3.24 LUXEMBOURG

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I. FRAMEWORK

The legal framework for covered bonds under Luxembourg has changed significantly recently. On 8 December 2021, the new Luxembourg Law on covered bonds has been approved by parliament. The amendments that are implementing the Directive (EU) 2019/2162 of 27 November 2019 as well as the amendments of Regulation (EU) 575/2013, Regulation (EU) 2019/2160 also from 27 November 2019, will enter into force on 08 July 2022. This new covered bond law is applicable for covered bond issued from 08 July 2022. Based on grandfathering conditions the former legal framework may also be applicable. Under the old framework the issuance of Lettres de Gage is regulated by Articles 12-1 to 12-12 of the Financial Sector Act of 5 April 1993 (the Financial Sector Act). These articles were introduced by the Act of 21 November 1997 for banks issuing mortgage bonds and amended by the Act of 22 June 2000, by the Act of 24 October 2008, by the Act of 27 June 2013 and by the Act of 21 June 2018. The Lettres de Gage regulations are supplemented by the *Commission de Surveillance du Secteur Financier* (CSSF) Circular 01/42 which lays down the rules for the appraisal of real estate and Circulars 18/705-707. The CSSF is the supervisory authority in Luxembourg irrespective of the date of issue and applicable legal framework.

Under the new legal framework the sic categories of covered bonds may be issued. The new law introduces Obligations Garanties Européennes (European Covered Bonds) as well as Obligations Garanties Européennes Lettres de Gage du Qualité Supérieur (High-quality European Covered Bons) which may be issuer in addition to Lettres de Gage Hypothécaires, Lettres de Gage Publiques, Lettres de Gage Énergies Renouvelables andf Lettres de Gage Mobilières, Lettres de Gage Mutuelles are not part of the new legal framework.

The amendments introduced in June 2013 included: (i) a broadening of the geographical scope to assets acquired globally but with certain rating requirements for countries outside the European Union (EU), the European Economic Area (EEA) and the Organisation for Economic Co-operation and Development (OECD);

(i) the introduction of Lettres de Gage Mutuelles which are backed by a system of institutional guarantee;

(ii) change of the rating requirements of eligible securitisations which now refer to the list of rating agencies established by the European Securities and Markets Authority (ESMA) rather than S&P, Moody's and Fitch;

(iii) an explicit definition of public enterprise; (v) a clarification that the cover assets have to be the property of the bank and (vi) a legal obligation for the issuers to publish information on the cover pools, the Lettres de Gage and the issuers.

The bankruptcy regulations have also been completely revised. If the court declares open one of the procedures provided for in the law on the financial sector, i.e. suspension of payments or compulsory liquidation, this decision entails the separation of the bank into the cover pools and additional activities. The cover pools with their corresponding bonds and their corresponding reserve with the central bank continue as proprietary compartments of a mortgage bank with limited activity. This bank still holds a banking licence. The court can also open a procedure of suspension of payments or compulsory liquidation for a cover pool, but this does not affect the other cover pools.

The CSSF is no longer administrator of cover pools in the case of bankruptcy of the Lettres de Gage bank but one or several administrators nominated by the court. This has not changed in the course of the approval of the new covered bond law.

In June 2018 already, Luxembourg amended its covered bond law, introducing Lettres de Gage Énergies Renouvela bles as a fifth covered bond type in Luxembourg making it possible to use projects generating renewable energy as collateral for cover pools. To our understanding the Lettre de Gage Énergies Renouvelables is the first covered bond framework that makes use of these type of assets as collateral for covered bonds. Furthermore, a 180-liquidity buffer was introduced to minimize the liquidity risk that could arise in a covered bond programme – using highly liquid assets that are available at any time during a specified period of time.

In December 2018, the CSSF published 3 Circulars supplementing the Financial Sector Act. Circular 18/705 lays down the rules for the appraisal of renewable energy assets, Circular 18/706 lays down the transparency requirements based on Article 12-6(2) and Circular 18/707 defines the minimum requirements for the maintenance and control of the cover register and the liquidity requirements for the cover pool.

In December 2021, Luxembourg amended its covered bond law, in the sense that in addition to credit institutions approved by the CSSF as covered bonds bank (banques d'émission de lettre de gage) starting from 08 July 2022 all credit institutions incorporated in Luxembourg as well as covered bonds banks may be allowed to issue covered bonds. The relevant changes to Article 2 of the new law also specify a limit for the cover pools. These credit institutions cover pools are limited to 20% of the total liabilities. Furthermore, the new law introduces the two types of covered bonds specified by the EU Directive: "European covered bonds" (obligations garanties européennes) as well as "(high-quality) European covered bonds" (obligations garanties européennes (de qualité supérieure)), whereas the latter meet the requirements of article 129 of the capital requirements directive (CRR).

II. STRUCTURE OF THE ISSUER

The covered bond issuers are not restricted anymore to credit institutions with a specialist bank license. Credit institutions that are incorporated in Luxembourg may also issue covered bonds based on the fulfillment of certain criteria (i.e. 20% cover asset limit based on total liabilities). The business activities of covered bonds banks are restricted. These issuers may only engage in other banking and financial activities if these activities are accessory and aux- iliary to their main business. In the past, the bank's principal activities were limited to mortgage lending, and public sector financing which were primarily funded by issuing Lettres de Gage Hypothécaires and Lettres de Gage Publiques. Lettres de Gage Mobilières were introduced in October 2008 and are backed by loans guaranteed by movable assets. Since 2013, the Luxembourg issuers are also allowed to issue Lettres de Gage backed by institutional guarantees (Lettres de Gage Mutuelles). These bonds are collateralised by loans to credit institutions in the EU, the EEA and the OECD or loans that are guaranteed by them as cover pool collateral, assuming that these credit institutions belong to a system of institutional guarantee. This system has to be recognised by a supervisory authority and guarantee to support its members in the case of economic difficulties. In 2018, Lettres de Gage Énergies Renouvelables focusing on renewable energy have been added and since June 2018, 'renewable energy' assets also qualify as cover pool collateral. Under the new legal framework the asset classes and corresponding cover pools are given by the covered bond types Lettres de Gage Hypothécaires, Lettres de Gage Publiques. Lettres de Gage Mobilières as well as European covered bonds and (high-quality) European covered bonds. The covered bond issuer holds the cover assets on its balance sheet in separate registers. Each class of covered bonds has its own register. They are not transferred to another legal entity (special purpose vehicle) like in a securitisation. All obligations arising from Luxembourg covered bonds are direct, unconditional obligations of the issuer. In the case of issuer insolvency, the cover pools are segregated by law from the general insolvency estate and are reserved for the claims of the bond holders. There is no direct legal link between a single asset in the cover pool and an outstanding bonds. Interest and principal payments of the various types of bonds (including any derivatives benefitting from the preferential treatment) are backed by the assets in the respective cover pools.

The issuers have to be banks and according to the Financial Sector Act they need to have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms, which restrict the extent of outsourcing legally possible. In addition, the way of permitted outsourcing is described in detail in different CSSF Circulars.

III. COVER ASSETS

Under the old law, the eligible cover pool assets are defined in Article 12-1 of the Financial Sector Act of 5 April 1993. Since the amendments of the covered bond legislation in June 2018, there are five asset classes: (i) mortgage assets, (ii) public sector exposures, (iii) movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets, (iv) assets issued by credit institutions that are backed by a system of institutional guarantee and (v) lending for renewable energy asset/projects. The cover assets including substitution assets have to be principally established in the EU, the EEA or the OECD. However, the cover pools can contain up to 50% assets from outside the EU, the EEA and the OECD, if a rating agency registered on the ESMA list has assigned sovereign ratings of credit quality step 1 to the respective countries, and up to 10%, if the sovereign ratings are credit quality step 2.

In each of the various cover pools the assets may be replaced by up to 20% of the nominal value of the outstanding Lettres de Gage by substitution assets, for example cash, assets with central banks or with credit institutions or bonds satisfying the conditions set out in Article 43 (4) of the law of 17 December 2010 concerning undertakings for collective investments.

It is also possible to hold the cover assets indirectly through a third-party bank.

The Lettres de Gage Mobilières are backed by movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets. In order to be cover pool eligible, the movable assets and the charges on the property of those assets need to be registered in a public register.

Lettres de Gage Énergies Renouvelables are backed by lending to projects generating renewable energy. That includes all necessary equipment for the generation, storage, and transmission of such energy, including electricity storage facilities, transformers, and power lines, whether under construction or finalised. To be cover pool eligible, production equipment must be used exclusively to produce renewable energy, while storage and transmission equipment needs to be used more than 50% in connection with renewable energy.

In addition, securitised assets are cover pool eligible if they comply with the eligibility criteria laid down for the various types of Lettres de Gage. The amount of securitised assets that are not cover pool eligible per se will be limited to 10% of the collateral pool. This can be achieved in two ways: one option would be that at least 90% of the assets of each securitisation (vehicle) are cover pool eligible. The other option would be that at least 50% of the assets of each securitisation (vehicle) are cover pool eligible. In that case, the percentage of securitisation assets shall not exceed 20% of the total collateral pool. The issuer can choose one of the two options for each type of Lettre de Gage but cannot combine the two options. Moreover, the securitisation tranches should have a rating of the first credit quality step by a rating agency that is registered on the list by ESMA. The law allows only true sale transactions and synthetic securitisations are explicitly excluded.

Any kind of obligation from public sector institutions including public-private partnerships (providing a controlling public sector stake or claims for payment against the public sector) are cover pool eligible. There is no limitation on the volume and the types of derivatives used as long as they are employed as hedging instruments. The cover pools are dynamic. Assets can be included, excluded and exchanged as long as the requirements of the law are not breached.

There is an explicit transparency requirement. The issuers have to publish information on the composition of the cover pool, the bonds and the issuers. The details are defined by the CSSF in Circular 18/706.

Under the new law, article 8 specifies the cover assets for Lettres de Gage Hypothécaires, Lettres de Gage Mobilières and Lettres de Gage Énergies Renouvelables as well as European covered bonds and (high-quality) European covered bonds. As regards European covered bonds a public register recording the ownership of and claims to such assets, or an alternative form of certification is required for physical assets. In the case of assets in the form of risk positions, the safety and soundness of the relevant counterparty for public entities is derived either from tax collection powers or from ongoing public oversight of the operational soundness and solvency of the counterparty. European covered bonds may also be covered by assets in the form of loans granted to public companies where the public enterprises provide essential public services on the basis of a license, concession contract or other form of entrustment by a public authority. Additionally, public undertakings are subject to public oversight and the public undertakings have powers that enable the generation of sufficient revenues.

IV. VALUATION AND LTV CRITERIA

Article 8 of the new law defines that the LTV limit for European covered bonds and (high-quality) European covered bonds is 70%. The physical assets pledged as collateral referred to in Article 4(2)(1) that secure assets referred to in Article 4(1)(2) do not have to comply with the 70% limit or the limits set out in Article 129(1) of Regulation (EU) No 575/2013. Beyond these bonds defined the LTV limit for residential property is 80% of the estimated realisation value. The LTV ratio is 60% for all other immovable and movable properties including commercial real estate loans. The actual loan, however, can exceed the 60% limit (or 80% limit in case of residential mortgages). In those cases, only the 60% (80%, respectively) of the mortgage lending value is eligible for the cover pool. The LTV ratio for 'renewable energy' loans is limited by law to 50%. The limit might, however, be increased to up to 80% if certain conditions (such as a regulated fixed remuneration regime or free of charge renewable energy sources) are met.

V. ASSET – LIABILITY MANAGEMENT

Under the old law, there is a minimum overcollateralisation level of 2% on a nominal basis as well as on a net present value basis. Mismatches in terms of currency or interest rate risk can be hedged and the respective hedge instruments have to be included in the collateral pool. The cover assets of the relevant cover pool must provide total interest revenue at least equal to the amount of interest of the covered bonds of the same category in circulation. The amendments of the Lettre de Gage law in June 2018 also included the introduction of a liquidity buffer of 180 days. The liquid buffer assets can consist of ECB eligible assets as well as assets qualifying as Level 1 or Level 2A assets under the European LCR rules (excluding own-use covered bonds). In addition, there are the requirements imposed by the rating agencies. The new covered bond law of Luxembourg specifies the requirements regarding the liquidity buffer in article 9, whereas in article 10 maturity extensions are ruled out for covered bonds in Luxembourg.

Article 6 of the new law specifies the coverage requirements for covered bonds issued under Luxembourg law. The issuer has to ensure that the present value of the cover assets is at all times equal to or higher than the present value of the liabilities arising from the outstanding bonds. In addition to that, nominal coverage is required. For Lettres de Gage Hypothécaires, Lettres de Gage Mobilières and Lettres de Gage Énergies Renouvelables as well as European covered bonds minimum OC is given by minimum of 5%. The CSSF may, in accordance with the covered bond directive, lower the OC requirement in accordance with in accordance with Article 129 CRR For, Lettres de Gage Publiques, Lettres article 6 defines a minimum OC of 10%.

The special auditor has to ensure that there is always sufficient collateral in the pool. This has to be certified by the special auditor when Lettres de Gage are issued. Cover assets may only be removed from the cover pool when the prior written consent of the special auditor has been received and provided that the remaining cover assets are sufficient to guarantee the legally protected cover.

The calculation of the nominal value and of the net present value of the collateral pool as well of the outstanding Lettres de Gage volume must be reported to the supervisory authority on a monthly basis.

The new law specifies in Article 10 that the issuer may not issue covered bonds in the form of soft bullets; i.e. maturity extension is ruled out by law.

VI. TRANSPARENCY

There is an explicit transparency requirement laid down in Article 12-6(2) and supplemented by CSSF Circular 18/706. The issuers have to publish information on the composition of the cover pool, the Lettres de Gage and the issuer. This is in line with the ECBC Covered Bond Label Initiative. Based on the new law, issuers' duties regarding the provision of information for investors include at least quarterly reports. The required details described in article 18 of the law, include, amongst others, the amount of outstanding bonds and the corresponding amount of cover assets, a list of ISINs, geographical distribution and types of cover assets, amount of loans and the valuation methods.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The supervisory authority of covered bond issuers is the CSSF, as already mentioned above. The CSSF has a specialised department which is responsible for supervising the covered bond issuers. It is entitled to demand relevant reports and intercede if liquidity problems have been identified at a bank.

The CSSF is also responsible for the approval of the various types of covered bonds secured by movable assets. Definitions, the details on which types of movable assets qualify and other practical issues will be clarified in a separate CSSF Circular. Based on the new law, the CSSF is also required to disclose information regarding covered bond issuers, relevant laws, regulations and CSSF circulars in the context of covered bonds on its website. The information include a list of institutes with the permission to issue covered bonds, a list of bonds which may be labelled as European covered bonds and a list of (high-quality) European covered bonds as well as a list of all other covered bonds including a classification of covered bond type.

For the independent control of the cover pool a special auditor which is recommended by the Lettres de Gage issuer has to be approved by the supervisory authority. Only auditing firms which satisfy the conditions set forth in the law of 2009 *regarding réviseurs d'entreprises* (independent auditors) can be appointed as special auditors. The issuer communicates the names of the partners of these auditing firms who will fulfil the function to CSSF. The special auditor must have a suitable qualification and must be able to call upon the experience and technical expertise of a recognised international auditing firm.

The special auditor is continuously responsible for monitoring the collateral pool and the outstanding Lettres de Gage. The auditor must ensure that there are sufficient assets in the collateral pool to service the obligations resulting from the outstanding Lettres de Gage up to the final maturity of the last outstanding bond. The auditor is obliged to inform the supervisory authority immediately, should any of the prudential limits be violated. The Lettres de Gage issuer is also obliged to immediately inform the supervisory authority of the violation of any limits.

Rating agencies do not play any mandatory role in the monitoring process. The issuers comply with the rating agencies' requirements on a voluntary basis.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The cover registers for mortgage, public sector, moveable assets, assets backed by a system of institutional guarantee and renewable energy assets include all necessary data to identify the assets and the derivatives included. As soon as an asset or derivative product is registered in the official cover register it forms part of the collateral pool.

The cover register is managed by the issuer but regularly monitored by the special auditor. The special auditor is obliged to inform the CSSF of any irregularities and provide an annual report.

Asset segregation

In the case that a procedure of suspension of payments or compulsory liquidation is opened for a Lettres de Gage issuer, the assets and derivatives in the collateral pool are separated from the other assets and liabilities of the bank. The respective collateral pools remain unchanged and continue with their corresponding Lettres de Gage and their corresponding reserve at the Luxembourgish Central Bank as proprietary compartments of a Lettres de Gage bank with limited activity. The cover pools do not become separate legal entities. The legal entity of the bank remains unchanged. The banking license continues for the bank with limited activity in order to achieve the purpose of administering the cover pool up to the final maturity of the last outstanding Lettre de Gage. The court nominates one or several administrators for the cover pools. This administrator is different from the general bankruptcy administrator. If a procedure of suspension of payments or compulsory liquidation is opened for one cover pool, the other pools are not affected by this decision and continue.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically become due when a procedure of suspension of payments or compulsory liquidation is opened for the issuing bank. Interest and principal are paid as per their original due dates. The same applies to derivatives registered in the cover register which are part of the cover pool. The net present value of the derivatives after netting ranks pari passu with the claims of the Lettres de Gage holders.

Preferential treatment of covered bond holders

Covered bond holders benefit from a preferential treatment in case of an issuer insolvency. The registration of the cover assets in the cover register provides the covered bond holders with a preferential right, above all other rights, preferences and priorities of any nature whatsoever, including those of the Treasury. But the salary of the administrator and the other fees that are necessary for continuing the bank with limited activity rank first before the claims of the covered bond holders and the derivative counterparties, which rank *pari passu*. The general bankruptcy administrator has no direct access to the assets in the collateral pool.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Referring to the old law, the Luxembourg covered bond legislation fulfils the criteria of Article 52 (4) of the UCITS Directive (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)). In its old format, the covered bond legislation did not fulfil the requirements set out in Article 129 of 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, the Capital Requirements Regulation (CRR), together with Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, the Capital Requirements Directive (CRD), implementing the Basel III rules into European law.[1] The last two amendments of the Luxembourg covered bond legislation did not make the Lettres de Gage legislation CRR-compliant. However, it should be possible for issuers to make their outstanding Lettres de Gage "CRR compliant" by limiting their cover pool exposure.

Lettres de Gage are principally eligible for repo transactions with the European Central Bank (ECB). However, on 28 November 2012, the ECB announced amendments of its eligibility criteria for its repo transactions. The changes entered into force on 3 January 2013. Covered bonds with external, non-intra group securitisations in the cover pool are no longer eligible as collateral for repo transactions as of 31 March 2013. This means

1 Please click on the following link for further information on the UCITS Directive and the CRR: https://hypo.org/ecbc/covered-bonds/.

that following the end of the grandfathering period in 2014, new and outstanding covered bonds with external RMBS or other ABS (both group-internal or external) in the cover pool are no longer repo eligible.

With regard to the new law, there have not been any changes leading to a different regulatory treatment of Lettre de Gages. European covered bonds, which have been introduced as a covered bond type in the new legislation, are also not CRR-compliament, whereas covered bonds which fulfill the requirements to be classified as (high-quality) European covered bonds are by definition CRR-compliant.

Issuers: Commerzbank Finance & Covered Bond, NORD/LB Luxembourg Covered Bond Bank.

For the most up-to-date information, please consult the new ECBC Covered Bond Comparative Database webpage on the Covered Bond Label website www.coveredbondlabel.com.

In the context of the transposition of the Covered Bond Directive (the final deadline for which was 8 July 2022), the ECBC has undertaken a full review and update of the Covered Bond Comparative Database to take account of the latest regulatory developments. This unique reference tool can be accessed via the link hosted on the Covered Bond Label website (www.coveredbondlabel.com/legislation/comparative_database).

For further national information on the Luxembourgish market, please see compare.coveredbondlabel.com/frameworks. To access the "Country Comparison" feature of the database, please see compare.coveredbondlabel.com/compare/select/frameworks.