

# First legal framework for renewable energy covered bonds

On 22 June 2018, Luxembourg adopted a law introducing the option for Luxembourg covered bond banks to issue a new type of asset: renewable energy covered bonds or *lettres de gage énergies renouvelables* (the **Renewable Energy Covered Bond**) into the existing framework of covered bonds issued by Luxembourg covered bond banks (the **Law of 2018**).

Various covered bonds labelled as green have already been issued in the last years, such as the Green Pfandbrief issued by Berlin Hyp in 2015<sup>1</sup>, backed by mortgages over commercial properties which received a green label. While these instruments combined existing covered bond legislation with a certification that the underlying assets qualified as green, no legal framework existed before the Law of 2018. The Law of 2018 establishes for the first time a real legal framework by introducing the Renewable Energy Covered Bond into the Luxembourg legislation governing Luxembourg covered bond banks.

Luxembourg is also pioneering in other green finance areas. The world's first green bond listing was on the Luxembourg stock exchange in 2007 and the "Luxembourg Green Exchange", which launched in 2016, is still the only trading platform dedicated to green finance products and is the largest platform globally<sup>2</sup>.

By introducing the Renewable Energy Covered Bond, Luxembourg intends to foster the development of the renewable energy industry and demonstrate its commitment to fight climate change<sup>3</sup>.

## Latest EU recommendations on covered bonds incorporated

The Luxembourgish legislator also used this opportunity to amend the Luxembourg covered bond framework to incorporate the recommendations from the European Banking Authority (EBA) in 2016. Following the amendments enacted by the Law of 2018, the *Commission de Surveillance du Secteur Financier* (CSSF) adopted three related circulars on 19 December 2018, which are discussed below.

The recommendations put forward by the EBA were also the basis for a legislative package proposed by the European Commission in March 2018 aimed at introducing European Union (EU) level rules for covered bonds. Currently, covered bonds are mainly regulated at a national level and the European Commission considers alignment in certain areas necessary to implement the Capital Markets Union action plan and develop the use of covered bonds as "a stable and cost-effective source of funding for credit institutions, especially where markets are less developed, in order to help finance the real economy"<sup>4</sup>.

Although the European Commission's initiative has been endorsed by various political decisions and also by stakeholders, concerns have been raised that the rules are too intrusive. In spring 2018 the European Commission presented its proposals for a directive on the issue of covered bonds and covered bond bank's public supervision (amending Directive 2009/65/EC and Directive 2014/59/EU) and for a regulation (amending Regulation (EU) 575/2019) regarding credit exposures in the form of covered bonds, which were approved by the European Parliament on 19 April 2019, and are currently going through the trilogue process<sup>5</sup>.

## What is a renewable energy covered bond?

The Law of 2018 introduces a new class of covered bonds which Luxembourg covered bond banks (governed by the Luxembourg law dated 5 April 1993 as amended (the **Banking Act**)) can issue, in addition to the existing classes of covered bonds linked to real estate mortgages, public sector financings, lending secured by moveable assets and lending to certain credit institutions. This new type of covered bond is notable in that it is not linked to one specific asset but aims to cover the renewable energy project as a whole by requiring that the underlying loan is backed by all critical assets related to the financing of the relevant project.

<sup>1</sup> <https://www.green-pfandbrief.com/#home4>

<sup>2</sup> Climate Bonds Initiative, May 2018, The green bond market in Europe. LuxSE, Press release 6 March 2019.

<sup>3</sup> The law is in line with the goals formulated during the United Nations COP 21 which resulted in the Paris Agreement, notably that public funds alone will not be able to respond to climate change

<sup>4</sup> COM (2018) 94, Explanatory Memorandum, p2

<sup>5</sup> The trilogue meetings are informal negotiations between the European Parliament, the European Council and the European Commission aimed at reaching an agreement at any moment of the legislative procedure, which will then be approved by the formal procedures of each institution.



A Renewable Energy Covered Bond may be issued by a Luxembourg covered bond bank to finance loans guaranteed by rights *in rem* or security interests over certain immovable or moveable assets generating renewable energy and by substitution rights to main project contracts.

The Law of 2018 draws on the work of the European Union<sup>6</sup>, defining renewable energy as “*energy from renewable non-fossil sources, namely wind, solar, aerothermal, geothermal, hydrothermal and ocean energy, hydropower, biomass, landfill gas, sewage treatment plant gas and biogases*”, but broadens that definition by also referring to “*energy produced from similar sources*”.

Technical definitions of “assets generating renewable energy” and of “main project contracts” are also included in the Law of 2018, thus providing for legal certainty and a clear understanding of the underlying assets over which the rights, security interests or substitution rights constituting the cover pool of Renewable Energy Covered Bonds may be taken.

## The cover pool of Renewable Energy Covered Bonds

### Substitution rights and the enforceability of the security interests

The cover pool of a Renewable Energy Covered Bond must comprise of rights *in rem*, security interests or substitution rights. The inclusion of the latter in the cover pool of a covered bond is another innovation of the Law of 2018. Substitution rights or step-in rights are granted by operation of applicable law or by contractual agreement and enable the bank to be substituted to the company generating renewable energy in a main project contract, when the company is in default under the granted loan.

By including substitution rights within the cover pool of Renewable Energy Covered Bonds, the robustness of the instrument itself is increased, since the bank or a third party designated by it can take over the project and ensure its continuance. This mechanism may ensure the creation of continuing cash flow, thus leading to payments under the defaulted loan and therefore avoiding failure of payments under the Renewable Energy Covered Bond.

Since the underlying assets of the cover pool of Renewable Energy Covered Bonds may be moveable or immovable and located in several member states of the EU, EEA, OECD or certain other states, the mechanisms to ensure the validity and enforceability of the right *in rem* may differ. The Law of 2018 addressed this by requiring that the right *in rem* be either registered in a public register or their enforceability and validity be confirmed by an independent legal opinion.

### Valuation of renewable energy projects

In order to take into account the specificity of the underlying assets of Renewable Energy Covered Bonds, the Law of 2018 limits the cover value of claims resulting from the loans guaranteed by rights or security interests over certain immovable or moveable assets generating renewable energy to a certain amount of the estimated realization value of such asset, depending on the progress of the project and the use of renewable energy.

Guidelines for the prudent valuation of the renewable energy projects have been published by the CSSF in a circular. Such valuation should be made by an independent appraiser, at least once annually, following a specific policy established by the relevant covered bond bank, “*who remains ultimately responsible for the proper valuation of the underlying projects*”<sup>7</sup>.

<sup>6</sup> Directive 2009/28/EC of the European Parliament and of the Council of 23 April 2009 on the promotion of the use of energy from renewable sources

<sup>7</sup> CSSF, Circular 18/705.

## Promoting green financing through renewable energy covered bonds

The Law of 2018 intends to increase financings of renewable energy projects. Loans underlying covered bonds may be granted in various forms including (a) by way of acquisition of debt securities or similar instruments<sup>8</sup> and (b) by way of acquisition of interests in companies generating renewable energy.

### Renewable energy asset backed debt acquisition

A covered bond bank may acquire debt instruments issued either by:

- i. a securitization company or a compartment of a securitization company whose assets comprise at least 90 % of rights *in rem* or security interests over certain immovable or moveable assets generating renewable energy and by step-in rights to main project contracts. The cover pool of the Renewable Energy Covered Bonds may not comprise more than 20% of such debt instruments; or
- ii. an issuer other than a securitization company if the proceeds of the issue are used for at least 50% to refinance assets generating renewable energy and if the cover pool of the Renewable Energy Covered Bonds does not comprise more than 20% of such debt instruments.

In any case, the renewable energy cover pool of the issuer must not comprise more than 20% of the above instruments.

The second option is an innovation in comparison with existing covered bond types for which only debt issued by a securitization company or compartment thereof may constitute a loan.

For each of these possibilities, a rating agency<sup>9</sup> must grant a step two rating to the relevant debt instruments. In contrast, for existing covered bond types, such rating must be a step 1 credit quality rating.

## Activities ancillary to renewable energy covered bond issuances

The Banking Act enables covered bond banks to engage in activities that are ancillary to the issuance of covered bonds. For instance, covered bond banks may take participations in companies and the Law of 2018 specifies criteria when the target company is generating renewable energy.

While in respect of companies other than those generating renewable energy, a covered bond bank may only acquire a third of the nominal value of all shares of the company (unless that company's object is in essence the same as the one of the covered bond bank), such limitation is not included when the target company generates renewable energy. Such limitation would indeed be contradictory to the bank's substitution rights, whose aim is to ensure the continuance of income even once the bank substituted itself.

The amount of participations taken in companies generating renewable energy may not exceed 20% of the covered bond banks net assets (*fonds propres*) in order to avoid risk concentration.

## Amendments to general Luxembourg covered bond framework

In its 2016 report<sup>10</sup>, the EBA analyzed the covered bond frameworks of 22 EU member states and provided recommendations to harmonize the national regimes, in order to strengthen the resilience of covered bonds throughout the European Union.

While Luxembourg's legislation on covered bonds is in large part aligned with the EBA's recommendations, in certain areas shortcomings vis-à-vis other jurisdictions were highlighted and the Luxembourgish legislator took the opportunity to implement such recommendations into the Law of 2018. Among other recommendations, the Law of 2018 introduced a liquidity buffer, a new type of eligible substitution assets, extended on a transparency requirement and clarified the use of derivatives by covered bond banks.

<sup>8</sup> Restrictively enumerated in the Banking Act.

<sup>9</sup> registered with ESMA pursuant to Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies

<sup>10</sup> EBA, Report on Covered Bonds, Recommendations on harmonisation of covered bond frameworks in the EU, EBA-Op-2016-23, 20 December 2016.



## Liquidity buffer

The Law of 2018 introduced a specific liquidity buffer. Covered bond banks will hence be required to maintain an additional buffer to ensure the liquidity of the cover pool for at least 180 days, thus providing additional security for investors. This is also an element taken into account by rating agencies when assessing issuances.

On a daily basis, the covered bond bank will have to reconcile the difference of the value of the cover assets becoming due and the claims becoming due under the issued covered bonds and the derivatives included in the relevant cover pool for a period of 180 days and maintain a liquidity buffer of certain eligible assets for the highest negative amount.

The covered bond bank is exempted from this obligation to maintain a liquidity buffer where it uses soft bullet or pass-through structures, meaning that it can defer repayment for at least 180 days compared to the initial redemption date, or if repayment depends on the availability of the liquid covered assets. This exemption was inspired by the equivalent Dutch law, while the method for calculation stems from the German law on covered bonds.

The CSSF clarified in a circular<sup>11</sup> that the *réviseur d'entreprises agréé spécial* has to assert that the above calculations have been undertaken by the covered bond bank. Also, in the event that the 180 days liquidity buffer may be insufficient, the *réviseur d'entreprises agréé spécial* will immediately inform the CSSF.

## Composition of cover pools – additional eligible substitution cover asset

The cover assets of one pool can be substituted by other cover assets up to an amount of 20% of the nominal value of the issued covered bonds. The Law of 2018 now added a new eligible substitution asset, namely commitments of public entities in any form.

The Law of 2018 also clarifies that any asset including financial instruments issued, or claims held against central banks or credit institutions established in a member state of the EU, the EEA or the OECD, and certain other states constitutes eligible substitution cover assets.



<sup>11</sup> CSSF, Circular 18/707, 19 December 2018.

### Transparency requirements

Following the EBA recommendation that more information should be published in order to facilitate investors' credit risk assessment of covered bonds, the Law of 2018 extended the existing disclosure obligation of covered bond banks to the publication of information about the structure of issuances.

This and other information has to be published on a quarterly basis on the covered bond bank's website<sup>12</sup>.

In addition to the general information disclosure, a covered bond bank issuing Renewable Energy Covered bonds also needs to publish information about the underlying cover assets, including, for each cover asset, the nominal value by type (production transmission, storage), the nominal value by type of technology (wind-onshore, wind-offshore, photovoltaic, etc.), the nominal value by development status (construction phase, operational phase, etc.).

### Clarification of the use of derivatives

The Law of 2018 clarified that covered bond banks may use derivative instruments and now provides that such derivative instruments which are registered in a cover pool may only be used to guarantee the global coverage of the covered bonds (principal and interest) and other liabilities of the cover pool.

Furthermore, for the protection of the bondholders, the Law 2018 provides that the derivative instrument cannot be terminated upon the opening of an insolvency of the issuing covered bond bank.

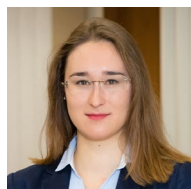
### Final thoughts

The Law of 2018 introduced a new class of covered bonds relating to renewable energy and provides a clear definition of the underlying renewable energy assets and is the first legal framework of a "green" covered bond. This reflects Luxembourg's commitment to contribute to promoting green finance. The Luxembourg legislator has also taken the opportunity to implement the EBA's recommendations. Only practice will show how these "green" criteria will be applied and how many new issuances of the Renewable Energy Covered Bonds will stem from this law.

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<sup>12</sup> CSSF, Circular 18/706, 19 December 2018.



