Chambers AND PARTNERS

CHAMBERS GLOBAL PRACTICE GUIDES

Banking & Finance 2023

Definitive global law guides offering comparative analysis from top-ranked lawyers

Luxembourg: Trends & Developments

Arnaud Arrecgros, David De Pasquale, Maurice Honnen and Despoina Souroviki
Maples and Calder (Luxembourg) SARL

Trends and Developments

Contributed by:
Arnaud Arrecgros, David De Pasquale, Maurice Honnen and Despoina Souroviki
Maples and Calder (Luxembourg) SARL

Maples and Calder (Luxembourg) SARL operates as the independent law firm of the Maples Group in Luxembourg, providing full-service advice on Luxembourg law with regard to corporate, finance, funds and investment management, tax and associated regulatory matters. Clients include leading corporations, banks and structured finance arrangers, as well as hedge funds, private equity firms and asset managers. The finance team, comprised of six lawyers, advises and represents both borrowers (including private equity and hedge funds) and lenders on cross-border financing and banking transactions, including corporate debt facilities, acquisition, asset and real estate financing and restructurings, funds financing in connection with the setting up of bridge and capital commitment facilities, and securitisations, as well as on capital markets matters.

Authors

Arnaud Arrecgros is head of Maples and Calder (Luxembourg)'s Finance team at the Maples Group. He has extensive experience in cross-border financing and banking transactions, including corporate debt facilities, acquisition, asset and real estate financing and restructurings, funds financing in connection with the setting up of bridge and capital commitment facilities, securitisations, as well as capital markets matters. He represents both borrowers (including private equity and hedge funds) and lenders on lending transactions and all types of secured transactions, advising in particular on the setting up of security packages and issues surrounding collateral in the context of debt restructuring transactions.

David De Pasquale is of counsel in Maples and Calder (Luxembourg)'s Finance team at the Maples Group. His practice involves advising institutional lenders and borrowers (corporations, private equity groups and investment funds clients) on cross-border financing transactions. David also advises clients on securitisation and capital markets transactions.

Contributed by: Arnaud Arrecgros, David De Pasquale, Maurice Honnen and Despoina Souroviki,
Maples and Calder (Luxembourg) SARL

Maurice Honnen is an associate of Maples and Calder (Luxembourg)'s Finance team at the Maples Group. He advises on various types of cross-border financing and banking transactions, as well as on securitisations and capital markets matters.

Despoina Souroviki is an associate of Maples and Calder's Luxembourg Office in the Finance team. Despoina's expertise covers banking and financial law with a focus on international financial law including securitisations, international bond issues, syndicated loan agreements and derivatives. She advises on various types of cross-border financing and banking transactions. She also has experience in EU supervisory law and in particular authorisations, withdrawals, qualifying holdings, own funds, passporting and "fit and proper" assessments, as well as matters related to the interpretation of the SSM Regulation.

Maples and Calder (Luxembourg) SARL

12E, rue Guillaume Kroll
L-1882
Luxembourg

Tel: +352 28 55 12 00
Fax: +352 28 55 12 01
Email: onlineenquiry@maples.com
Web: www.maples.com

Contributed by: Arnaud Arrecgros, David De Pasquale, Maurice Honnen and Despoina Souroviki,
Maples and Calder (Luxembourg) SARL

Current Perspectives

Despite the complicated business environment seen over the past year, the Luxembourg banking and finance field of practice remained very active for the most part, fuelled by innovative market trends and new entrants.

Fund finance

Following some turmoil in the banking industry during the first half of the year, the market demonstrated strong levels of activity across the third and fourth quarters, with material increases in volumes, including over the summer period. The fund finance market has been marked by (i) a diversification in the lenders' pool and (ii) a technical diversification in the financing arrangements that are being implemented.

On the technical side, alongside new subscription line facilities being set up, together with the ancillary accessions and extensions, there has been, in line with market anticipation, a growing number of hybrid and tailor-made financing arrangements, co-investment lines and a surge in net asset value credit facilities ("NAV facilities").

The significant increase in NAV facilities derives from various factors; primarily, these factors are linked to the current business environment. The increase in prices has, to begin with, led some managers to question the cost of subscription lines. In addition, the less favourable fundraising conditions have caused fund-raises to last for longer periods. Finally, challenging market conditions have often discouraged the sale of assets and required follow-on investments, including after the exhaustion of subscription lines, leaving managers in need of new types of financing arrangement that accommodate longer investment period strategies.

However, beyond the constraints caused by the market, the managers have become increasingly familiar with NAV facility arrangements over the past few years, and they are now more comfortable making use of these as a tool to aid them in implementing their portfolio management and investment strategies.

There has also been a diversification in the lenders' pool, with new participants such as regional banks, debt funds and insurance companies increasing their market share in the field. The liquidity squeeze that has affected the traditional credit institutions since the winter of 2022, which resulted from a multiplicity of factors (capital constraints, regulatory environment and material increase in interest rates, to name a few), is one of the major causes for such diversification, forcing managers to seek capital from new types of lenders (other than traditional banks and credit institutions). It is likely that these new players will help satisfy the liquidity demand for the foreseeable future.

This trend is also encouraged by managers' appetite for establishing relationships across a fund group with several different lending entities, so as to address concentration concerns pertaining to the failure of a number of US banks during the first quarter of the year, for the sake of greater agility in case similar scenarios occur in the future.

The foregoing context has led to more attention being paid to particular provisions of the finance documents in the course of their negotiation.

As an example, lenders are now typically more reluctant to limit their ability to direct payment of unfunded commitments to bank accounts other than the pledged collateral accounts that are opened in the name of the fund. This would allow the lenders to direct the funding of these amounts to any other account in the case of an enforcement scenario and in instances where the account bank or depositary is financially vulnerable.

Borrowers also tend to look closely at the conditions subject to which the collateral account may be transferred to a succeeding account bank or depositary, making sure these are not unreasonably or unnecessarily constrained.

The market is therefore adapting to conditions where the prospect of a bank's failure seem possible. In addition there has, over the past year, been a lot of scrutiny on related concerns by market players, and on the legal framework applicable to credit institutions in such circumstances. Since the failure of Silicon Valley Bank in early 2023, the finance industry expressed concerns in particular with respect to the options available to the parties when the account bank fails.

The banking union

In order to anticipate the possible consequences that could detrimentally affect their interests in the case of a failure of an account bank in Luxembourg, many market participants on the lender side expressed concerns at the relevant time. In this context, the second and third pillars of the banking union become relevant.

The banking union was created in 2014 as part of the EU's response to the global financial crisis. Consisting of three pillars (banking supervision, banking resolution and the deposit guarantee scheme (DGS)), its aim was to protect the stability of the financial system. Banking supervision aims at preventing a failure whilst the goal of banking resolution and DGS is to minimise the impact of a failure on the financial system by ensuring depositors' protection and that critical functions continue to operate.

The key element to determine the possible failure of a bank is the failing or likely to fail assessment (FOLTF), which is performed by the European Central Bank (ECB) in collaboration with the Single Resolution Board (SRB). There are four requirements for a bank to be declared as FOLTF:

- it no longer fulfils the requirements for authorisation by the supervisory authority;
- it has more liabilities than assets;
- it is unable to pay its debts as they fall due; and
- it requires extraordinary financial public support.

Once the bank is declared as FOLTF, the resolution authority determines whether the FOLTF bank meets the resolution requirements and whether it will be resolved pursuant to the provisions of the Banking Resolution and Recovery Directive (BRRD) or be liquidated in accordance with the national insolvency law. The key factor for determining whether the BRRD resolution process is to be followed is whether there is public interest in avoiding the liquidation of the FOLTF bank. There can be no doubt that the public interest requirement would be met for most of the banks acting as account banks in Luxembourg. The BRRD currently includes four resolution tools: the bail-in tool, the sale of business tool, the bridge institution tool and the asset separation tool.

As a reminder, it is important to note that in July 2022, the Luxembourg law of 5 August 2005 on financial collateral arrangements was amended. Among the changes implemented to modernise the law, an express reference to the Regulation

(EU) 2021/23 of 16 December 2020 on a framework for the recovery and resolution of central counterparties (commonly referred to as the Recovery and Resolution Regulation) was added in Article 2-1, so that the Financial Collateral Law is stated to apply without prejudice to such regulation.

However, under the current legal framework, deposits up to EUR100,000 are protected under the DGS. In a bank failure scenario where deposits are determined unavailable, depositors shall have access to their funds within seven working days from such determination in Luxembourg. The deposits of limited partnerships would normally be covered by the DSG. This is not the case though for SICAVs (including limited partnerships), SOPARFIs or SPFs which are currently excluded from the DGS.

In April 2023, the Commission, having assessed the results of the first years of the banking union, adopted a legislative proposal to reform the crisis management and deposit insurance framework. One of the major improvements of the reform is that funds held by non-bank financial institutions including e-money institutions, payment institutions and investment firms will now be protected.

Securitisation

European Commission takes legal action against Luxembourg over exemption for securitisation vehicles from interest limitation rules

When Luxembourg implemented the first EU Anti-Tax Avoidance Directive (ATAD I), it exempted EU-regulated securitisation vehicles. Put simply, ATAD I denies entities the deduction of interest expenses in excess of their interest income. This exemption aimed at safeguarding the tax neutrality of certain securitisation vehicles. In particular, entities that receive non-interest income, such as securitisation vehicles holding portfolios of non-performing loans, relied on this exemption.

In 2020, the EU Commission issued a letter of formal notice to Luxembourg, requesting it to amend its laws in order to remove this exemption. The Commission considered the exemption to be an infringement of EU law. Although the Luxembourg government quite swiftly submitted a bill to parliament proposing to remove this exemption, the parliament never approved this bill. The Commission therefore decided to bring the case before the European Court of Justice.

Whatever the outcome of this dispute may be, market players have in many instances been able to manage the risk linked to the EU interest limitation rules. The Luxembourg Capital Markets Association (LuxCMA), for instance, issued an interpretation according to which capital gains from non-performing loans may be booked as interest income equivalent for tax purposes up to a certain threshold. Although not binding upon the Luxembourg tax authorities, the LuxCMA's positions reflect market practice and are well respected. Additional support recently came from the Irish Revenue, which updated its guidance on the Irish interest limitation rules (which derive from the same directive) in line with the LuxCMA's interpretation.

Luxembourg trust structures emerge as a new trend for securitisations

Luxembourg trust structures (*fiducies* in French) have occasionally been promoted as an alternative to the well-known *société à responsibilté limitée* (private limited liability company) to mitigate the risks deriving from the EU interest limitation rules. As a rule, trusts are not subject to

Luxembourg taxation but are taxed at the level of the economic beneficiary.

There has been a notable recent trend towards using Luxembourg trust structures in legal practice. A search with the Luxembourg Trade and Companies Registry seems to confirm this trend: the vast majority of the currently 71 Luxembourg securitisation funds, which are dedicated securitisation vehicles without legal personality, are set up in the form of Luxembourg trusts (the remainder being co-ownership structures). Twenty-two of those special trust structures were formed in 2022 and 2023 (data cut-off date: 31 August 2023).

These figures do not take into account the numerous Luxembourg trust vehicles employed in securitisations which are not reflected in the Luxembourg Trade and Companies Registry's statistics because they have not opted into the special rules for securitisation funds.

Initially, Luxembourg trust structures were not widely accepted by foreign investors – not least because some Luxembourg market participants were reluctant to present the *fiducie* as essentially equivalent to the Anglo-Saxon trust. This is not surprising since Luxembourg is a jurisdiction with a civil law tradition with a concept of property that has evolved separately from that of common law jurisdictions.

However, the reluctance to call the *fiducie* a trust may be seen as unjustified for two reasons. First, etymologically, the Latin origin of the word *fiducie*, fiducia, literally translates to trust. The legal framework applicable to Luxembourg trusts is designed to meet all of the requirements that would allow the *fiducie* to qualify as a trust within the meaning of the Hague Convention on the Law Applicable to Trusts and their Recognition. This is particularly important as it makes Luxembourg a jurisdiction that recognises the institution of the trust for the purposes of Article 13 of the Hague Convention, which strengthens the recognition by contracting states of foreign law-governed trusts whose significant elements point to Luxembourg.

Ironically, it appears that the same civil law legacy that originally caused uncertainty with regard to the *fiducie* concept in common law jurisdictions is precisely one of the reasons for its growing popularity, as corresponding concepts sometimes exists in the foreign jurisdictions where market participants to deals being implemented these days are located (for instance, the *fideicomisco* in Mexico).

The most important characteristic of the Luxembourg trust is that the assets held in trust form a segregated estate that is separate from the trustees' personal estate, and are hence protected against claims of the trustees' personal creditors, even after the opening of insolvency proceedings. Conversely, the recourse of creditors whose claims arose in connection with the trust are limited to the trust property only.

Given that Luxembourg is a civil law jurisdiction, it would have been inconceivable to simply replicate the equitable principles of Anglo-Saxon trust law into Luxembourg statutory law to govern the relationship between the parties. Likewise, it would have been impracticable to design an entirely new set of rules. For this reason, the Luxembourg legislature decided to apply the rules applicable to mandates to the relationship between the settlor and the trustee. This provides for the highest degree of legal certainty as it allows legal practitioners to resort to an abundance of case law and legal doctrine that has developed over two centuries in all jurisdictions applying the Napoleonic civil code. Importantly, these rules impose a fiduciary duty on the trustee towards the settlor, called *devoir de loyauté* (literally "duty of loyalty").

This duty, however, does not extend automatically to the beneficiaries that are not parties to the trust agreement. Their rights need be expressly stipulated and will be enforced in accordance with the well-established rules on third-party rights (*stipulation pour autrui*). The parties otherwise have ultimate freedom to contractually determine their rights and obligations in the trust instrument.

Although the beneficiaries formally have only a personal claim against the trustee, the legal mechanics of the trust are such that effectively the rights of the beneficiaries display more similarities with proprietary rights (*doits réels*). For instance, the law on Luxembourg trusts expressly provides that a conveyance of trust property in violation of the terms of the trust cannot be held against the beneficiaries if the purchaser had notice thereof. The beneficiaries may, in such case, seize the trust assets in the hands of the purchaser. Parallels with the laws of following and tracing in Anglo-Saxon trusts law can therefore be drawn.

Despite the general flexibility of Luxembourg trusts, certain restrictions apply. Under Luxembourg law, trusts can only be established expressly, requiring a written agreement between the settlor and the trustee. Also, the capacity to act as a trustee is reserved to a defined number of financial entities, most of which are regulated (securitisation trusts, however, do not necessarily need to be licensed). Since 2020, the parties to a Luxembourg trust need to be disclosed to the Luxembourg authorities for anti-money laundering purposes.

With respect to securitisations in particular, it should be noted that there are two ways in which a securitisation trust may be structured. The first is to set up the securitisation trust in the form of a securitisation fund mentioned above. Such trusts may avail of the features of the Luxembourg securitisation framework, most prominently the possibility to compartmentalise multiple transactions within the same structure. The other is a common trust, which is not subject to the securitisation law. Compartmentalisation is not possible within those structures; however, administrative formalities are reduced as these trusts are not required to be registered with the Luxembourg Trade and Companies Registry. Their constituent document does not need to be published, which is helpful in transactions where confidentiality is important.

CHAMBERS GLOBAL PRACTICE GUIDES

Chambers Global Practice Guides bring you up-to-date, expert legal commentary on the main practice areas from around the globe. Focusing on the practical legal issues affecting businesses, the guides enable readers to compare legislation and procedure and read trend forecasts from legal experts from across key jurisdictions.

To find out more information about how we select contributors, email Katie.Burrington@chambers.com