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Banking & Finance

Luxembourg: Trends & Developments

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Trends and Developments

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Current Perspective

Looking at the beginning of 2020, the global effect of COVID-19 has undeniably affected the banking and finance market in Luxembourg. Certain cross-border financing transactions were adversely affected due to the disruption caused to industries such as aviation, hospitality and retail. The real estate finance, and certain sections of asset finance, markets were most affected. While other fields of practice demonstrated exceptional dynamism, we saw a trend towards greater conservatism on the lending side, resulting in deals taking longer to close, and increased levels of due diligence (in particular, in respect of enforcement scenarios).

Cross-border real estate finance transactions have fallen to an unprecedented level, with deal volume dropping dramatically since March, resulting in many properties coming off the market. It remains unclear how long these effects will continue or if the situation will deteriorate further due to the pessimistic forecasts for the hospitality industry in fly-to markets and retail and office space (except for new logistics and retail platforms and facilities).

The securitisation market, however, has continued to prove its vitality in spite of a slowdown in the creation of new securitisation structures that target heavily affected sectors, such as the hospitality, aviation and automotive industries. Fund finance has also demonstrated good resilience, with existing facilities being upsized, additional borrowers acceding to higher advance rates, terms being extended and sponsors forming new funds to seize the opportunities arising from the unprecedented circumstances, often compensating for the slowdown felt in other practices. UK and North American institutional lenders have been keen to respond to funds' demand for traditional bridge financing arrangements. Net asset value (NAV) or hybrid financing arrangements are also trending, a valid option where higher advance rates may not be borne. Alternative lenders have stepped in to largely negate the prospect of higher pricing and fund sourcing issues (due to regulatory thresholds).

The outlook for the remaining months of 2020 and the year to come looks positive; thanks to the support of Luxembourg and EU lawmakers, who have been proactive in drafting new laws and regulations (a number of which will be addressed later on in this article), and local practitioners, whose responsiveness and inventiveness has promoted creative solutions in response to the market's changing demands.

Professional Guarantee of Payment

The former regime

The Luxembourg law of 5 August 2005 on financial collateral arrangements, which implemented Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (the Collateral Law), created a popular regime to govern financial collateral arrangements, to the point that, within a short time, it became one of the key assets making Luxembourg an attractive jurisdiction for financing transactions and contributed to the continued attractiveness of Luxembourg as a financial centre. It left, however, in the eyes of many practitioners, a sense of unfinished business. Unlike security interests in rem (a pledge or transfer of title for security purposes), which benefit from the regime set by the Collateral Law, existing Luxembourg law sureties and guarantees of payment remain governed by traditional principles of contract law laid down under the Civil Code and case law, while autonomous (first demand) guarantees and accessory sureties abide by conflicting and entrenched regimes.

The introduction, by means of the adoption of the law of 10 July 2020 on professional guarantee of payment (the PGP Law), of a new, flexible and creditor-friendly form of surety in the Luxembourg legal framework was both a bold and a welcome initiative.

The surety (*cautionnement*) constitutes the traditional guarantee of payment under Luxembourg law and the only existing guarantee provided for in the law. A surety is an accessory to the underlying guaranteed obligations and such accessoriness is deemed mandatory and essential. The main adverse consequence of this from the perspective of creditors is that it prevents the waiver of defences arising out of the underlying obligations or arrangements. Accordingly, the surety is enforceable only if and to the extent the underlying obligations remain valid, due and payable. The balance between the interest of the creditor and of the surety was deemed broken (in favour of the surety) in the course of the 1980s following several amendments made to the legal framework over time.

As a result, and in a quest to satisfy market expectations, practitioners introduced new forms of guarantees that were later consecrated by case law. The resulting autonomous first demand guarantees, which may be realised and enforced upon the contractually agreed conditions being met and regardless of the fate of the underlying obligations, addressed the main impediment of the surety regime. However, it did not satisfy the market expectations, as any reference to the underlying secured obligations or arrangements triggered a risk of requalification into a surety. This resulted in practical predicaments, for instance, in respect of the duration of the autonomous guarantee or the payable amount. Since tracking the underlying obligations and releasing the autonomous guarantee upon discharge of the underlying obligations was not possible, setting a termination date – or complex renewal mechanisms – was/were required. Similarly, the amount payable by the guarantor could not refer to the outstanding amounts payable under the secured obligations at any given time, but would typically consist of a set amount or of a predetermined payment schedule.

For such reasons, the standard security package governed by Luxembourg law – set up in the context of cross-border financing transactions and managed out of common law jurisdictions –- would typically include financial collateral arrangements over real assets located, or deemed to be located, in Luxembourg only, while the parties resorted to guarantees of payment governed by the law governing the underlying/secured obligations. This was, however, unsatisfactory in the context of financing arrangements governed by Luxembourg law and entered into between special purpose vehicles established in Luxembourg in light of concerns relating to the potential adverse consequences of conflict of laws rules, risks of requalification, recognition of foreign judgments and/or subsequent recovery proceedings.

The PGP regime

The flexibility offered by the newly created professional guarantee of payment (the PGP) is likely to turn the tide and supplement security interests in rem in Luxembourg law security packages.

The PGP regime offers the utmost flexibility for the parties to contractually determine the terms of the payment obligations bearing on the guarantor, which/who may be a foreign or Luxembourg natural person or legal entity. Should the parties wish to mirror the terms of the common law guarantees to which they may be accustomed, the flexibility offered by the PGP makes it possible without triggering any risk of requalification. For additional comfort, the PGP Law expressly states that the provisions of the Civil Code governing accessory sureties (such as the *cautionnement*) may not impair the enforcement of the agreed upon terms under the PGP.

The PGP may, for instance, validly and expressly refer to the terms of the underlying secured obligations (which may be existing or future, to the extent identifiable), while preventing the guarantor from availing itself of any defences that may arise in respect of the underlying obligations from time to time. Furthermore, it may require payment without discussion and on first demand. As another example, the amount payable by the guarantor under the PGP may track the amounts outstanding under the secured obligations, and the PGP may automatically terminate upon the discharge of the secured obligations.

Aligning with one of the main innovations of the Collateral Law, the accessoriness of the PGP is further alleviated as the parties may freely determine the circumstances conditioning the realisation of the PGP regardless of whether the underlying secured obligations have accelerated following the occurrence of a default thereunder. This would permit the guarantee to be called upon the occurrence of predetermined circumstances at a time where the guarantor is still in a stable financial condition, without requiring the secured parties to accelerate the underlying secured obligations. Such a decision may often trigger adverse consequences resulting in all the obligors becoming insolvent.

The ability to determine such conditions contractually may also render the PGP particularly useful in the context of synthetic securitisation schemes. Synthetic securitisations consist of the transfer to the securitisation vehicle of the credit risk associated to certain exposures (unlike true sale securitisations, where title to such assets need to be transferred). In this context, guarantees are meant to achieve the same purpose as a risk transfer instrument. The parties to a PGP may freely determine and agree upon credit events which would, upon occurrence, trigger the right to call the guarantee and may not necessarily be related to the main debtor, but rather to the guarantor itself.

Again, conforming to the rules already applicable to financial collateral arrangements:

- the powers of trustees or agents acting in the name of secured parties, in favour of which a PGP may be set up, are expressly recognised, nullifying the need for sophisticated legal devices aimed at addressing issues resulting from conflicts between common law mechanisms and civil law principles (such as the setting up of parallel debts); and
- the waiver of the guarantor's rights of subrogation and recourse may be validly granted in advance (the validity of such an anticipative waiver was questionable both in light of civil law principles and as to the corporate interest of the guarantor until consecrated under the Collateral Law).

From a practical perspective, a PGP could be established under private seal and would not be subject to taxes or registration duties, mirroring the informality that characterises financial collateral arrangements. The only formal conditions are that the PGP should be documented in writing (or in electronic form) and that the parties must expressly submit the surety to the PGP Law. This latter condition was further strengthened during *travaux parlementaires* (parliamentary discussion around its implementation) in the context of passing the legislation. Practitioners tend to welcome this approach; however, the concern was that the intention of the parties should not be disputable. The use of the court-made autonomous first demand guarantees in civil law jurisdictions since the 1970s resulted in an abundance of case law, spanning many decades, where the qualification of guarantee agreements was challenged. The approach taken by the legislature in the PGP Law should negate this source of uncertainty.

Last but not least, a PGP will be fully immunised against any insolvency or pre-insolvency proceedings (initiated in Luxembourg or abroad) affecting the main debtor under the secured obligations, mirroring the insolvency remoteness of financial collateral arrangements.

Expected results

There seems to be a consensus among legal practitioners in Luxembourg that the PGP Law enhances the attractiveness of the financial centre as a jurisdiction of choice to structure complex cross-border financing arrangements and that it may become a popular instrument to structure specific transactions, such as synthetic securitisations or portfolio guarantees, where secured claims are originally undetermined.

While neighbouring jurisdictions had previously attempted to create a new form of surety that would combine advantageous features of traditional accessory and autonomous guarantees, their success remains debatable. Unlike these former attempts, the PGP Law was built on well-established case law that confirms both the precedence of contractual freedom and the unassailability and insolvency remoteness of the foregoing financial collateral arrangements. It is predicted that this will constitute a key factor in the future success of the PGP.

Unlike in France, where rules governing autonomous first demand guarantees were expressly introduced in the French Civil Code following a legal reform in 2006, only the surety (*cautionnement*) and the new PGP benefit from express legal provisions in Luxembourg, while the rules governing the autonomous first demand guarantees remain case-law driven. This can be seen as paradoxical, and it would not be surprising if the anticipated success of the PGP is, in the long run, at the expense of the use of autonomous first demand guarantees.

Existing guarantee agreements could also benefit from the new PGP regime by way of an amendment incorporating an express reference to the PGP Law. The advantageous inclusion of PGPs in Luxembourg law-governed security packages set up to secure all sorts of financing arrangements (whether in the context of fund finance deals, structured finance and securitisations schemes or, more generally, any kind of transaction that may be secured by obligations to pay) may very well become standard, putting an end to a creative legislative cycle opened 15 years ago.

The Adaptive Securitisation Practice

While dithering in respect of the securitisation market remained prevalent for most of the year in 2019, resulting in a significant decrease in issuance volume, 2020 has, to date, and despite the global pandemic, shown a new dynamism.

Interestingly, market surveys indicate that the main criteria that drives issuers to the Luxembourg market is the legal certainty and flexibility that it offers. Two factors resulted in the market either adopting a cautious approach and waiting for clarity or exploring innovative alternate structuring solutions. First, uncertainty resulted from the entry into force of 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 (the EU Regulation on Securitisation). This uncertainty was further fuelled by the practical implementation (notably, the risk of concurrent application of this regulation and of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and the delimitation of the respective scope of that regulation and of the law of 22 March 2004 on securitisation) thereof. Second, Luxembourg's implementation of the European Anti-Tax Avoidance Directive (Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I), in particular, on securitisations of non-performing loans.

Market surveys tend to show a heightened interest in securitisation funds, as tax transparent structures are exempt from the interest limitation rules under ATAD. This interest resulted in an actual trend in favour of securitisation funds in the form of fiduciary estates during the first half of 2020. The law of 27 July 2003 on trust and fiduciary contracts (the Fiduciary Law) allows the issuance of notes on a fiduciary basis in the name of the securitisation vehicle but for the benefit of the noteholders. We believe that this trend will be encouraged by the lack of guidelines from local tax authorities (which were originally expected by 15 October 2019) and the letter of formal notice issued by the European Commission on 14 March 2020 to Luxembourg and Portugal, whereby the Commission requested Luxembourg to amend its ATAD I law so as to exclude SSPEs (ie, securitisation vehicles that are subject to the EU Regulation on Securitisation) from the exemption from interest limitation rules. This can only result in increased uncertainty and concern as to whether and when Luxembourg will submit to the EU Commission's request.

New constraints from originators' jurisdictions abroad also brought a new flow of diversified payment rights securitisations to Luxembourg.

Meanwhile, on 28 May 2020, the European Securities and Market Authority (ESMA) updated its Q&A on the EU Regulation on Securitisation, providing useful guidance while the awaited technical standards have yet to be approved and come into force. This contribution was particularly welcomed by practitioners as the proper completion of certain specific fields of the templates contained in the draft Regulatory Technical Standards and Implementing Technical Standards needed to comply with the reporting obligations for which the approaches taken by EU supervisory authorities were not always aligned. The efforts of ESMA will therefore help to achieve common, uniform and consistent supervisory approaches and practices in the day-to-day application of the EU Regulation on Securitisation.

As a final note, the EU Commission published, at the end of July, as part of its Capital Markets Recovery Package, a proposal for a regulation amending the EU Regulation on Securitisation to help the recovery from COVID-19, and make it easier for banks to use securitisation to transfer risks related to loans extended to SMEs. As pointed out by the EU Commission, by transforming loans into tradable securities, securitisation could free up bank capital for further lending and allow a broader range of investors to fund economic recovery. By publishing this proposal long before the comprehensive review scheduled for January 2022, the Commission has demonstrated that it sees securitisation as an important tool to achieve economic recovery. The proposed amendments would consist of extending the STS securitisation framework to on-balance-sheet synthetic securitisations, and removing regulatory obstacles to the securitisation of non-performing exposures by allowing the servicer to act as risk retainer and by taking into account the non-refundable purchase price discount when calculating the amount of the mandatory risk retention slice.

Creation of the Register of Fiducies and Trusts

The expected increase in attractiveness of securitisation funds addressed in the foregoing paragraphs will bring about practical application of another recent development: the Luxembourg law of 10 January 2020 that established a register of *fiducies* (fiduciary arrangements) and trusts (the RFT Law). The RFT Law completed the implementation of Luxembourg's anti-money laundering and counter terrorism financing measures, which commenced with the implementation of the law of 12 November 2004 on the fight against money laundering and terrorist financing (the AML Law) and was furthered by the law of 13 January 2019 pertaining to the register of beneficial owners (the UBO Law). The RFT Law mirrors the obligations set out in the UBO Law, which applies to corporations.

The RFT Law sets out obligations on any *fiducie* or trust (and similar legal constructs) managed in Luxembourg. Notably, they are obliged to maintain (for a period of five years) at their place of administration, up-to-date information on:

- their ultimate beneficial owners, which include the settlor(s), the trustee(s)/fiduciary agent(s), the protector(s) (if any), the beneficiaries or the classes of beneficiaries (as applicable) and any other natural person that exercises an effective control thereon; and
- foreign law-governed entities that are subject to the AML Law, or would be subject to it if they were based in Luxembourg, to the extent they provide services to the *fiducie* or trust.

Any such *fiducie* or trust must, upon request, provide the aforementioned information to investigating judges, prosecutors, supervisory authorities (notably the local supervisory authority, the *Commission de Surveillance du Secteur Financier*), tax authorities and any other national authorities as well as self-regulatory bodies.

The RFT Law also created a new register of *fiducies* and trusts that is managed by the tax authorities. Any *fiducie* or trust that has at least one fiduciary agent or trustee established in Luxembourg must be registered by electronically filing key and accurate information, including on its ultimate beneficial owners. This would also apply to entities established outside of the EU under certain conditions, notably in the case where they own real estate in Luxembourg. The information is kept for five years after the termination of the *fiducie* or trust. In case of inaccurate or incomplete filing or failure to register, the tax authorities may sanction the persons in breach (legal entities, but also natural persons such as the managers of the fiduciary agent).

The RFT Law establishes three levels of access rights, similarly to the register established in 2019, for beneficial owners of corporations. While full access is granted to national authorities or self-regulatory bodies, natural or legal persons may be granted limited access upon motivated demand and subject to the payment of a fee, to the registered information to the extent that a legitimate interest in preventing the use of the financial system for money laundering or the financing of terrorism or where the *fiducie* or trust owns a direct or indirect controlling interest in any entity other than those established in a member state and that is subject to information duties on their ultimate beneficiary owners under the Fourth Anti-Money Laundering Directive.

Securitisation funds established in Luxembourg in the form of a fiduciary estate (in accordance with the Fiduciary Law) will fall within the scope of the RFT Law. In light of the ambiguity and shortcomings of the RTF Law, and despite such shortcomings having been identified during *travaux parlementaires*, particular attention must be paid at the early structuring stages to determine which information will need to be registered (notably where the securitisation fund resorts to third-party financing from creditors or considers issuing and listing non-beneficiary tradable instruments or securities).

Blockchain

Lastly, the Luxembourg Government published a bill (the Blockchain Bill) that supplements the Luxembourg law of 6 April 2013 on dematerialised securities to provide clarity that securities may be issued and recorded via distributed ledger technology (DLT). The validly of transfers of securities executed through DLT is already recognised under Luxembourg law.

The Blockchain Bill intends to enable central account keepers or clearing systems to record securities via DLT. An issuer will still need to resort to a central account keeper or a clearing system to intermediate between it and the ultimate securities holders. The Blockchain Bill is nonetheless an important step towards achieving the ultimate goal (ie, the effective reduction of intermediation).

Luxembourg has repeatedly demonstrated its regulatory affinity for fintech. Earlier this year, Luxembourg made headlines by being the first jurisdiction worldwide to host the distribution of shares in investment funds on blockchain via FundsDLT, a blockchain-based funds distribution platform developed in co-operation with, among others, Clearstream and the Luxembourg Stock Exchange.

Expectations are that, within a few years, syndicated loans in the form of blockchain-based smart contracts will become commonplace. The very light formalism required for taking security under the Collateral Law makes Luxembourg pledge agreements relatively blockchain-compatible. It will only be a matter of time until security may be taken over shares registered on a DLT platform.

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