

# New Law Revising Mortgage Bank Regime in Luxembourg

The Luxembourg law provisions on mortgage banks (*banques d'émission de lettres de gage*) and mortgage bonds (*lettres de gage, Pfandbriefe*) have been amended by a law dated 27 June 2013 (the "**Law**") which has entered into force on 5 July 2013. The Law provides for a number of changes and innovations further strengthening the legal framework for the issuance of mortgage bonds in Luxembourg and creating new opportunities for mortgage banks in Luxembourg. The Law in particular strengthens the protection of holders of mortgage bonds in case of opening of insolvency proceedings, introduces mutual mortgage bonds as a new category of mortgage bonds and extends the scope of eligible assets backing mortgage bonds to exposure on public sector entities from or on assets located in non-OECD countries.

This briefing outlines the main features and innovations of the Law.

## Scope of the Law

Rather than punctually modifying the provisions of the Financial Sector Law of 5 April 1993 (as amended) (the "**FSL**"), the Law has replaced in its entirety Section 3 of Chapter 1 of Part 1 of the FSL on mortgage banks, thus introducing a new revised mortgage bank regime in Luxembourg.

While the modifications to the suspension of payment and liquidation regime have been inspired by the German *Pfandbrief* legislation, the legislator did not decide to follow the German approach entirely and notably has maintained the existing special bank principle, i.e. only duly licensed mortgage banks whose

principal activity is to issue mortgage bonds backed by loans complying with specific eligibility criteria in terms of borrower or collateral quality are allowed to issue mortgage bonds (Art. 12-4(3) FSL).

## Effects of Opening of Insolvency Proceedings over Partially Insolvent Mortgage Banks

The Law reviews the regime for collective proceedings opened over mortgage banks, specifically in case of suspension of payments

## Key Features

- Possibility of putting a partially insolvent mortgage bank into "limited activity"
- Mutual mortgage bonds as a new mortgage bond type
- Cover pool exposure on non-OECD public entities or assets located in such states
- Increased legal certainty for cover pool eligibility
- Cover pool transparency and investor information
- Control of movable asset valuation

proceedings or judicial liquidation proceedings of the mortgage bank (Art. 12-9 f. FSL). The Law in addition introduces the possibility of opening such proceedings over cover pools or single compartments thereof (Art. 12-11 f. FSL).

## Segregation of a Solvent and an Insolvent Mortgage Bank Part

As for any Luxembourg credit institution the insolvency proceedings that may be opened over a mortgage bank are suspension of payments proceedings (Art. 60-8 ff. FSL) or judicial liquidation proceedings (Art. 61 ff. FSL). Pursuant to Art. 12-9 (1) FSL, in case any such proceeding is opened by the court over the mortgage bank, the mortgage bank is by operation of law divided into two parts:

- one part of the mortgage bank containing the different categories of mortgage bonds, which, together with their cover pools and relating reserves deposited with the central bank constitute as many separate and distinct patrimonial compartments (*compartiments patrimoniaux*) as they form separate estates by virtue of article 12-5(3) FSL (Art. 12-9(1)(a) FSL). The entirety of sums arising from the recovery, the repayment or the payment of assets of the realisation of cover assets registered in the cover register or of guarantees which have been provided in relation with the cover assets are also part of this separate estate of the mortgage bank. The provisions governing suspension of payment or judicial liquidation proceedings for credit institutions generally do not apply to these patrimonial compartments. However, the court may, by application of Art. 12-11 or 12-12 FSL also open suspension of payment or judicial liquidation proceedings over single patrimonial compartments in case of liquidity shortfalls or in

case the obligations vis-à-vis the respective mortgage bond holders cannot be satisfied. In such case, most of the provisions governing suspension of payment or judicial liquidation proceedings for credit institutions apply to the insolvency proceedings opened over a single patrimonial compartment.

- another part of the mortgage bank containing the remaining estate related to the accessory activity of the mortgage bank. The provisions governing suspension of payment or judicial liquidation proceedings for credit institutions apply to this remaining estate.

This division of the mortgage bank in case of opening of suspension of payments or liquidation proceedings over it allows for a more efficient reorganisation or liquidation of the mortgage bank, as the separation allows to reorganise or wind up the insolvent part without affecting the solvent part (which can continue to operate normally).

The solvent part of the mortgage bank will constitute a so-called mortgage bank "in limited activity" (Art. 12-9(3) FSL). The insolvency proceedings will not affect the functioning of the mortgage bank "in limited activity" which will be strictly separated from the compartments or accessory activities subject to suspension of payments or liquidation proceedings. by virtue of Art. 12-8 FSL.

### Activity of the Mortgage Bank "in Limited Activity"

The purpose of the mortgage bank "in limited activity" is the management of the patrimonial compartments and the integral payment at maturity of the obligations arising out of the mortgage bonds.

Pursuant to article 12-9(4) FSL, the initial licence of the mortgage bank provided for in Art. 12-1 FSL is by operation of law upheld for the mortgage bank "in limited activity" for the achievement of its purpose. The mortgage bank "in limited activity" also remains subject to the legal and regulatory provisions applicable to mortgage banks in general.

Where the courts open suspension of payments or judicial liquidation proceedings over a patrimonial compartment by application of Art. 12-11 or 12-12 FSL, the mortgage bank "in limited activity" will continue its activities with the remaining patrimonial compartments (Art. 12-9(5) FSL).

The patrimonial compartments do not have a distinct legal personality though from the mortgage bank "in limited activity".

### Administration of the Mortgage Bank "in Limited Activity"

The court opening suspension of payments proceedings or judicial liquidation proceedings over a mortgage bank introduces in Art. 12-10(1) FSL has to appoint one or more administrators (*administrateurs*) in charge of the administration of the mortgage bank in limited activity.

The administrator must present all guaranties of good repute and professional soundness and may be revoked upon request by the Luxembourg financial sector supervisory authority *Commission de Surveillance du Secteur Financier* ("CSSF").

The mission of the administrator consists of executing the obligations arising out of the mortgage bonds at

their respective maturity dates (Art. 12-10(1) FSL).

For such purpose, the administrator manages the cover pools of the mortgage bank "in limited activity" and exercises the rights of the mortgage bond holders and the mortgage bank on the cover pool assets progressively in accordance with their respective maturities (Art. 12-10(5) FSL).

The administrator manages each patrimonial compartment independently and distinctly in the sole interest of the mortgage bond holders.

For such purpose, the administrator can take all necessary acts of management in the interest of the integral payment at maturity of the respective mortgage bonds (Art. 12-10(6) FSL).

The administrator has the right to issue new mortgage bonds for the account of the mortgage bank "in limited activity" (Art. 12-10(6) FSL).

The administrator regularly or upon request informs the CSSF or the court about the status of its mission and establishes a balance sheet when starting its function and subsequently on an annual basis a balance sheet, a report on the situation of the mortgage bank "in limited activity" as well as its patrimonial compartments.

The administrator represents the mortgage bank "in limited activity" and the patrimonial compartments, including vis-à-vis the administrator or liquidator of the insolvent part of the mortgage bank (Art. 12-10(3) FSL).

The administrator may conclude a service agreement with an EU/EEA/OECD licensed and supervised mortgage bank for the management of the mortgage bonds

and the realisation of the cover assets in accordance with the maturity dates for the respective mortgage bonds. The validity of such service agreement is subject to prior written approval by the CSSF (Art. 12-10(7) FSL).

The administrator may, in accordance with Art. 12-10(8) FSL, transfer all mortgage bonds with their respective cover pools to a mortgage bank which is similar in nature to a Luxembourg mortgage bank and is subject to a level of supervision comparable to the one exercised by the CSSF. The transfer is subject to prior approval by the CSSF or, upon request by the administrator and after hearing of the CSSF and the administrator, the court (Art. 12-10(8) FSL).

The CSSF – instead of being itself the administrator of the cover pools as under the old regime - exercises its supervisory function over the mortgage bank "in limited activity" and exercises all its powers over its patrimonial compartments and the administrator (Art. 12-10(9) FSL).

## Introduction of Mutual Mortgage Bonds

The second major innovation in the Law is the introduction of the new category of mutual mortgage bonds (*lettres de gage mutuelles*) (Art. 12-1(1)(f) and (g) FSL). This new mortgage bond category has been added to the existing categories of public sector mortgage bonds, real estate mortgage bonds and movable assets mortgage bonds (followed by the name of the relevant movable asset category, such as ships or aircrafts).

Mutual covered bonds are covered bonds backed by exposures on credit institutions that are members of a mutual institutional guarantee system.

## Institutional Guarantee System

According to Art. 12-3(2)e) FSL, an institutional guarantee system is characterised by the following elements:

- The statutory object of the system is to mitigate imminent or existing economical difficulties for its members institutions.
- The system grants, in the framework of its object, the necessary means to maintain the liquidity and solvency in order to avoid the bankruptcy of member institutions by immediately available funds.
- The risk control and classification infrastructure of individual member institutions and the guarantee system is adequate and informs the member institutions of the respective risk classification.
- The system publishes at least annually a report on the status of its assets and liabilities, a profit and loss account, a report of the situation and a report on the risks concerning the guarantee system in its entirety.
- The system has a sufficient number of members with an essentially similar activity.
- The members are obliged to put at the disposal of the guarantee system, upon its demand and without delay, the audit reports, ratios and values of the respective member institution and its branches.
- The members are obliged to inform without delay the

guarantee system of their intention to take over an undertaking which does not participate in the system or to modify or terminate an existing participation in such undertaking.

- The members are also required to inform the system immediately, once this becomes apparent, of a situation in which the respective member is unable to cover the risks resulting from its activities by own funds or to meet its obligations in time.
- In case of imminent or existing financial distress, members have to prepare, upon demand of the system, a recovery plan which it is obliged to implement upon approval by the system.
- Finally, the risk control and classification set-up both of the individual member institutions and of the guarantee system needs to be approved as being sufficient and adequate by the CSSF (upon receipt of the opinion of the Luxembourg Central Bank) or another comparable supervisory authority, competent for the guarantee system, and has to be controlled in regular intervals.

### Mutual Mortgage Bond Backing

Mutual Mortgage Bonds have to be backed by loans granted by the mortgage bank:

- either to EU/EEA/OECD established credit institutions participating in an institutional guarantee system (Art. 12-1(1)f FSL); or
- which are guaranteed by bonds issued or other commitments given in whatever form by such

institutional guarantee system member institutions (Art. 12-1(1)g FSL).

As the loans mentioned above may be granted by the mortgage bank in whatever form, cover pool assets for mutual mortgage bonds may also for instance be bonds acquired by the mortgage bank:

- which are guaranteed by such institutional guarantee system member institutions, or
- which are themselves mutual mortgage bonds issued by such institutional guarantee system member institution which is itself a recognised mortgage bank, or
- which are issued by a securitisation vehicle or compartment thereof whose assets are constituted or guaranteed to a certain extent by such institutional guarantee system member institutions.

## Cover Pool Exposure on Non-OECD Country Collateral

The cover pool of mortgage bonds may now to a certain extent be composed of exposures on non-OECD member states, provided the relevant country has a specific rating granted by a rating agency registered with ESMA by virtue of the EU Rating Agency Regulation N° 1060/2009 (Art. 12-1(d) FSL). Such exposure may either be on a public sector entity (*collectivité de droit public*) of such non-OECD member state in the cover pool for public sector mortgage bonds, but may also be on real estate or movable assets located in such non-OECD member state. The Law

however does not foresee that cover pools of mutual mortgage bonds may have exposure on credit institutions of non-OECD member states participating in a mutual guarantee system.

## Other Important Changes

### Increased Legal Certainty of Cover Pool Eligibility

The Law provides for more legal certainty by introducing a legal definition of "public undertaking" (*entreprise publique*) in line with the definition thereof set out in Council Regulation (EC) N° 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty.

The Law has further been amended so as to clarify that it is sufficient that the mortgage bank holds the cover assets as their owner (Art. 12-5(1), subpara. 1 FSL), without a need to hold them on the asset side of its balance sheet. The Law confirms that eligible assets (coupled with their respective collateral) may be transferred to the mortgage bank under a Luxembourg transfer of ownership for collateral purposes (*transfert de propriété à titre de garantie*) contract or a similar collateral arrangement to which foreign law applies in order to secure claims of the mortgage bank standing on the asset side of its balance sheet, but which are as such not eligible for the cover pool (cf. Art. 12-5(1), subpara. 2 FSL).

## Cover Pool Transparency and Investor Information

A further innovation relates to the cover pool register. In order to ensure the transparency and investor information, the mortgage bank will have to publish information on the composition of the cover pools, the issuances and the issuer of the mortgage bonds. The modalities of such publication are to be specified by the CSSF (Art. 12-6(2) FSL).

## Control of Movable Asset Valuation

The special auditor (*réviseur d'entreprise agréé spécial*) of the mortgage bank now has to control whether the valuation of movable assets has been made by the mortgage bank according to the valuation rules which the mortgage bank has to establish for such purpose and which have been approved in advance by the CSSF (Art. 12-7(2) FSL). This mechanism existed previously only for the real estate mortgage bond cover pool and has now been extended to the movable asset mortgage bond cover pool.

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