EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 4 February 2004

at the request of the Ministry of Finance of the Grand Duchy of Luxembourg on a draft law on securitisation

(CON/2004/3)

1. On 5 December 2003 the European Central Bank (ECB) received a request from the Luxembourg Ministry of Finance for an opinion on a draft law on securitisation *'Projet de loi relative à la titrisation'* (hereinafter the 'draft law').

2. The ECB's competence to deliver an opinion is based on the second indent of Article 105(4) of the Treaty establishing the European Community, the second indent of Article 4(a) of the Statute of the European System of Central Banks and of the European Central Bank, and on the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1] as the legislative proposal contains provisions applicable to financial institutions that 'materially influence the stability of financial institutions and markets'. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council of the ECB has adopted this opinion.

Preliminary remarks

3. The draft law, as submitted by the Luxembourg Ministry of Finance, establishes a specific legal framework for securitisation transactions in Luxembourg. The draft law draws upon experience with laws already in place in other countries and covers the legal status of securitisation undertakings and of securitisation funds respectively, the authorisation conditions for these securitisation entities and the supervisory powers of the Luxembourg financial supervisory authority – the *Commission de surveillance du secteur financier (CSSF)* - regarding these entities, the liquidation of these entities, the nature of the securitised risks and the rights of investors and creditors. One chapter of the draft law is also devoted to the rights, powers and authorisation conditions for a new category of financial sector player namely fiduciary representatives (*représentants-fiduciaires*). Fiduciary representatives must be registered in Luxembourg and the investors and creditors of a securitisation undertaking may use them to manage their interests.

1 OJ L 189, 3.7.1998, p. 42.

Finally, the draft law also contains some provisions relating to the accounting and tax treatment of securitisation transactions.

4. The ECB notes that in Europe both domestic securitisation markets and structures as well as the corresponding legal, accounting and fiscal frameworks are highly fragmented. The ECB therefore welcomes the initiative of the Luxembourg authorities to provide more secure and transparent rules for the securitisation market with a view to increasing financial markets participants' use of securitisation techniques. The ECB acknowledges the benefits of having an explicit and comprehensive regulatory framework for these complex transactions, which are rapidly growing in Europe. In the ECB's view, such domestic frameworks should particularly aim to enhance legal certainty and transparency and ensure financial stability and should include a robust supervisory regime of the entities in charge of securitisation transactions. On the one hand, the ECB notes that the draft law offers great flexibility for establishing securitisation transactions and that the objective of the Luxembourg authorities was to provide practicable procedures at reasonable costs. On the other hand, the ECB is of the view that the objective of flexibility should co-exist with other goals of a regulatory nature such as investor protection and risk control and that the domestic framework should contain the legal safeguards necessary to ensure the safe and transparent conduct of these activities.

5. A number of issues addressed by the draft law or its explanatory memorandum highlight certain legal uncertainties regarding cross-border securitisation transactions, in particular regarding the law applicable. For example, the draft law will apply only to securitisation entities situated in Luxembourg, which means that, if the acquiring and the issuing vehicles are segregated (see also paragraph 8), the draft law will only cover entities situated in Luxembourg. The draft law also highlights gaps whose removal could reduce obstacles to performing certain cross-border securitisation deals and enhance legal certainty. In this regard, the ECB regards securitisation as an area where considerable progress in integrating European financial markets could still be made notably in terms of the convergence of market practices, instruments and legal rules. Recently the European Union (EU) has launched efforts to introduce the necessary adjustments to any current proposal for EU legislation and reach a common understanding of certain securitisation-related concepts. In this respect the ECB would refer to the on-going work in the context of the review of capital requirements for banks and investment firms[2] and the review of the Basel Accord or in the context of the implementing measures for the Prospectus Directive[3]. Looking beyond the Financial Services Action Plan, the ECB sees merit in a strategy of increased harmonisation in the area of securitisation at EU level.

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2 See the Commission Services' Third consultation paper on the review of capital requirements for banks and investment firms, Part 1 - Draft proposed risk-based capital requirements of the Working Document of 1 July 2003.

3 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, p. 64.

Definition of securitisation

6. The draft law defines securitisation as 'the operation by which a securitisation entity acquires or assumes, directly or through the intermediary of another entity, the risks connected to debts, to other goods, or to liabilities assumed by third parties or inherent to all or part of the activities carried out by third parties in issuing the securities whose value or return depends on these risks'. The ECB notes the broad definition proposed by the Luxembourg Ministry of Finance. In addition, the ECB understands the Ministry's desire to favour an economic and financial approach to defining securitisation thus covering all forms of securitisation transactions within the scope of the draft law. However, questions could arise as to whether the draft law is sufficiently explicit in defining concepts such as the 'acquisition of risks' or 'the assumption of risks'. For example, in the context of traditional securitisation, the securitisation vehicle acquires the claims and not only the 'risks connected to debts'. The ECB considers that it might also be useful to clarify this in some parts of the draft law and in particular its chapter on 'risk assumption'.

Securitisation vehicles proposed under the draft law

7. Under the draft law, it will be possible to create securitisation entities, either in the form of securitisation undertakings or of securitisation funds without legal personality. The draft law leaves open to market participants the choice of using securitisation undertakings or securitisation funds and the Luxembourg legislator intends to follow closely the model adopted for the Luxembourg *organismes de placement collectif (OPC)*[4] while taking into account the particular characteristics of the functions and purposes of securitisation vehicles. Firstly, the ECB notes that, for the sake of clarity, it would be preferable for the draft law to expressly state that these securitisation entities are not undertakings for collective investment in transferable securities within the meaning of the UCITS Directive[5]. Secondly, with regard to securitisation funds, it is provided that either the management company (cf. Article 7(1) and (3) of the draft law) or the fund itself (cf. Article 9 and Article 10(1) and 10(4) of the draft law) will be the issuers. The ECB notes that a securitisation fund's lack of legal personality could give rise to legal uncertainty regarding its capacity to issue securities directly. Thirdly, the concepts of *valeurs mobilières* (securities) and of *titres de créances* (debt instruments) seem to be used interchangeably in the draft law and the ECB is of the view that the link between Article 7(3) and Article 9 of the draft law could be further clarified in this respect. Fourthly, the ECB understands Article 7 of the draft law and the explanatory memorandum (cf. page 26) as meaning that the Luxembourg authorities intend to allow securitisation funds to issue either units -representing a co-ownership right - or debt instruments representing a claim over the fund. If this choice is indeed available, the ECB considers that it should be expressed more clearly in the draft law and that rules relating to the redemption of units should be included. This might also lead to a distinction having to be made between investors (investing in fund units or debt

4 Luxembourg forms of undertakings for collective investment in transferable securities (UCITS).

5 Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended OJ L 375, 31.12.1985, p. 3

instruments issued by the securitisation fund or the securitisation undertaking) and originators investing in the securitisation entities.

8. As regards the 'sub-structures' of securitisation vehicles, Article 1(2) of the draft law provides that securitisation entities shall mean the entities that wholly perform securitisation and those that participate in such transactions by assuming all or part of the securitised risks (the acquiring entities) or by issuing securities to cover the financing of the securitised risks (the issuing entities). In this context, the ECB notes that the draft law does not make it obligatory for securitisation transactions to be exclusively performed through a single securitisation entity. Under this scheme, it should be possible to transfer the assets of an entity distinct from the entity issuing the securities, i.e. the acquiring entity and even to envisage an issuing entity dealing with several acquiring entities. The ECB is aware that similar structures that dissociate the two activities are used by market participants and are authorised by the legislation of other Member States. In the ECB's view, it is necessary to ensure that the complexity of such structures, especially in a cross-border context and for vehicles with segments, does not create obstacles in terms of transparency, risk control and effectiveness of the legal transfer of assets and does not contradict the objective of reinforcing the direct correlation between the rights of investors and the underlying assets of the securitisation entities. In addition, the provisions of the draft law do not specify how the rules that apply to the acquiring and issuing entities will coexist (see however Article 63). The ECB would also recommend clarifying the rules that apply to securitisation undertakings and securitisation funds respectively, since the possibility of segregating the functions of acquiring and issuing entities seems to be envisaged for both types of vehicle.

9. The ECB notes that the draft law allows the creation of some segments within securitisation entities. This possibility is expressly provided for in Article 8 of the draft law and it is understood that securitisation undertakings also have this right[6]. This provision may produce some economies of scale by allowing several originators to use the same vehicle for issuing asset-backed securities. However, secure segregation mechanisms must be put in place to ensure strict separation between pools of assets so that losses incurred in a given segment do not affect the profitability of the other segments. The ECB considers that this should also be clarified when acquiring entities and issuing entities are dissociated.

Protection of investors and disclosure requirements

10. The draft law's extensive coverage in terms of underlying assets and risks covered aims to follow developments in the securitisation markets, where the range of asset classes is constantly expanding. The scope of the draft law is not limited to securitisations resulting from a transfer of claims or other assets. This flows from the definitions in Article 1 and Article 53(1) of the draft law. The ECB understands that such wide coverage could include highly complex structures. In this respect, the ECB notes that Article 10(4) of the draft law obliges investors to accept the

6 See for instance Article 33 of the draft law's Chapter 3 (the liquidation of securitisation entities).

securitisation fund's rules when acquiring securities issued by the fund. However, the draft law does not specify in detail the obligations imposed on securitisation vehicles in terms of the disclosure of information when securities are offered to the public, especially as regards the underlying assets and the assessment of the risks involved. The ECB would point out in this respect that the proposed implementing measures[7] for the Prospectus Directive (hereinafter the implementing measures) aim to define the minimum information necessary depending on the type of issuer and the nature of the securities offered to the public or admitted to trading on a regulated market, to enable investors to make an informed assessment. More details are foreseen regarding the applicable disclosure regime for issuers of asset-backed securities.

11. The additional information requirements identified for asset-backed securities in the implementing measures include the types of securities issued, the underlying assets and the structure of the transaction and cash flow (credit enhancements, subordinated debt, priority of payments, etc.) and should improve the quality of the information provided to investors. This applies particularly to information on the nature of underlying assets and the general characteristics of debtors which constitute, in the ECB's view, particularly important types of information. The ECB also places great importance on a detailed description of the characteristics of the securities issued and of the types of structures used (including type of credit risk transfer) as well on an external assessment of the risks involved. Considering the various securitisation structures across Europe, it would be advisable for the draft law to clearly specify the respective obligations of the parties to the securitisation transaction vis-à-vis investors. Similarly, a practical consideration in relation to prospectuses concerns their availability to the public; in this respect the draft law could specify more clearly the nature of the legal entity responsible for drafting and disseminating the prospectus and how access can be obtained to the prospectuses, information notes for investors, management rules of securitisation funds and segments, etc.

Supervisory aspects

12. According to Article 19 of the draft law, securitisation entities that continuously issue securities to the public must be authorised by the CSSF to fulfil their functions. In this respect the ECB would first note that the concept of 'continuing issue' relates to the definition of credit institution in the consolidated Banking Directive[8]. According to recital 6 of the consolidated Banking Directive, repayable funds may be 'in the form of deposits or in other forms such as the continuing issue of bonds'. The ECB deduces, from the wording of the explanatory memorandum that these securitisation entities will not be considered to be credit institutions for supervisory purposes. Second, the draft law refers to the continuous issuance of securities to the public, which seems to imply that the issuance of securities to professional investors (private placement) would not be

7 DG Internal Market Services' working document ESC 36/2003 on the implementation of Articles 5, 7, 10, 11, 14 and 15 of the European Parliament and Council Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market and amending Directive 2001/34/EC. Text available on http://europa.eu.int/comm/internal_market/en/finances/mobil/docs/prospectus/working-doc-esc36-2003_en.pdf.

8 Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126, 26.5.2000, p. 1.

covered. This provision could be interpreted as meaning that, in such circumstances, securitisation vehicles would not have to be authorised by the CSSF. The ECB considers that the concept of 'continuous issuance' as applied in this context should be clarified so as to leave no ambiguity[9]. The ECB feels that avoiding any ambiguity in the scope of supervisory competences is particularly important in view of the draft law's aforementioned objectives of providing more secure and transparent rules. These competences should be designed to enable effective and comprehensive supervision, without introducing undue complications in supervisory regimes for different types of transactions. In particular, the complexities that are introduced by creating three different authorisation regimes for securitisation entities, i.e. authorised entities, non-authorised entities falling within the scope of the draft law and a third category comprising the entities not subject to the draft law, should be assessed against their benefits. The ECB recommends further clarification on these aspects in order to ensure sufficient supervision coverage of the entities involved in securitisation transactions in Luxembourg.

13. Article 61(1) of the draft law provides that 'a securitisation entity shall only be authorised to transfer its assets in accordance with the terms and conditions laid down by its statutes or its management rules'. The ECB feels that these management rules should clearly specify the conditions that apply to the transfer of underlying assets, to ensure that investors are fully aware of possible changes to the risk characteristics of the portfolio of underlying assets. Such additional detail might also cover certain safeguards in relation to securitisation entities' ability to borrow. The ECB also notes that under Article 14 of the draft law management companies of securitisation funds do not solely manage securitisation funds, which means that they are entitled to extend their activities to the management of UCITS or pension funds provided that they fulfil the required criteria. The ECB would emphasise both the risks involved in blurring the borders between these different types of financial activity and the need for management companies to comply with strict standards in terms of conflicts of interest, disclosure and risk management rules.

14. According to Article 22 of the draft law, authorised securitisation entities must entrust the custody of their liquid assets and their securities to a credit institution that is established or has its registered office in Luxembourg. According to the explanatory memorandum, this provision aims to ensure optimal protection for investors and facilitate the CSSF's supervision of authorised securitisation entities. The ECB understands this provision as including branches of credit institutions established in the EU.

Cross-border legal issues

15. The draft law aims *inter alia* to make it easier for securitisation entities to acquire or transfer receivables. However, in the case of foreign debtors, the question of the conditions under which the assignment could be invoked against third parties might not fall within the scope of Luxembourg law, thus highlighting the limits of a strictly domestic approach. Cross-border securitisation

9 In the context of the Prospectus Directive, securities 'issued in a continuous or repeated manner' means 'issues on tap or at least two separate issues of securities of a similar type and/or class over a period of 12 months' (Article 2(1)(l)).

transactions have to deal with conflict of law issues, which may affect the validity or enforceability of international assignments of receivables. In its Green Paper of 14 January 2003 on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation[10], the European Commission points out that 'the Rome Convention does not deal explicitly with the question under which conditions the assignment can be invoked against third parties. The question is important because it determines the effectiveness of the assignment of the claim and the transfer of the property'. Currently each Member State applies its own rules in this area and the solutions vary widely from one court to another. At international level the General Assembly of the United Nations adopted a Convention on the assignment of claims in international trade in New York on 31 January 2002. The ECB notes that certain of the provisions of the draft law are inspired by this Convention (cf. the commentary to Articles 55 and 58) which, *inter alia*, aims to make key aspects of the rules on the conflict of laws more consistent and remove legal obstacles to certain international financing practices. Among the Member States to date only Luxembourg has signed the Convention on 12 June 2002. The ECB hopes that the solutions adopted and/or examined at international level will lead to an increased convergence of the applicable rules in this area at EU level.

Use of asset-backed securities as collateral for central bank operations

16. From a collateral policy point of view, the ECB would highlight the criteria that assets must fulfil in order to be eligible as collateral for Eurosystem monetary policy and intraday credit operations. Asset-backed securities may be accepted as collateral provided they fulfil these eligibility criteria. A case-by-case assessment is always performed by central banks, carrying out this task might necessitate them obtaining any relevant information from supervisory authorities. The ECB notes that the draft law potentially allows the issue of a wide range of types of assets, some of which may be eligible. The obligation that the securities are transferable in book-entry form is one of the requirements laid down for eligibility as collateral. The ECB therefore welcomes the fact that Article 7(3) of the draft law, despite the absence of a general regime for dematerialised securities in Luxembourg, allows the management company of the securitisation fund to issue book-entry securities.

Statistics reporting

17. The regular and timely collection of accurate and reliable statistical data on securitisation vehicles across Europe is of importance for monetary policy purposes. Work is currently under way to improve euro area statistics on securitisation. In general, in carrying out its statistical tasks, the ECB identifies reporting agents using a combination of criteria based on EU law and national regulatory provisions, including supervisory agreements or tax provisions.

10 COM(2002)654 final.

The ECB would recommend that the Luxembourg authorities add a provision to the draft law to ensure that securitisation entities provide the Banque centrale du Luxembourg with the information necessary to comply with the statistical obligations imposed by the ECB.

18. This opinion will be published on the ECB's website.

Done at Frankfurt am Main on 4 February 2004.

[signed]

The President of the ECB

Jean-Claude TRICHET