

LUXEMBOURG GOES "GREEN" - INTRODUCTION OF A NEW LUXEMBOURG RENEWABLE ENERGY COVERED BOND REGIME

The Luxembourg law provisions on covered bond banks (*banques d'émission de lettres de gage*) and covered bonds (*lettres de gage, Pfandbriefe*) have been amended by a new law of 22 June 2018 modifying the financial sector law of 5 April 1993 ("FSL") to introduce renewable energy covered bonds (the "RECB Law").

The RECB Law provides for several changes and innovations further strengthening the legal framework for the issuance of covered bonds and creating new opportunities for covered bond banks in Luxembourg. The RECB Law introduces renewable energy covered bonds as a new statutory covered bonds class and further strengthens covered bonds holder protection by implementing certain of the recommendations on the harmonization of the covered bond frameworks in the European Union published on 20 December 2016 by the European Banking Authority (the "EBA Recommendations").

The RECB Law is a further step for reaching sustainable development objectives and reinforces the position of the Luxembourg as a centre of excellence in green and sustainable finance.

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

Key features of the RECB Law:

- Introduction of renewable energy covered bonds as a new covered bond class
- Introduction of a cover pool liquidity buffer requirement
- Expansion of eligible substitute collateral to public entity commitments
- Increase of Luxembourg covered bond market transparency

INTRODUCTION OF RENEWABLE ENERGY COVERED BONDS

The major innovation in the RECB Law is the introduction of the new renewable energy covered bond class (*lettres de gage énergies renouvelables*).

This new statutory class of covered bonds (*lettres de gage* or *Pfandbriefe*) will be added to the existing classes of covered bonds, namely public sector covered bonds, real estate covered bonds, movable assets covered bonds (followed by the name of the relevant movable asset class, such as ships or aircrafts) and mutual covered bonds.

DEFINITIONS

Renewable energy covered bonds are covered bonds backed by loans secured by rights in rem in or by charges on immovable or moveable renewable energy property and by rights of step-in into the material contracts of the financed project.

"Renewable energy" refers to energy from renewable non-fossil sources, namely wind, solar, aerothermal, geothermal, hydrothermal and ocean energy, hydropower, biomass, landfill gas, sewage treatment plant gas, biogases and energy produced from similar sources.

SECURITY PACKAGE FOR THE LOANS IN THE COVER POOL

Renewable energy covered bonds present a high quality standard due to the fact that any material property linked to the financing of the renewable energy project has to be pledged in favour of or transferred as security to the covered bond bank financing the transaction.

Material renewable energy property, be it movable or immovable property, includes any material project contract of the renewable energy undertaking, any revenue of such undertaking (including notably existing and future revenue claims and received payments, generated by renewable energy sources) and any equipment necessary for the production, storage or transmission thereof. The production equipment to be received as security needs to be fully used in relation to renewable energy and storage and the transmission equipment to be received as security must be used more than 50% in relation to renewable energy. Material renewable energy property includes additionally any access or usage rights to the equipment, the right to feed the renewable energy into the electricity network and all rights linked to the distribution of renewable energy.

The covered bond bank may also take additional security to the extent possible, such as a pledge in its favour of the shares held in the renewable energy undertaking.

With regard to rights in rem and certain charges securing the loans covering existing covered bond classes, the law requires that these are registered in a state public register. In the context of the new class of renewable energy covered bonds, certain rights in rem or charges securing the loans covering renewable energy covered bonds will have to be registered in public registers, while others may not be subject to registration in a public register under the laws applicable to them. In order to ensure the validity and enforceability of the rights in rem and charges against third parties and ultimately the solidity and soundness of this new covered bond class, the RECB Law foresees that in cases where there is no legal requirement to ensure validity and enforceability of the rights in rem and charges through a public register entry under applicable law, the validity and enforceability of such rights and charges will have to be confirmed to the covered bond bank by independent, written and reasoned legal opinions for each of the countries concerned.

THE IMPORTANCE OF STEP-IN RIGHTS

In addition to the security in form of rights *in rem* in or charges on immovable or moveable renewable energy property, the covered bond bank needs to ensure that step-in rights are granted to it in respect of all material contracts available in the financed project.

A "step-in right" is defined in the RECB Law as the right of the bank resulting from law or contract to step into the position of the renewable energy undertaking under material project contracts in case the renewable energy undertaking defaults under the loan granted to it. "Material project contracts" are certain contracts, rights or commitments existing in any renewable energy project and which are essential to permit the pursuit, sale or transfer of the project in case of financial difficulties of the renewable energy undertaking. These material project contracts are defined and listed in the RECB Law. In the context of renewable energy covered bonds, the right of the bank to step into the material contracts of the undertaking linked to renewable energy is of essence to secure the continuous income from the financed energy project for the bank.

Another step-in foreseen in the RECB Law, but that is not a mandatory part of the security package foreseen by law, concerns the bank stepping into the renewable energy undertaking by taking a participation, and typically a controlling stake, in it. Such step-in may result from the enforcement of a share pledge granted in favour of the bank as part of the project finance security package. Under the existing covered bond bank regime, covered bond banks are not allowed to acquire investments of more than one third of the nominal value of all the shares of a company, unless the company has a corporate object clause which limits it to carrying out activities which a covered bond bank is authorized to carry out itself. The RECB Law adds the possibility for the bank to acquire participations in renewable energy undertakings where such participations are aimed, notably to pursue and promote the covered bond activities of the bank and, in particular to avoid losses on rights and security on renewable energy property. A further condition for such acquisition of participations is that the liability of the bank arising from the participation is limited by the legal form of the undertaking. However, in order to ensure that banks do not concentrate too much risk in relation to a single undertaking, the RECB Law provides that the amount of such participations must not exceed in total 20% of the bank's own funds, without prejudice to restrictions for holdings outside the financial sector under the EU Capital Requirement Regulation (EU) No 575/2013.

RELATIVE LIMITS FOR USE OF RENEWABLE ENERGY PROPERTY AS COLLATERAL

The RECB Law sets forth three different relative limits for the use of renewable energy property as collateral, corresponding to the underlying key risk drivers:

- In general, renewable energy property may only be used as collateral up to a maximum of 50% of the estimated realisation value.

- This threshold is raised to a maximum of 60% if the estimated realisation value is based on a regulated fixed remuneration regime or if the relevant renewable energy project operates with free of charge renewable energy sources (such as wind or sun) and to a maximum of 70% of the estimated realisation value if both conditions are met.
- The thresholds may again be raised by an additional 10% for renewable energy assets for which the construction phase has been accomplished.
- Immoveable as well as moveable assets which are still under construction may only be taken into account for up to 20% of the ordinary collateral.

The above limits do however not apply to financing provided in the form of bonds or other debt instruments acquired (or subscribed) by the bank.

VALUATION OF RENEWABLE ENERGY ASSET VALUATION AND CONTROL

The RECB Law takes account of the particular nature of renewable energy property with respect to applicable valuation standards. It charges the CSSF to define valuation principles based on prudent valuation standards for this type of asset class. The estimation of the realisation value referred to above has to be carried out with sincerity and prudence in accordance with such rules, only taking into account the durable characteristics of the asset and durable revenue which they can procure to any owner who makes normal usage of them in accordance with their purpose.

Furthermore, the special auditor (*réviseur d'entreprises agréé spécial*) of the covered bond bank is required to control whether the realisation value of the renewable energy property serving as security has been determined based on prudent valuation standards applicable to this type of assets defined by the CSSF. The special auditor also needs to verify that the frequency of revaluation of the realisation value of renewable energy property is consistent with the nature, facts and specific circumstances of the asset and that such re-evaluation is performed at least annually, based on current market data and appropriate valuation assumptions.

ACQUISITION OF RENEWABLE ENERGY DEBT INSTRUMENTS ISSUED BY SECURITISATION VEHICLES AND OTHER ISSUERS

The RECB Law introduces the possibility for the covered bond bank, instead of itself originating (or acquiring) eligible renewable energy project loans, to subscribe or acquire bonds or other debt instruments that are issued by a securitisation vehicle or other issuer if certain conditions aimed to ensure the high quality of the cover pool are met. Such conditions relate to (i) the proportion of the issuer's assets that need to consist of financing by the issuer

of renewable energy projects, (ii) the existence of a security structure equivalent to the structure required for renewable energy project loans granted by the covered bond bank itself (for securitisation vehicles only), and (iii) a credit quality step of 2 or better granted by a credit rating agency registered with ESMA pursuant to EU Credit Rating Agency Regulation (EC) No 1060/2009. However, the renewable energy cover pool assets of the bank must not in total be constituted by more than 20% of these bonds or other debt instruments.

AMENDMENTS OF THE GENERAL RULES

The main amendments of general rules governing the covered bond bank regime are, amongst others, the introduction of a cover pool liquidity buffer requirement, an adaptation of the regulation regarding the use of derivatives, an expansion of the eligible substitute cover asset items and an increase of transparency requirements for covered bond banks.

1 - Introduction of a Liquidity Buffer

To minimize the cover pool liquidity risks that can arise in the context of a covered bond issuance or issuance programme, the RECB Law introduces a mandatory cover pool liquidity buffer requirement.

To ensure the cover pool liquidity for a 180-days period, the bank is henceforth obliged by law to carry out daily reconciliations. For this purpose, the bank must calculate each day the total of the daily differences arising between cover pool claims falling due and the liabilities falling due under the related covered bonds and under the derivatives registered in the relevant cover pool register. The highest negative result so calculated for the next 180 days has to be covered any time by the total of cover assets which are eligible for ESCB central bank credit or which are liquid assets of level 1 or 2A under Delegated Regulation (EU) 2015/61 (with the exclusion of covered bonds issued by the bank itself).

The law foresees exemptions from the mandatory liquidity buffer requirement for principal payments of covered bonds with respect to certain soft bullet and conditional pass-through (CPT) structures.

In order to permit the continuation of existing cover pools in run-off mode, the liquidity buffer requirement is only applicable to covered bonds issued after the entry into force of the RECB Law. Covered bond banks may however optionally choose to apply the liquidity buffer provisions with respect to covered bonds issued before the entry into force of the new law.

2 - Regulation of the Use of Derivatives

The RECB Law adapts the rules on the use of derivatives in the light of the EBA Recommendations and of the German *Pfandbriefgesetz*. The RECB Law specifies that derivatives registered in the cover pool register may exclusively be used to ensure global coverage of the liability for payment of principal and interest under the covered bonds in issue and the other liabilities of the cover

pool. The law further provides that such derivatives can in no circumstances be terminated because of the opening of insolvency proceedings over the bank or any of its segregated estates (compartiment patrimonial).

3 - Expansion of the Admission of Substitute Collateral to Public Entity Commitments

To further increase the quality and liquidity of the cover pool for the benefit of the covered bond holders, the RECB Law expands the scope of eligible substitute cover assets to public entity commitments in any form as provided for by article 12-1 (1), letter d) of the FSL. The RECB Law further clarifies that assets in any form with EU, EEA, OECD or certain other countries' central banks (such as cash account claims or claims based on securities issued by them) are eligible substitute cover assets.

4 - Greater Transparency Requirements for Covered Bond Banks

The RECB Law now requires covered bond banks to publish, in addition to the information already required to be published before, information on the structure of the covered bond issues. The CSSF is further charged to determine the list of information items to be published and the modalities of publication, including the frequency.

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