in excess of 5 per cent of the nominal value of each class issued in the securitisation. An eligible vertical interest may be a less attractive option as it would require the sponsor to retain a 5 per cent interest in the more senior class of securities issued by the issuer that could otherwise have been sold to third parties (whereas the eligible horizontal interest would already have been held as noted above).[26]

iii Tax issues

Tax characterisation of the notes issued in a securitisation

The rated notes issued in a properly structured securitisation generally are treated as debt for US federal income purposes so long as the beneficial owner of the notes is not the issuer or any of its affiliates. The benefits of treatment as debt are twofold:

- a US issuer's interest expenses are generally deductible; and
- US-source interest payments paid to foreign noteholders generally benefit from an exemption from US federal withholding tax.

There are, however, no clear rules for making the distinction between debt and equity; instead, the determination is based on the balancing of a number of factors.[27] In 1994, the Internal Revenue Service issued Notice 94-47,[28] which laid out the principal factors for making the determination, noting that none is dispositive and that all facts and circumstances must be considered. In general, the factors relate to the likelihood of repayment and to how much the rights of the noteholders resemble the rights of typical creditors. It is also necessary to look to case law to guide the interpretation of these factors.

In addition, in 2016, the Internal Revenue Service issued final regulations under Section 385 of the Internal Revenue Code[29] that may result in recharacterisation of debt issued by US entities owned by multinational parent entities (whether US or foreign-based), with some exceptions. In general, Section 385 requires documentation of factors that are used to determine characterisation, such as the issuer's obligation to pay a sum certain and the reasonable expectation of the ability to pay. Compliance with the new requirements does not guarantee characterisation as debt, but non-compliance is likely to result in characterisation of equity.

Securitisation vehicle entity taxation

A properly designed securitisation vehicle will be structured not to be subject to material entity-level net income taxes. Typically, unless an offshore vehicle (that is not deemed engaged in a taxable US business) is employed, the vehicle will be structured to qualify as some form of 'pass through entity' such as a partnership or grantor trust. Various requirements must be met to achieve 'pass-through' treatment, including that an intended partnership is not treated as a publicly traded partnership under Section 7704 of the Internal Revenue Code

Foreign Account Tax Compliance Act

Sections 1471 through 1474 (commonly referred to as the Foreign Account Tax Compliance Act or FATCA)[30] were added to the Internal Revenue Code as part of the Hiring Incentives to Restore Employment (HIRE) Act,[31] requiring that 'foreign banks . . . disclose their US account holders to the US Government or face significant penalties'. Pursuant to FATCA, if a foreign entity or financial institution does not comply with FATCA requirements, a 30 per cent withholding tax will be applied to certain US-source payments, including, in general, payments of interest on the rated notes issued in a securitisation.

iv Regulatory compliance

Anti-money laundering

The Department of Justice, Internal Revenue Service, Department of Treasury and the Financial Industry Regulatory Authority, among others, all have anti-money laundering-related laws or regulations applicable to financial transactions and financial institutions. These regulations primarily relate to identification of sponsor,[32] record-keeping[33] and anti-money laundering compliance policies.[34] Securitisation transaction documents typically require that the sponsor demonstrates that it complies with all applicable anti-money laundering laws, regulations or procedures.

Sanctions

The Office of Foreign Assets Control (OFAC) of the US Treasury Department administers and enforces economic and trade sanctions against foreign countries, regimes, and other international actors based on US foreign policy and national security interests. There are several sanctions programmes that vary as to the scope and targeted group, as well as sanctions against specific individuals. Securitisation transaction documents typically require that the sponsor demonstrates that it is not the target of any OFAC investigations and is not in violation of any OFAC sanctions. It is also good practice for entities conducting non-US business to have OFAC sanctions compliance policies.

v Jurisdiction

There is no law or regulation that mandates the jurisdiction that the issuer is formed in or governs the transaction documents; however, commonly, the issuer is formed in Delaware and the transaction documents are governed by the laws of New York. The reasons for choosing Delaware and New York, among others, are 'the well-developed and therefore more predictable legal framework in these jurisdictions' and 'the sophistication of the judiciary in these states.'[35] These states also have laws that are beneficial for securitisations. For example, the Asset-Backed Securities Facilitation Act, which Delaware enacted in 2002, effectively deems that all sales of assets as part of a securitisation are true sales.[36] Another example is that regardless of whether the transaction involves parties or assets in New York, New York law allows transaction parties to choose New York law to govern transactions valued at US$250,000 or greater[37] and to enforce rights and obligations of transactions valued at US$1 million or greater.

III SECURITY AND GUARANTEES

The issuing entity may have to take steps to establish that the investors' security interest in the securitised assets is superior to all other claims on the assets (i.e., perfection). If the assets are real property subject to recorded mortgages, no additional steps have to be taken, as recordation of a mortgage is sufficient to achieve a perfected lien. For most other types of collateral, the method of achieving a perfected security interest is pursuant to Article 9 of the Uniform Commercial Code.[38] This requires the filing of a financing statement,[39] a standardised form, usually with the Secretary of State or similar municipal agency of the state in which the issuing entity was organised.[40] The financing statement must give the legal name and address of the 'place of business'[41] of the issuing entity (in this case, the debtor)[42] and the trustee, on behalf of the noteholders (in this case, the Secured Party).[43] The financing statement also requires a description of the assets on which there is a lien. The most common description is 'all assets of the debtor,' which may be additionally described as 'currently owned or after-acquired'. Once the financing statement is filed, the lien is perfected.[44] Real property and other collateral types are subject to varying local rules.

In addition to perfecting investors' security interest, securitisations may also include a guarantee of the issuer's obligations as additional credit enhancement. In most cases, in the event of a default, investors' recovery is limited to the collateral,[45] though some securitisations may benefit from financial guaranty insurance policies from monoline insurers. Foreclosure on collateral in the event of default can be effected in a variety of ways. In some instances, this may be done as a direct foreclosure on the collateral whereby the indenture trustee takes ownership of the collateral. Another method is indirect foreclosure on the collateral whereby the indenture trustee takes ownership of the equity interests of the entity that owns the collateral. One common method of indirect foreclosure is for a special purpose vehicle (SPV), created for the sole purpose of holding the equity interests of the issuer to act as guarantor. Such guarantor pledges its interest in the issuer's equity to the securitisation so, in the event of a default, the indenture trustee can foreclose on the issuer's equity interests and thereby indirectly on the collateral held by the issuer. If the collateral is not held by the issuer, but instead by subsidiaries of the issuer, the issuer's interest in each such subsidiary's equity may be pledged to the securitisation with the subsidiaries acting as additional guarantors. Indirect foreclosure on the collateral can be more efficient and economical if the collateral is comprised of a large number of assets; for example, a cell tower securitisation may include hundreds or thousands of sites so direct foreclosure would be time consuming and cost-prohibitive. Securitisation guarantees must be limited in nature so as not to disrupt the bankruptcy-remoteness of the securitisation. Therefore, you will not see a full recourse guarantee to an operating company that is not part of the bankruptcy-remote securitisation structure.

IV PRIORITY OF PAYMENTS AND WATERFALLS

The most common form of cash management is to collect the funds generated by the assets in one or more bank accounts established in the issuer's name and subject to a deposit account control agreement. These agreements permit the secured party (in this case, typically the trustee) to direct the deposit bank regarding the deposited funds.[46] In some instances, the bank accounts may be established in the secured party's name, in which case no account control agreement is needed. If there are multiple accounts for the deposit of funds, the funds are then transferred to, and distributed from, a single account.

In addition to the accounts described above, the order in which funds are distributed (the 'waterfall' or priority of payments) may reflect distributions to reserve accounts if they are paid over time, using funds that have passed through the waterfall, up to an amount set out in the transaction documents.[47] Reserve accounts are generally established to ensure that sufficient funds are available for certain payments due as they become due, but can also be for payments required upon certain occurrences described in the transaction documents. Payments for which funds may be reserved include those for the payment of interest on the notes, essential expenses and payments required upon the occurrence of certain events, such as a breach of a financial covenant. In each case, reserve accounts add stability to the transaction, whether that is in providing assurance that interest payments will be timely, as with an interest account, or that operations will not be disrupted because of insufficient available funds. The waterfall may also reflect multiple tranches of debt. Debt is typically divided into tranches to allocate risk among the noteholders such that the lowest-rated tranche absorbs losses first (i.e., credit-tranched). Debt can also be time-tranched, such that funds are distributed to different tranches at different points in the waterfall.

For example, a waterfall reflecting two tranches of debt and an interest reserve account may include language indicating that funds will be deposited in the following order prior to an event of default under the transaction documents or an event that triggers the acceleration of the debt (a Rapid Amortisation Event): (1) to the interest payment account for each class of senior notes, then (2) to the interest payment account for each class of notes that are subordinated notes, and then (3) to an interest reserve account. Following an event of default or a Rapid Amortisation Event, the same waterfall may include language indicating that funds will be distributed (1) to the senior notes until the outstanding principal amount of each such class will be reduced to zero, and then (2) to the subordinated notes until the outstanding principal amount of each such class will be reduced to zero. In both scenarios, the subordinated notes will be paid after the senior notes. However, in the second scenario, there is a risk that the subordinated notes may receive only partial payment, or even no payment, as the available funds are limited to what is left after the senior notes have been paid in full.

V ISOLATION OF ASSETS AND BANKRUPTCY REMOTENESS

One of the key features of a securitisation is that the assets are sold or contributed to one or more bankruptcy-remote SPV that is a subsidiary of the originator or owner of the assets. The bankruptcy-remote nature of the SPVs and the sale or contribution of the assets results in protections for both the originator and investors. The benefit for the originator is that most losses relating to the securitisation can only be recovered from the securitised assets and the related cash flows, protecting the originator's assets. The benefit for the investor is that if the originator is subject to an insolvency proceeding, the securitised assets will not be considered part of the originator's bankruptcy estate that can be liquidated for the payment of creditors.

i SPV formation

To provide these benefits, the SPV that receives or purchases the assets must be organised to be separate from the originator of the assets to ensure that the SPV will not be substantively consolidated with its parent company or the asset originator. The SPV may be any kind of legal entity, but, regardless of legal form, the SPV's governing documents must include certain bankruptcy-remote and special-purpose provisions of the SPV. These provisions limit the SPV's activities to those related to owning and holding the securitisation assets and performing obligations under the transaction documents. These provisions typically include the following items.

The SPV must:

- maintain separate books and records;
- maintain adequate capital in light of its contemplated business purpose;
- pay liabilities and expenses from its own funds;
- maintain separate bank accounts;
- conduct business in its own name; and
- conduct business with the parent company and its affiliates or asset originator on an arm's-length basis.

The SPV is prohibited from:

- engaging in business not expressly contemplated under the transaction documents;
- formation of additional subsidiaries;
- engaging in activities other than owning, financing and collecting on or sale of the underlying assets;
- commingling of assets with other entities; and
- providing credit to satisfy the obligations of any other entity.

Some transactions require one or more independent managers or directors, often engaged from a third-party service provider and paid a nominal fee. Before undertaking certain 'material actions', the independent managers or directors must vote in favour of undertaking these actions, principally the filing, consent or support of an insolvency proceeding. This mitigates the risk that the SPV will commence voluntary bankruptcy proceedings for the convenience of the parent company under common control with the SPV.

ii Sale or contribution of assets

The asset originator transfers the assets, by sale or contribution, to the SPV. The sale or contribution agreement must be structured such that the transfer will be legally recognised as a 'true sale' or 'true contribution', as applicable, and not be recharacterised by a bankruptcy court as a loan or other secured financing, to ensure that the transferred assets are considered the SPV's property and not property of the originator's bankruptcy estate. The analysis of whether a transfer is a true sale includes consideration of whether the assets were sold without recourse to the transferor and for fair value on terms that reflect an arm's-length transaction. The requirements for establishing a true contribution are simpler: the asset originator and the SPV must be solvent and the contribution must be reflected in the SPV's capital account. In addition to being a simpler bankruptcy analysis, contributions are more flexible because the transfer can be effected by the asset originator taking back equity in the SPV in exchange for the contributed assets without cash consideration, while a sale requires payment for the purchase of the assets.

VI OUTLOOK

Despite its argued role in the financial crisis, the securitisation market has grown steadily since the end of the financial crisis, if in a different form.[48] Significant kinds of new asset classes and securitisation methods have arisen in recent deals and are showing steady and healthy growth. The recent expansion of the securitisation market in the United States to include novel and non-traditional asset classes demonstrates resilience in the concept of securitisation as a financing method. As the markets have recovered, regulatory frameworks have evolved to help align the interests of investors and originators. The remainder of this chapter illustrates a number of non-traditional asset classes prevalent in securitisation in the United States.

i Solar securitisation

Recent developments have paved a path for financial innovation in the renewable energy industry. Solar securitisations are at the centre of this trend.[49] Solar providers have developed four primary arrangements with consumers: leases, loans, power purchase agreements and property-assessed clean energy (PACE) loans.[50]

Loans are one of the newest forms of residential solar finance.[51] Rather than offer leases, solar providers grant loans to homeowners, allowing them to purchase the system and then make interest payments until the maturity of the loan. Solar power purchase agreements create arrangements pursuant to which property owners purchase solar power generated by third-party owned panels installed on their property for a fixed price and period.[52] Solar PACE loans offer an alternative solution to solar financing.[53] Municipalities that offer solar PACE programmes allow homeowners to install solar panels without making an initial down payment. Such municipalities cover the cost of installation by issuing municipal bonds secured by the home, which are paid back by customers through annual tax assessments.[54] Each of these asset types has been securitised in recent years and securitisations are often collateralised by more than one type of solar financing arrangement.[55]

While the solar securitisations share many similarities with other securitisations, a key distinguishing feature is the crucial role of tax equity investors in many solar securitisations, where tax credits also play a role in the underlying economics, leading to a complex structure in which another class of fixed income investors is involved in the process.[56]

ii Wireless tower securitisations

Wireless tower securitisations, which are backed by wireless towers and the related wireless carrier contracts, have significantly increased since 2009, a trend that is expected to continue.[57] This is partially a result of the increased need for wireless infrastructure in the wake of continuing – and increasing – demands for wireless services and rapid advancements in wireless technology, which require increased wireless infrastructure. Such securitisations are an attractive asset class to investors, in part because of the likelihood of stable cash flows, because wireless towers are critical to the operations of the wireless carrier tenants.[58] Since 2020, we have seen increased use of wireless tower securitisations in the context of mergers and acquisitions transactions, with the technique being used for acquisition financing.

iii Whole business securitisation

Whole business securitisation is a growing segment of the securitisation market for certain types of business, such as franchised operators and businesses with extensive pools of intellectual property royalties, among other similar structures. As of August 2019, whole business securities issuances were more than US$6.9 billion.[59] While through the first half of 2020 issuances of whole business securitisations within the restaurant and retail sector were down, citing economic constraints resulting from pandemic lockdowns and increased unemployment,[60] we saw the sector showing strong improvement in the second half of 2020. A whole business securitisation is backed by the cash flows of an operating company[61] rather than simply financial assets, as in traditional ABSs. In practice, this means transferring the key intellectual property and revenue-producing assets of the company into a securitised structure, with the existing management team managing the securitised assets. Whole business securitisation can be said to have a hybrid nature combining both secured corporate financing and an asset securitisation.[62] Candidates for this type of financing typically hold intellectual property or other recurring contract revenue that can be collected on a stable and predictable basis over a considerable period.

A unique feature of whole business securitisation is the originator's ongoing involvement in managing the business.[63] In a whole business securitisation, the income stream of a department or the company as a whole is being securitised, compared with traditional securitisations, in which a specific pool of assets is isolated and then securitised. Substantially all the income-generating assets, often agreements pursuant to which the company receives payment, are contributed to one or more asset entities. As with other securitisations of other asset classes, the issuer typically retains the parent holding company or one of its affiliates as the servicer or manager of the assets after the asset transfer. However, rather than merely collecting on the receivables, as in a more traditional securitisation, the manager in a whole business securitisation is actively involved in managing the assets and thereby ensuring the ongoing generation of cash flows. Most whole business securitisation structures employ carefully constructed backup management mechanics to avoid interrupting the performance of the company and the deal in the event of a termination of the manager.

iv Digital infrastructure

Digital infrastructure securitisation assets include data centres, distributed network and antennae systems and fibre-optic networks, and are likely to proliferate in kind. With the global datasphere expected to grow from 45 zettabytes in 2019 to 175 by 2025, the need for digital infrastructure is expected to continue to increase.[64] The rise in data demands caused by the covid-19 pandemic, as well as the increased development of emerging technologies such as 5G wireless, augmented reality and autonomous cars, will contribute to this growth.[65] The projected rise in data usage, the financial stability of tenants leasing digital infrastructure, and the reliable cash flow on medium to long-term contracts lends to the attractiveness of this asset and also poses a low risk to investors.[66]

Data centre securitisations are backed by customer payments for access to space and network services at build-to-suit and colocation facilities, tenant lease payments from other types of facilities – such as managed service data centres – and related real property. Because of the high cost associated with building and maintaining a data centre, many companies have opted to use third parties for these services. For customers who process large amounts of information, data centres are invaluable, as they rely on them to provide a safe and secure facility equipped with reliable power and network capabilities.[67] This asset class is attractive to investors because of the long average contract terms, the importance of these leases to the tenant's business and the tenant's generally high credit quality.[68]

Distributed antenna systems (DAS) comprise equipment attached to buildings and existing infrastructure to increase user data capacity in congested areas.[69] With the emergence of 5G wireless connections, this system of antennas complements existing cellular towers to bring higher quality wireless service.[70] Tenants and licensees utilising these network services generally consist of large telecommunications companies with excellent credit giving relative assurance of steady cash flow.[71] To date, DAS securitisations have been backed by customer payments pursuant to licences for access to the DAS equipment and agreements. The agreements that allow the DAS equipment owner to attach DAS to private property, such as hotels, and to municipal property, such as utility poles, are also contributed to the securitisation.[72]

Digital infrastructure securitisations – especially those with fibre network assets – can benefit from innovative security packages, including qualifying for 'transmitting utility' status under the relevant Uniform Commercial Code of the state where the fibre network is located.[73] In such an instance, in states where the relevant provisions of the Uniform Commercial Code have been adopted, there is typically a specific filing office for transmitting utilities, which in most cases is the central filing office for the state, with some variation among states.[74] This 'transmitting utility' method of perfection simplifies dealing with complex real- and personal-property analysis and complex fixture networks.

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Endnotes

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7 The sponsor is the party who 'organizes and initiates' the transaction. 17 CFR §229.1101(l). Often the sponsor is not a direct party to the transaction, but is, instead, an affiliate of transaction parties.
8 17 CFR §229.1101(e).
9 The 'issuing entity' of the notes is either the trust, as in the first structure, or another entity that owns or holds the assets. 17 CFR §229.1101(f).
10 The underlying assets in an esoteric securitisation include cell towers, billboards, franchise royalties and tax liens.
11 In a publicly offered securitisation, such party is an 'underwriter' and in a privately offered securitisation, an 'initial purchaser'.
12 17 CFR 240-10b-5. In general, Rule 10b-5 prohibits untrue or misleading statements or omissions in connection with the purchase or sale of any security.
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22 An eligible vertical interest is an interest in each class issued. id.
23 17 CFR §246.4(a)(3); an eligible cash reserve account held by the trustee in cash or cash equivalents can also be employed. 17 CFR §246.4(b).
24 17 CFR §246.4(a)(1)-(2).
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26 See, however, Section V.ii for an example of a securitisation that is not subject to the US Risk Retention Rules.
27 Several factors for distinguishing debt from equity are laid out in *Fin Hay Realty Co. v. United States*, 398 F2d 694.
28 1994-1 C.B. 357.
29 26 U.S.C. §385.
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31 Pub. L. 111-47, 124 Stat. 97 (2010).
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37 N.Y. GOL §5-1401.
38 See, e.g., N.Y. UCC Law §9.
39 UCC §9-102(39).
40 UCC §9-301(1).
41 UCC §9-307.
42 UCC §9-102(28).
43 UCC §9-102(73).
44 UCC §9-309.
45 For MBSs issued by GSEs other than Ginnie Mae, the GSE provides a guarantee of payment backed by the GSE's credit. For MBSs issued by Ginnie Mae, the guarantee of payment is backed by the full faith and credit of the US government.
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