



Securitization in Luxembourg – Where do we stand? And next steps...

13 February 2020



EY

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Agenda

1. Introduction
2. Revisiting the basics
3. Market trends and insights
4. Tax update: ATAD, DAC 6 and VAT: Practical impact and actions
5. New due diligence requirements:
Key principles for effective due diligence
6. IBOR transition considerations for the
Securitization market



Introduction



Papa Saliou Diop

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Revisiting the basics



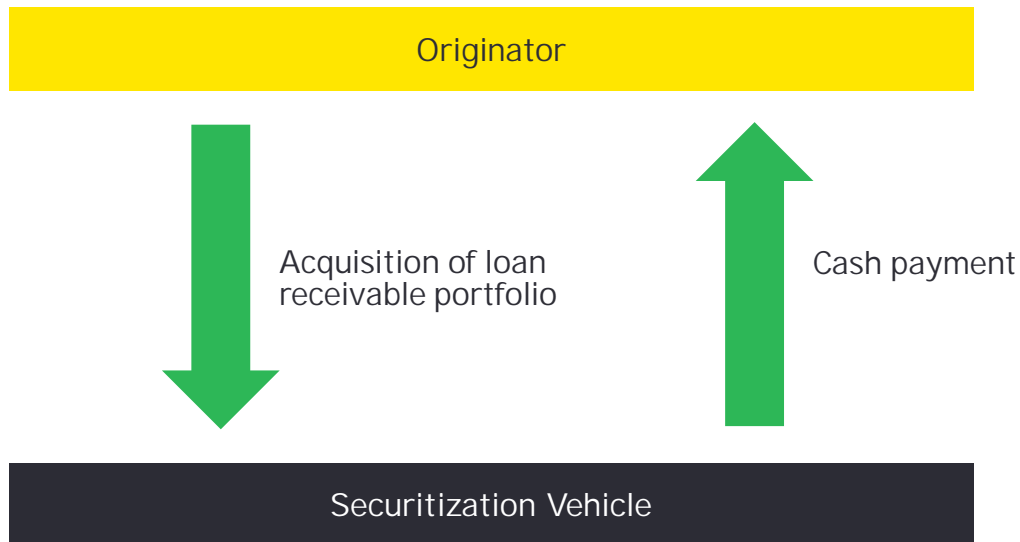
Noor Muazeem Aly Sahabun
*Senior Manager, Securitization audit,
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True-sale versus synthetic securitization

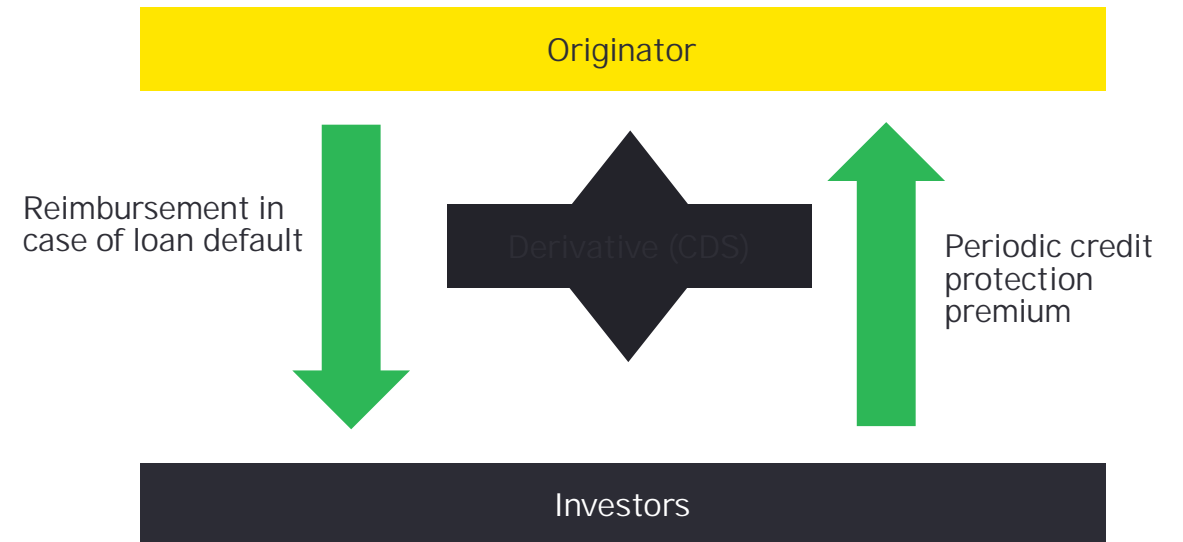
True-sale securitization

Originator passes ownership of loans to securitization vehicle "SV". The loans are removed from originator's balance sheet and SV becomes entitled to their cashflows



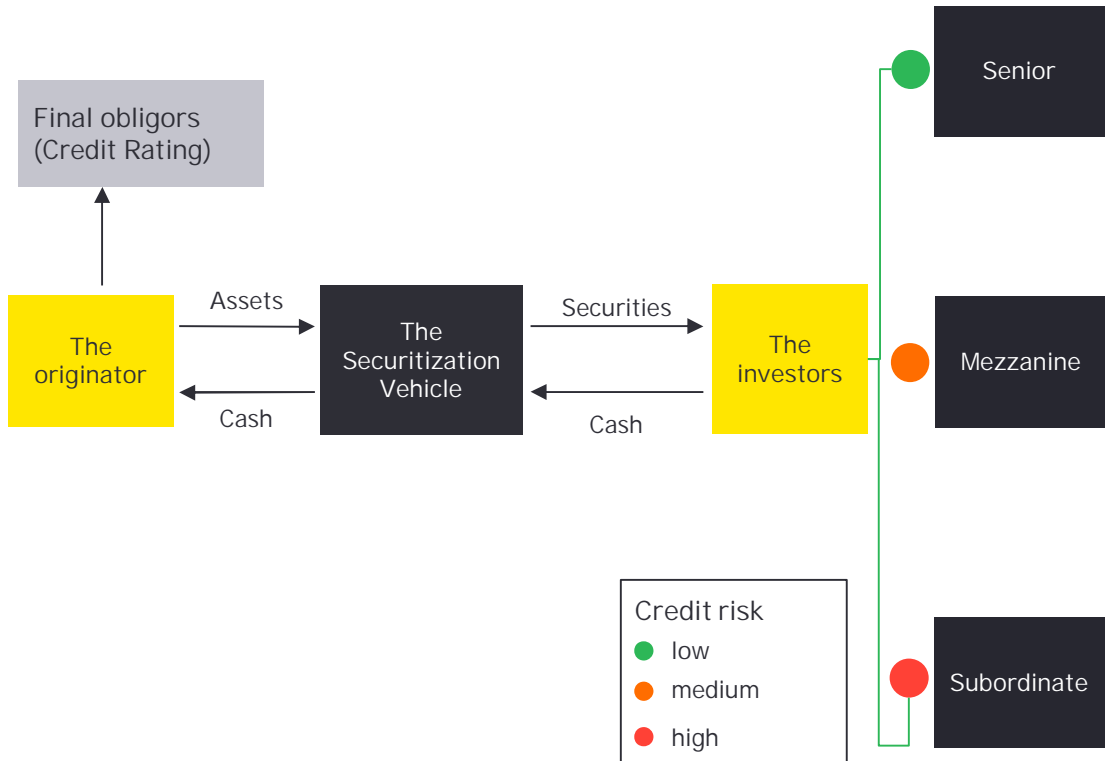
Synthetic securitization

Originator transfers credit risk of bundled loans via credit derivatives or guarantees to capital markets. The loans themselves remain on originator balance sheet

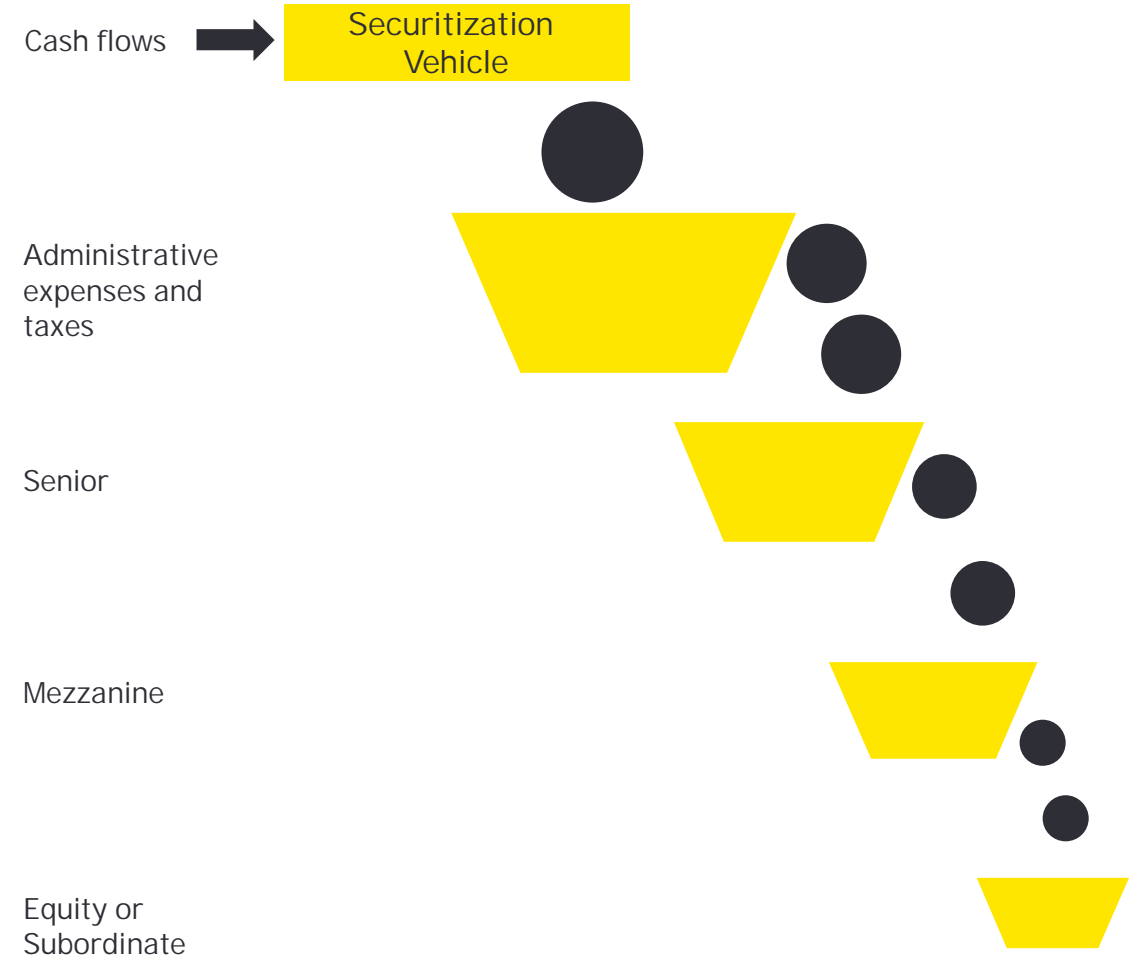


Securitization structure as per EU regulation = Credit Risk + tranching

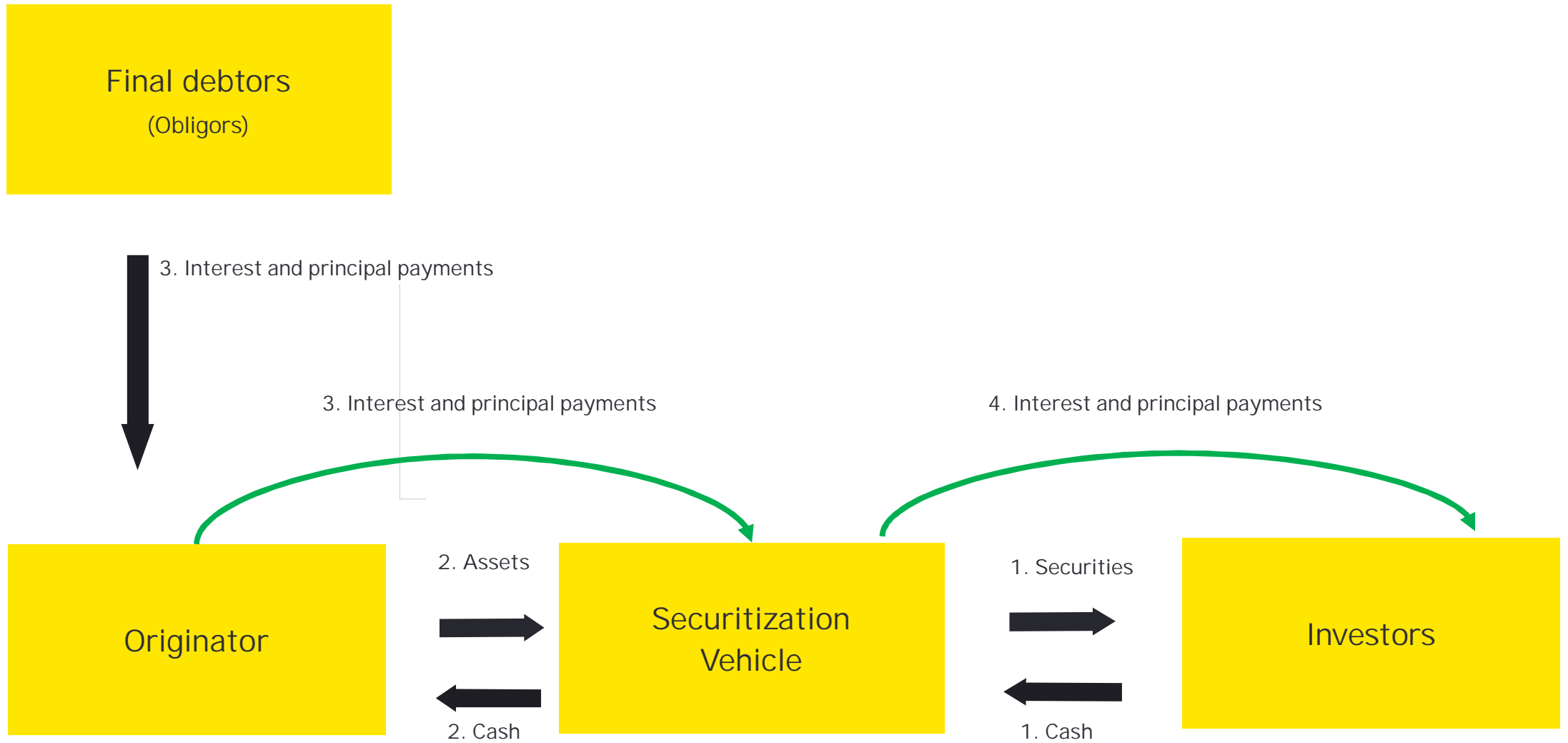
Process of securitization



The waterfall in securitization



Securitization scheme



Market trends and insights



Oliver Cloess

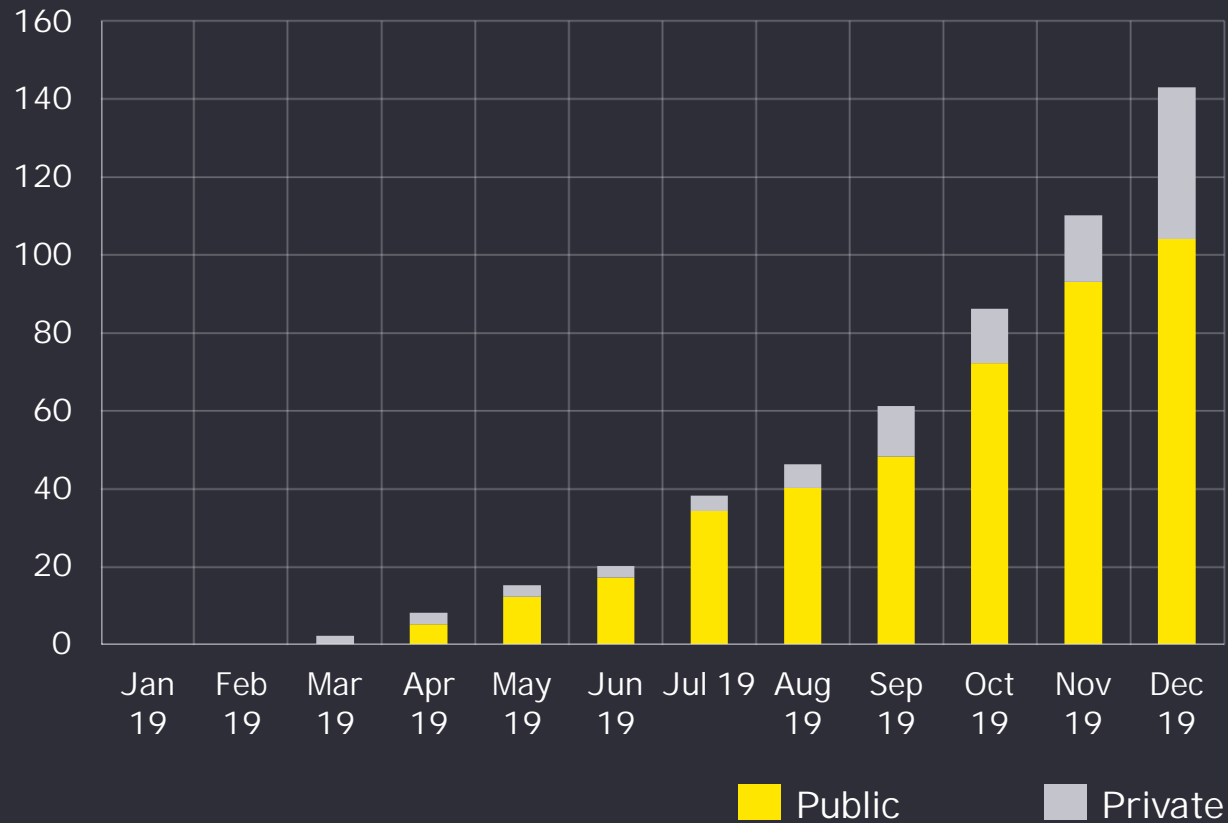
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Securitization Leader,
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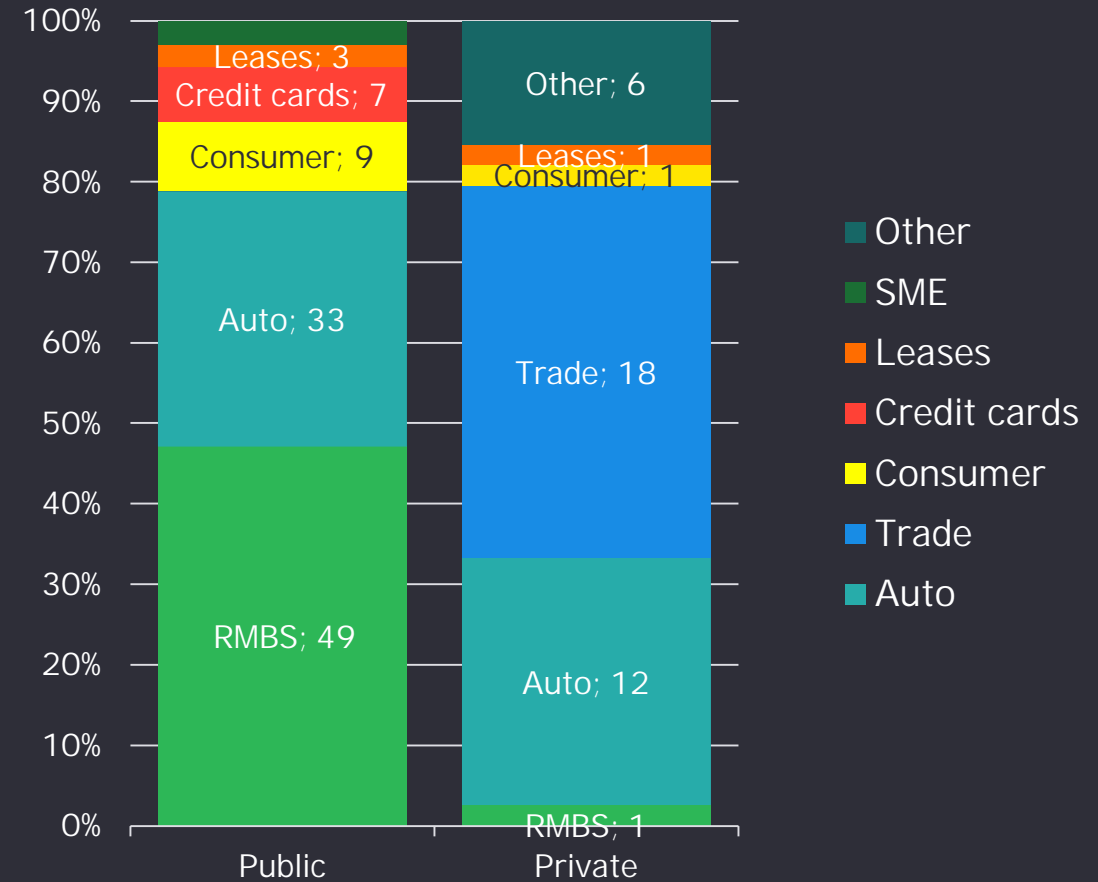
European trends

ESMA - STS Notifications 2019

ESMA NOTIFICATIONS 2019

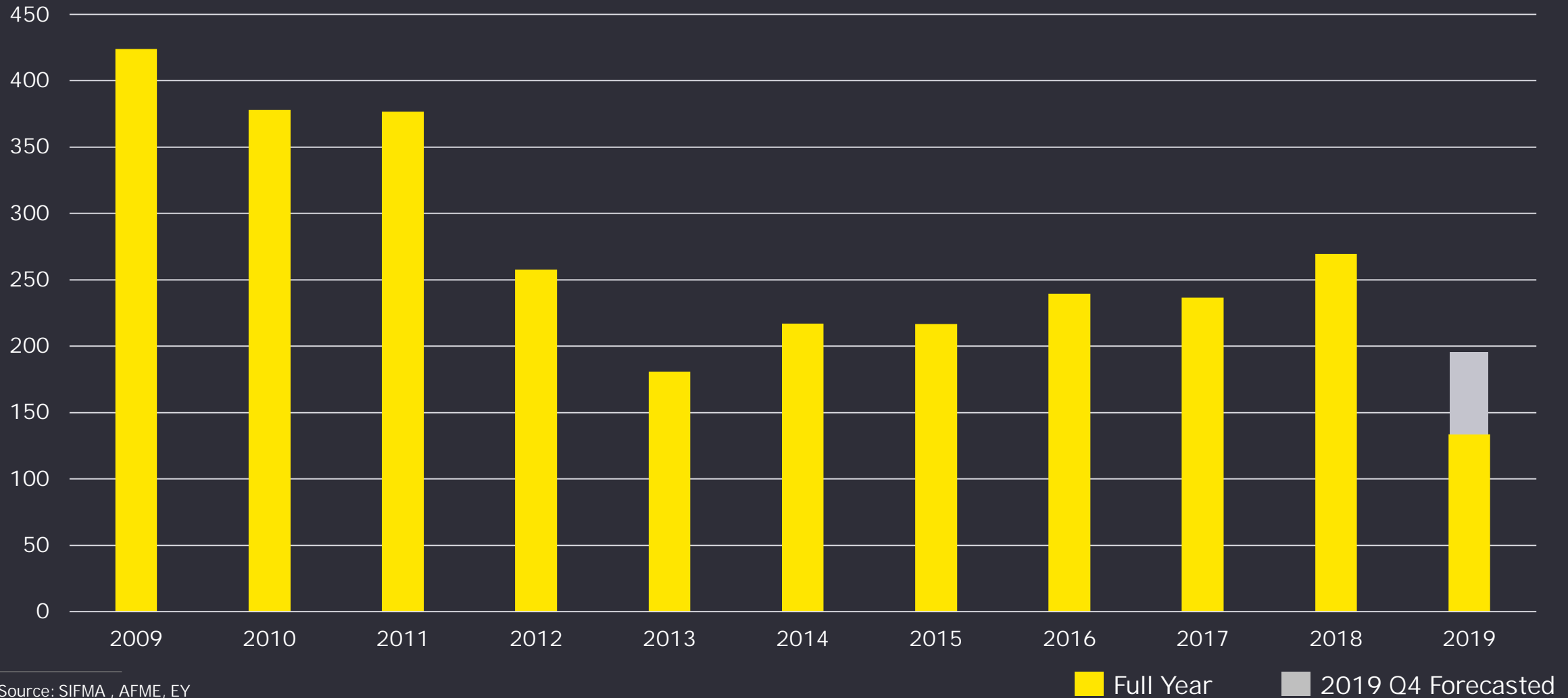


ASSET CLASSES 2019



Source: ESMA, EY

SIFMA - Historic European Issuance Volumes (EUR billion)

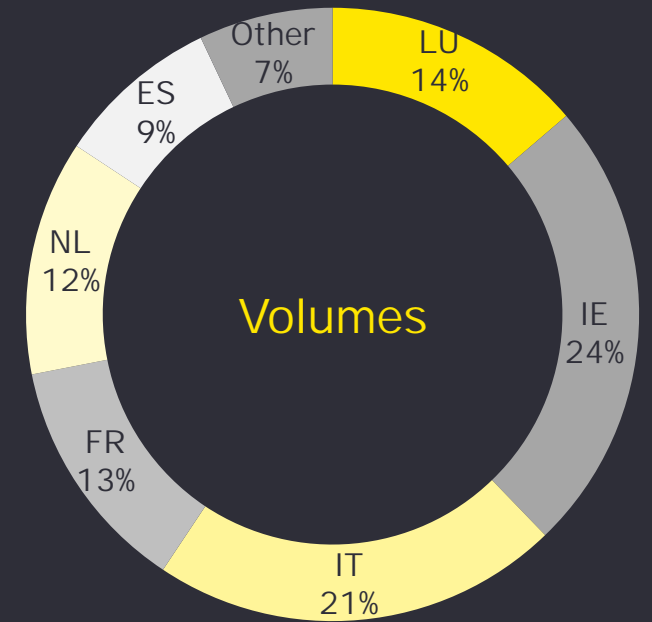
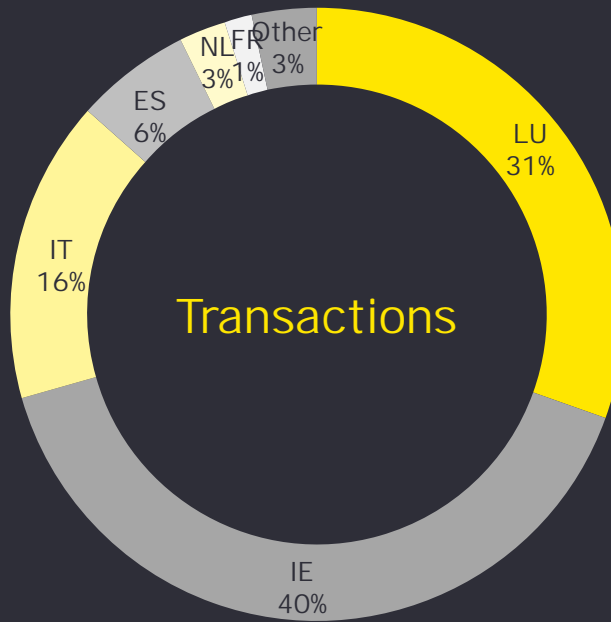
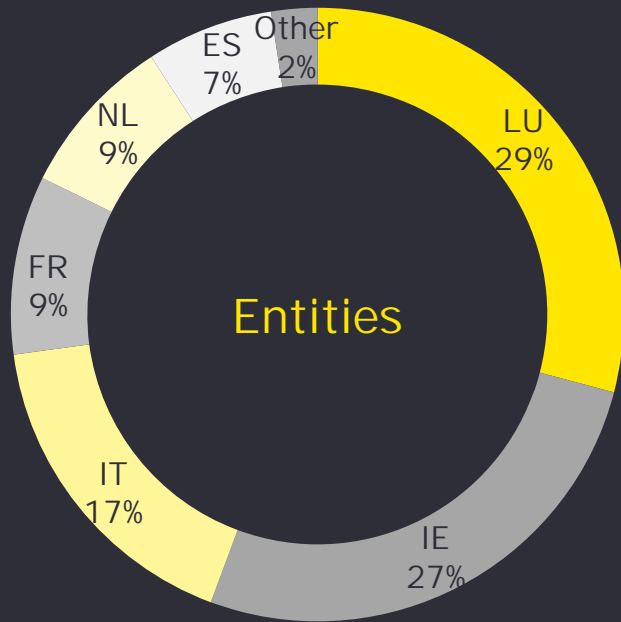


Source: SIFMA, AFME, EY



Luxembourg trends

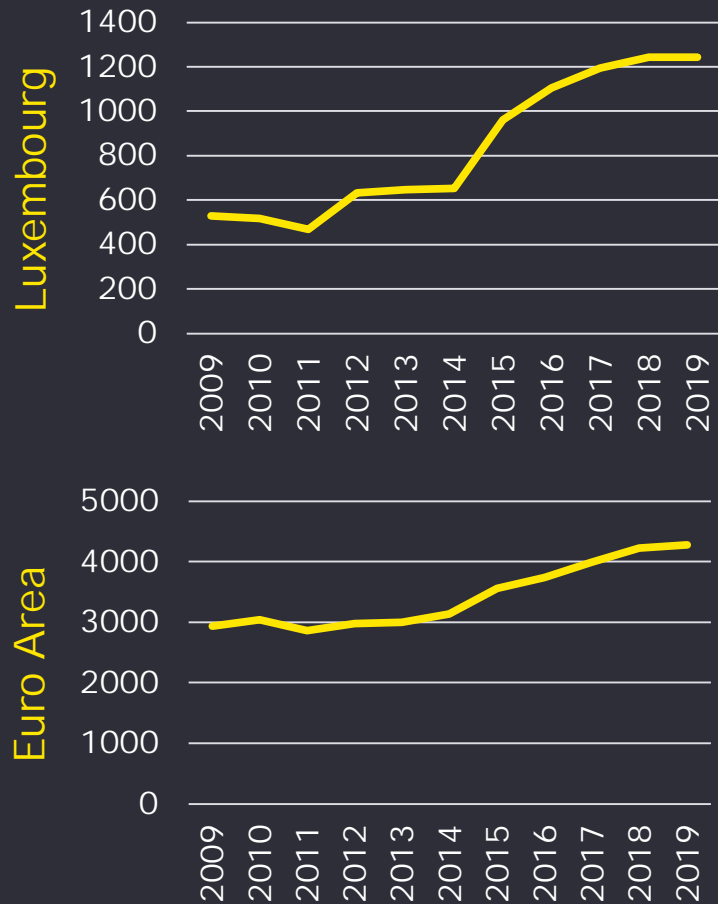
ECB FVC – Luxembourg - Country Market Share (Q3 2019)



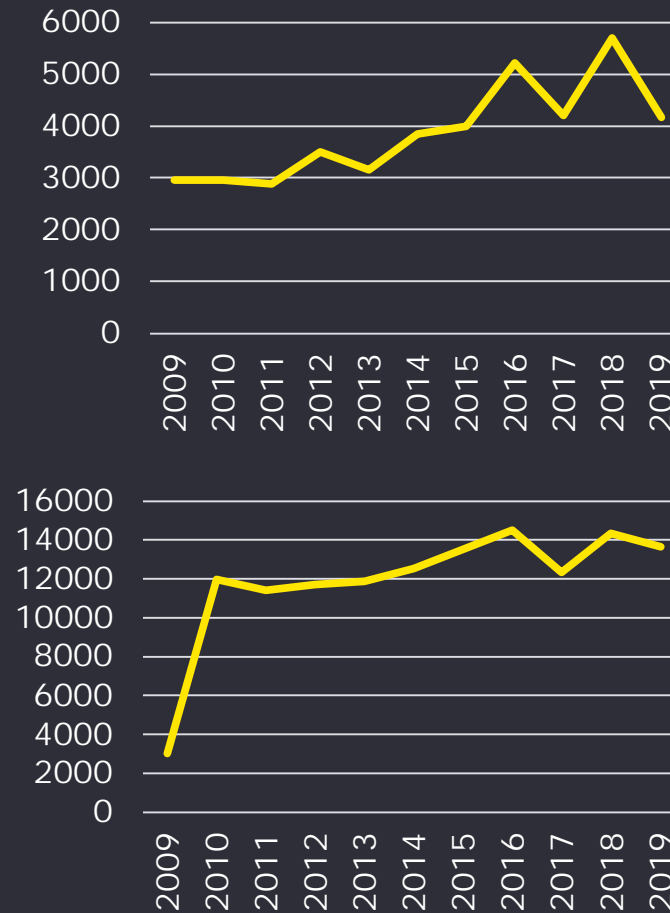
Source: ECB FVC statistics

ECB FVC – Luxembourg – Historic Developments and Status Quo (Q3 2019)

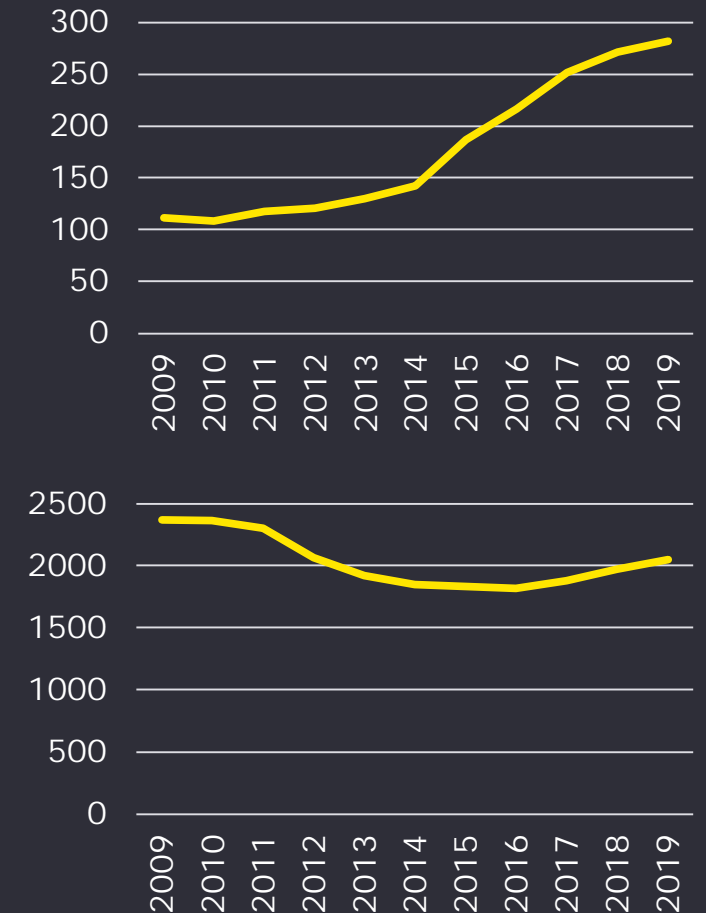
Entities (no.)



Transactions (no.)

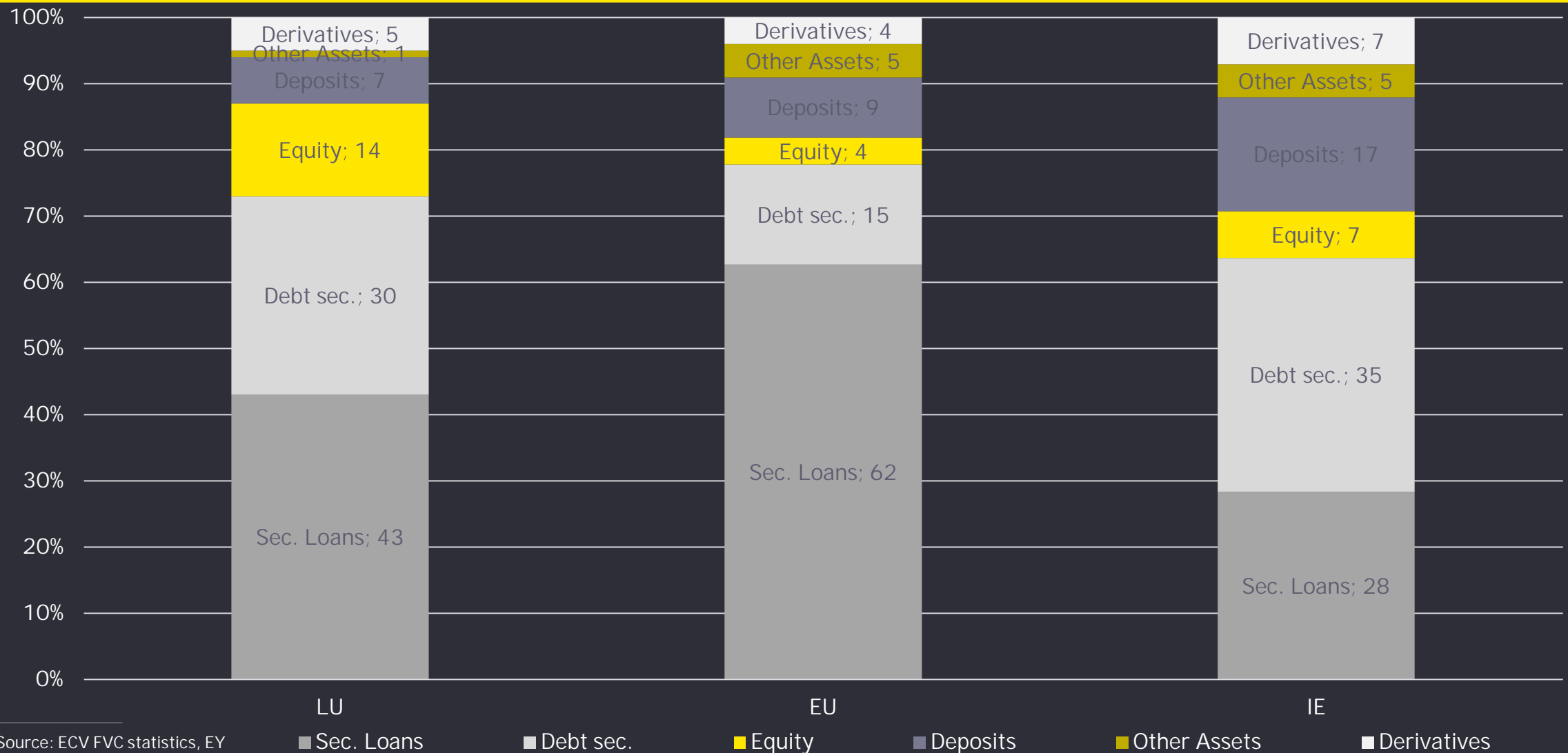


Volumes (EUR billion stock)

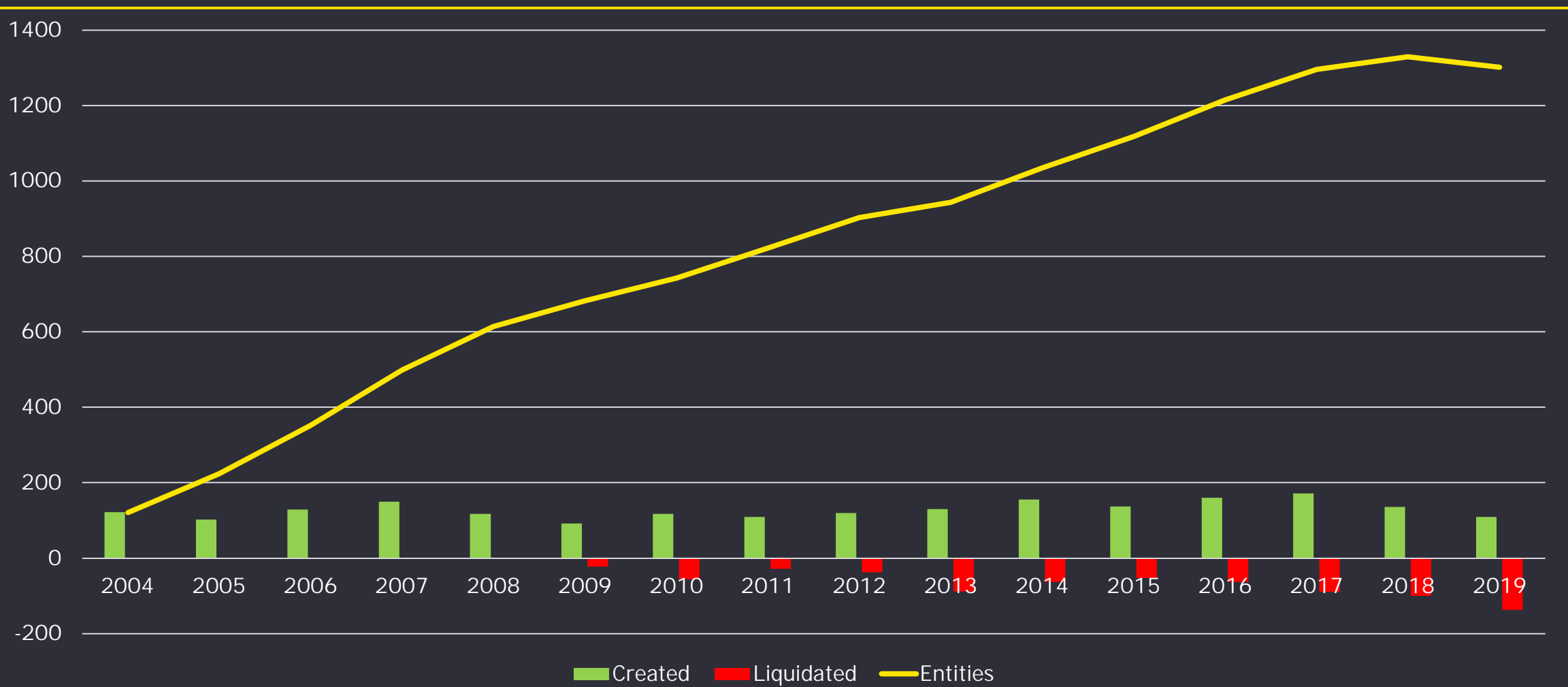


Source: ECB FVC statistics

ECB FVC – Luxembourg - Asset Classes (Q3 2019)

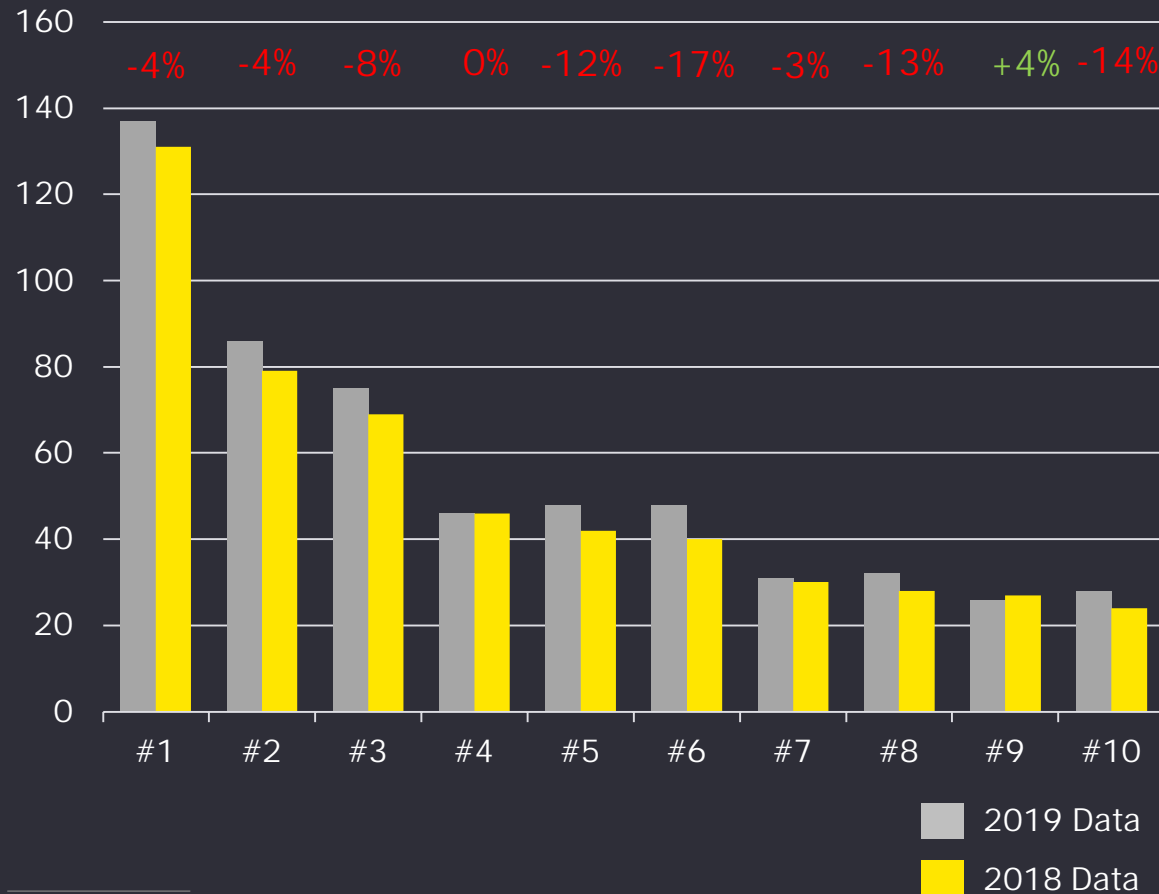


EY research – Historic Movements in Securitization Entities



Source: ECB FVC statistics, EY, www.rbl.lu

EY research – Luxembourg Domiciliation Environment 2018 versus 2019

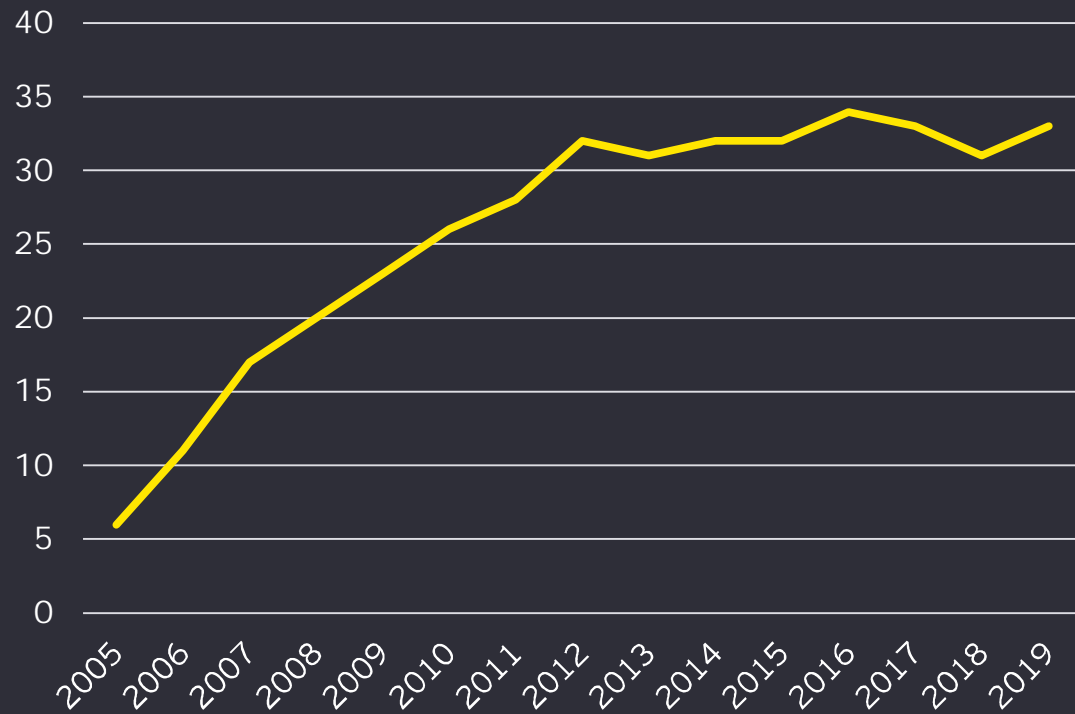


Source: ECB FVC statistics, EY. www.lbr.lu

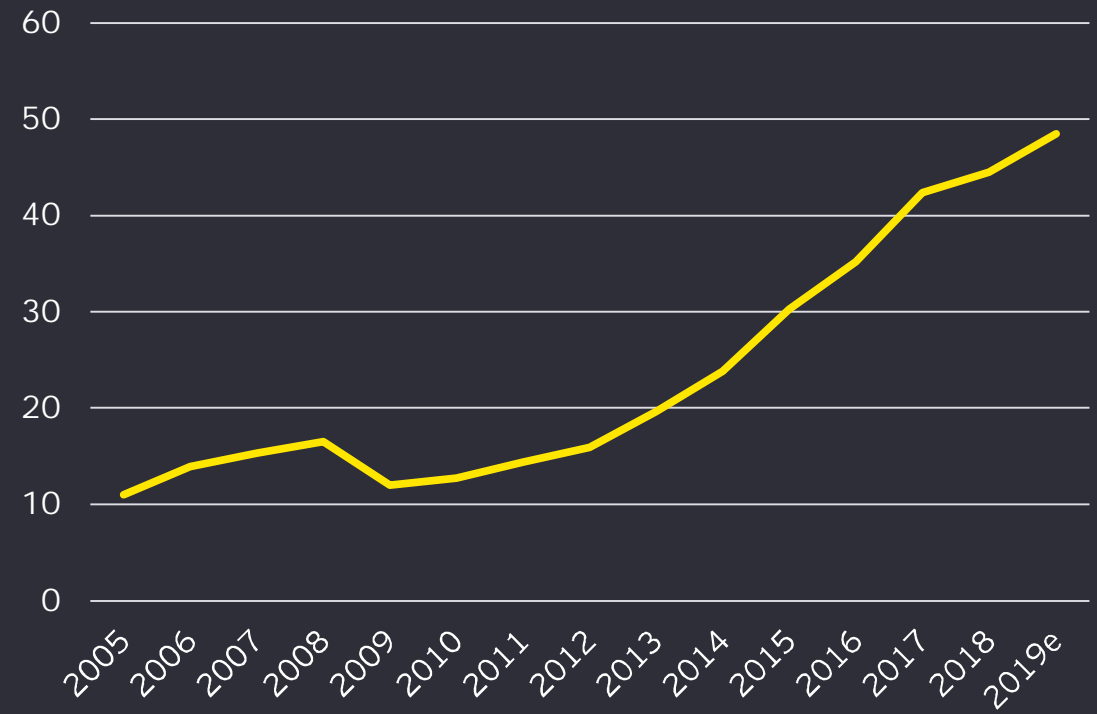
- ▶ In total more than 200 different domiciles reported
- ▶ Overall, The Big 10 CSPs have shown a decrease in market share, falling from 42% (2018) to 40% (2019)
- ▶ The 200+ other domiciles aggregate to a 60% (2019) market share – increasing from 58% (2018)
- ▶ Main reason: an increasing demand for substance offices, micro agents or self administered SVs
- ▶ Consolidation expected

CSSF – Number and Issuance of Authorized Securitization Undertakings

Historic number



Issuance in Euro billion



Source: CSSF reports

The future means for Luxembourg

- ▶ Well positioned for further growth
- ▶ Existing structures are not yet affected by ATAD I
- ▶ EU Securitization Regulation will continue to be a driver
- ▶ Increasing number of small SVs (single compartments)
- ▶ Increasing number of securitization funds
- ▶ Clarification on ATAD I interest limitation will probably boost the market

Tax update: ATAD, DAC 6 and VAT: Practical impact and actions



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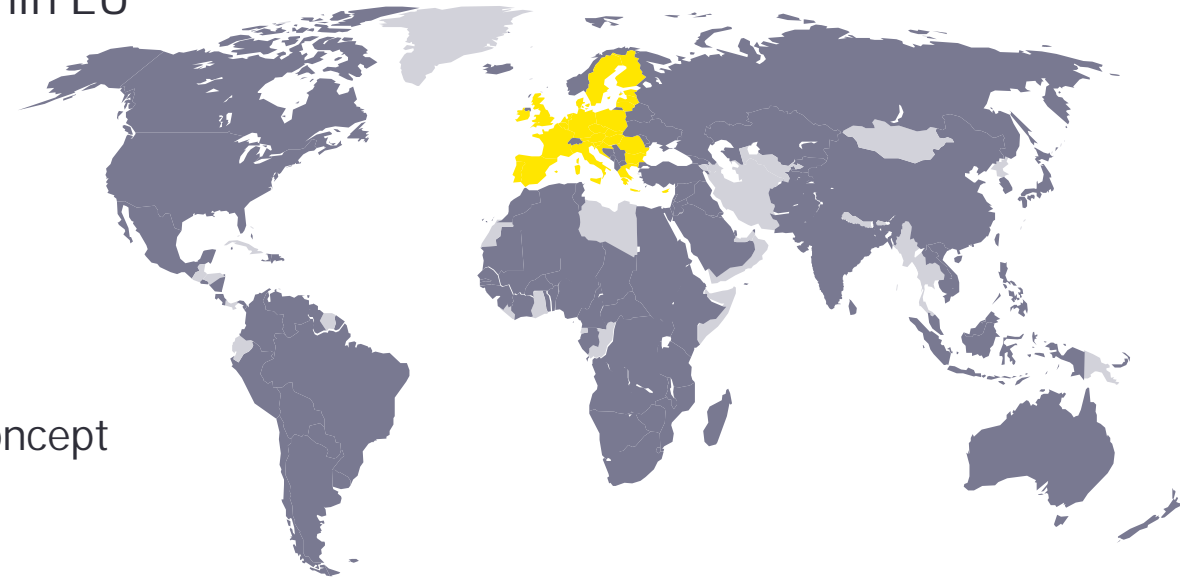
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ATAD and DAC 6

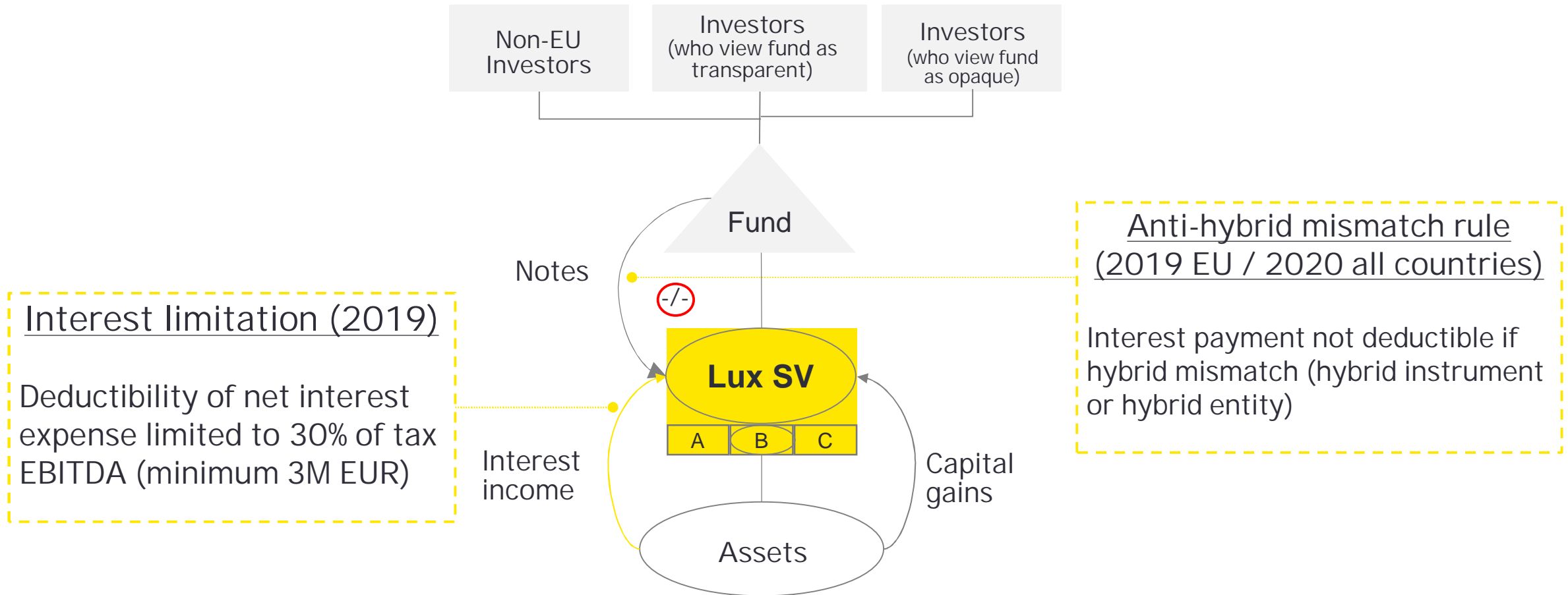
Background on ATAD 1 and ATAD 2

- ATAD 1 (2019)
 - Interest limitation rules
 - Hybrid financial instruments and hybrid entities within EU
- ATAD 2 significantly expands scope:
 - 2020:
 - Mismatches involving third countries
 - Additional types of mismatches
 - More mismatches in scope due to “acting together” concept
 - 2022:
 - Taxation of certain partnerships (“reverse hybrids”)



23 December 2019: Luxembourg ATAD 2 implementing law published

Luxembourg implementation of Anti-Tax Avoidance Directive Specifics for Securitization Vehicles





ATAD 1

ATAD 1 - Interest limitation rule

The mechanics

- ▶ “Exceeding borrowing costs”
 - Interest expenses on all forms of debt
 - + Other costs economically equivalent to interest
 - Interest revenue
 - Other economically equivalent taxable revenue
- ▶ Deduction limited to 30% of taxable EBITDA (minimum 3M EUR)

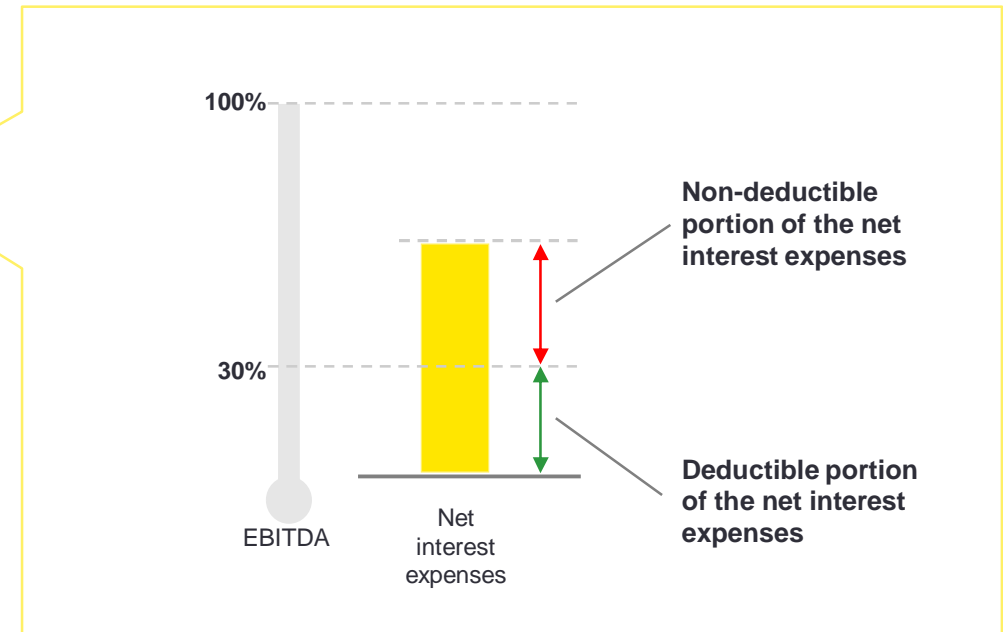
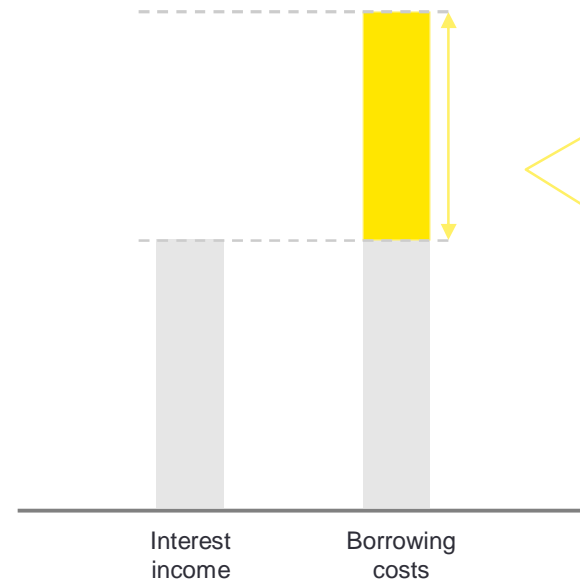
Exclusions:

- ▶ Grandfathering rule:
 - ▶ Interest on debt in place as of 17 June 2016 excluded
- ▶ Exclusion for SVs covered by EU Regulation 2017/2402
- ▶ Exclusion for stand-alone entities (no direct or indirect owner holds more than 25% in capital, vote or economics)
- ▶ Exclusion for AIFs

▶ EBITDA:

Income subject to corporate income tax (ie not including tax-exempt income, e.g., dividends)

- + Exceeding borrowing costs
- + Depreciation and amortization



ATAD 1 - Interest limitation rule

Concept of borrowing cost and interest income

Interest definition includes, e.g.:

- ▶ Fixed interest
- ▶ Floating interest
- ▶ Profit/income participating interest
- ▶ Notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings
- ▶ "Certain" foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
- ▶ Guarantee fees for financing arrangements
- ▶ Arrangement fees and similar costs related to the borrowing of funds

Open questions:

- ▶ Confirmation of symmetrical interest definition needed
- ▶ Capital gains
- ▶ Redemption losses and provisions for related risks
- ▶ Foreign exchange and results on other hedging instruments

Specific questions for SVs:

- ▶ Interest limitation rule applies to SV and not compartment
 - ▶ Mechanism to protect against cross-contamination?
- ▶ Application of exception for stand-alone entities?
- ▶ Treatment of equalisation adjustments
- ▶ Fair value adjustments on assets resulting in increase of value of notes
- ▶ Are commitments to investors holding equity instruments interest?
- ▶ Unclear relevance of statutory books



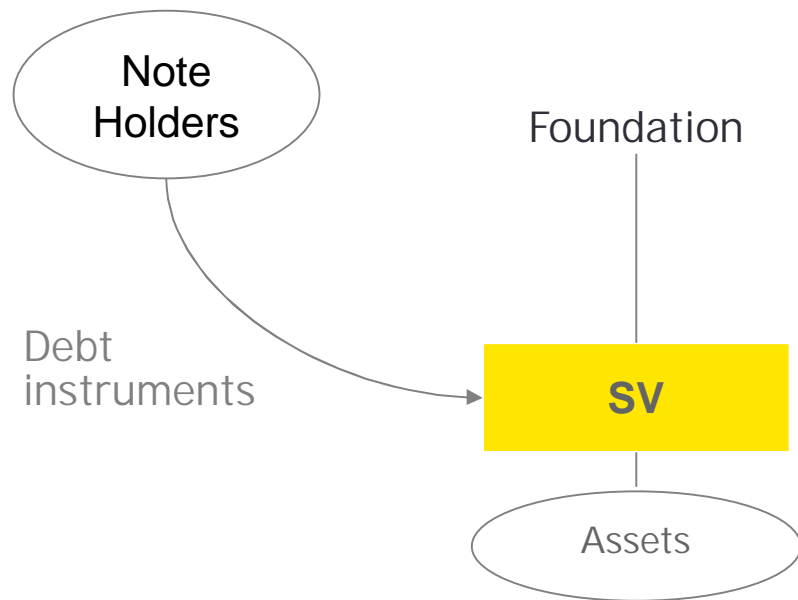
ATAD 2

When do ATAD 2 consequences apply?

- Link between taxpayer and investor:
 - Associated enterprise
 - 25% / 50% link through capital, voting rights of profit entitlement
 - Same consolidated group
 - “Significant influence”
 - Structured arrangement
- Hybrid mismatch as defined in law:
 - Deduction of payment in one country and non-inclusion in another (D/NI):
 - Hybrid financial instrument
 - Hybrid entity
 - PE mismatches
 - Double deduction (DD)
 - Dual residence mismatches
 - Hybrid transfers

ATAD 2 - Anti-hybrid mismatch rules

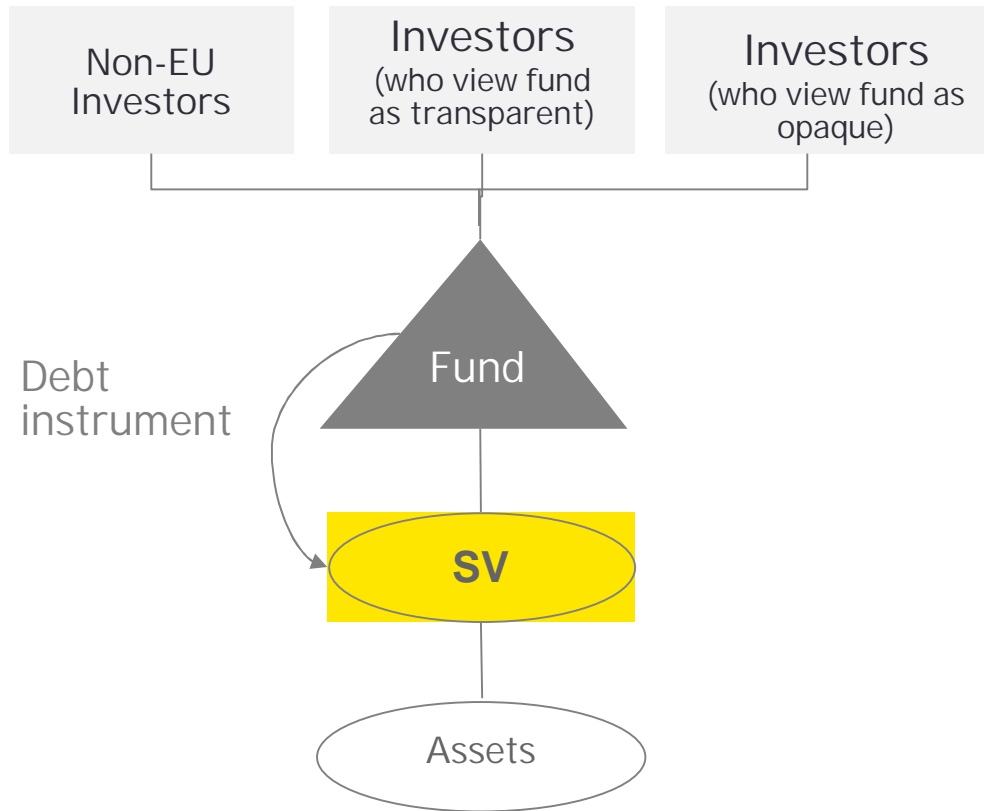
Questions in context of securitization companies



- ▶ Traditional orphan structures as a rule **are** not problematic since noteholders would normally not be “associated enterprises”.
- ▶ Potential Exception: if Notes are to be regarded as a “structured arrangement”.
 - ▶ Hybrid mismatch and
 - ▶ One or both of the following conditions are met:
 - ▶ The mismatch outcome is priced into the terms of the arrangement
Or
 - ▶ An arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise
 - ▶ Could not reasonably have been expected to be aware of the hybrid mismatch
 - ▶ Did not share in the value of the tax benefit resulting from the hybrid mismatch
- ▶ Equity funded SVs?

ATAD 2 - Anti-hybrid mismatch rules

Questions in context of securitization companies



- ▶ Investors in a LP are considered as “acting together”
 - ▶ “Associated enterprise” threshold (50%) now assessed on the basis of Fund’s holding in LuxCo SV.
- ▶ Disallowance of interest deduction by LuxCo SV in proportion to investors who:
 - ▶ Treat Fund as opaque (e.g., Netherlands, Italy, Australia, Korea, or the U.S. due to U.S. reverse check-the-box (CTB) election on Fund);
 - ▶ Treat Fund as transparent but SV as disregarded entity (DRE) or as a partnership, unless underlying income is considered as “dual inclusion” income (see below).



DAC 6

When, and then what?

Transition

From the date of entry into force of DAC 6 (25 June 2018) until 30 June 2020, arrangements where the first step of implementation has been taken after 25 June 2018 must be reported by 31 August 2020

After 1 July 2020

Within 30 days beginning the day after the arrangement either:

- ▶ Was made available or ready for implementation Or
- ▶ When the first step in the implementation was undertaken



Automatically shared with other Member States



First exchange by 31 October 2020



Penalties determined by national laws "Effective proportionate and dissuasive"

Draft Luxembourg Law

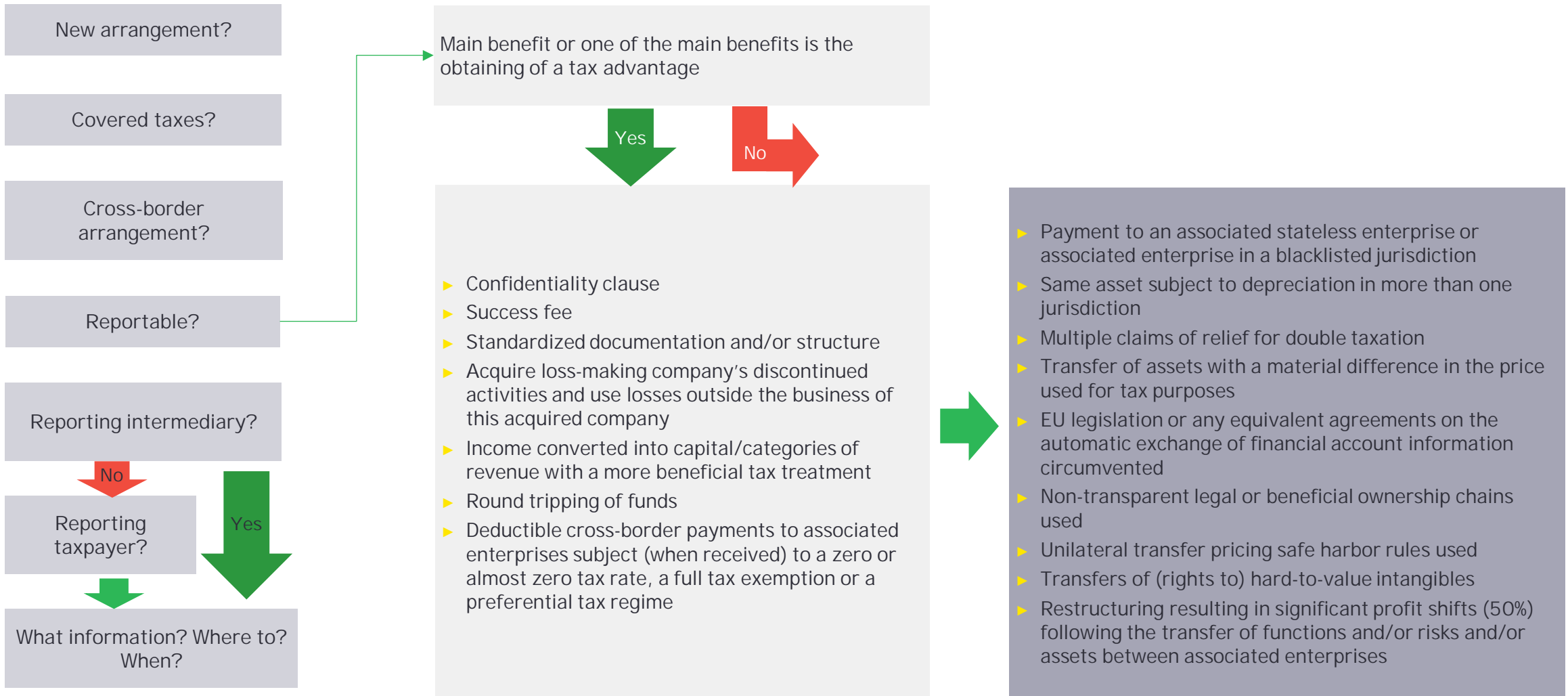
- ▶ Draft law 8 August 2019
- ▶ The text is very similar to that of the Directive
 - ▶ Specificities
 - ▶ High penalty level of EUR 250,000; and
 - ▶ Exemption from nominative reporting to tax authorities granted to lawyers, who still have information duties to Luxembourg operators qualifying as intermediaries and more generic reporting duties to the Luxembourg tax administration.
 - ▶ 14 January 2020 Conseil d'Etat:
 - ▶ Requested extension of the exemption from reporting to all intermediaries subject to professional secrecy, at least in tax advisory matters, thus including lawyers, certified accountants and independent auditors.
 - ▶ Increase of instances where taxpayer has to report?

Who needs to report?

Primary responsibility to disclose rests with each intermediary*.	Exceptions		Where? First EU MS listed below:
	Intermediary covered by legal professional privilege ('LPP')	Must inform other intermediaries and if none the relevant tax payer of their obligation to report	Where: <ul style="list-style-type: none"> ▶ A tax resident ▶ It has a permanent establishment (PE) through which services are provided ▶ Incorporated/governed ▶ Registered with professional association
	Intermediary has proof of disclosure by another intermediary	Disclosure will be made by the other intermediary	

Relevant taxpayer's responsibility to disclose if no intermediaries with EU nexus or all intermediaries with EU nexus covered by LPP.	More than one relevant tax payer? First in the list below		Where? First EU MS listed below:
	Agreed the arrangement with the intermediary	Manages implementation of the arrangement	Where : <ul style="list-style-type: none"> ▶ A tax resident ▶ It has a permanent establishment (PE) benefiting from the arrangement ▶ Where receives income or generates profits or carries on an activity, although not a tax resident and no PE

Hallmarks?



What needs to be reported?

- a) Identification of the intermediaries *and relevant taxpayers*, including their name and place of birth (for individuals), tax resident jurisdiction and Tax Identification Number (TIN), associated enterprises (where appropriate)
- b) Details of the hallmarks that are met
- c) A summary of the content of the arrangement, including commonly known name (if any), description of business activities or arrangements
- d) The date on which the first step in implementing has been made or will be made;
- e) The value of the cross-border arrangement
- f) National provisions that form the basis of the arrangement
- g) Member State of the taxpayer and other Member States which are likely to be concerned by the arrangement
- h) Persons that are likely to be affected by the arrangement and the Member States to which they are linked

VAT

ES



Securitization Vehicles and VAT

Taxable Status of SV

Circular 723 dated 29 December 2006

Investment vehicles listed in Article 44, §1, d) of the Luxembourg VAT Law includes:

- ▶ Securitization vehicles as per Law of 2004
- ▶ Similar entities performing securitization transactions as per art.1, point 2 of BCE Regulation n° 24/2009

Article 44, §1, c) of the Luxembourg VAT Law exempt from VAT debt transactions, excluding debt collection services

Brexit: Impact in Luxembourg and in the UK

- ▶ Deduction right for Luxembourg SV
- ▶ No ESL for UK suppliers

Management of SV

Article 44, §1, d) of the Luxembourg VAT Law

Circular 723 dated 29 December 2006

- ▶ ABBL list of services
- ▶ Appendix II of UCITS Directive

No Input VAT deduction right for SV, except, e.g., :

- ▶ Loans portfolio outside the EU
- ▶ Debts portfolio outside the EU

Attractiveness of Luxembourg: Luxembourg VAT rates: Standard VAT rate (17%) remains the lowest in Europe

Voting question

What type of issue do you have or do you expect in relation to the VAT position of the Securitization Vehicles you are responsible for?

1. VAT registration
2. VAT costs (no exemption applicable)
3. Input VAT recovery
4. Brexit
5. More than one of the above
6. None of the above

New due diligence requirements: Key principles for effective due diligence



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Due Diligence in the Securitization Regulation – An Introduction

Securitization Regulation framework

- ▶ As from the 1st of January 2019, the “Amendment of the Capital Requirements Regulation (CRR)” (EU Regulation 2017/2401) and the “EU Securitization Regulation” (Regulation EU 2017/2402) became both effective, with the former requiring additional risk weight in case of infringement of the DD provisions of the Regulation EU 2017/2402, and the latter setting out various DD obligations applicable to institutional investors
- ▶ The European Banking Authority (EBA) has developed two Regulatory Technical Standards (RTS) on some topics of the EU Regulation 2017/2402 (the homogeneity of the underlying exposures in securitization and the risk retention), which deal with, among others, the DD requirements
- ▶ As of today, the “Luxembourg Securitization Law” (Law of 22 March 2004 on securitization and amending) does not dictate any DD requirements

PRELIMINARY KEY TAKEAWAYS

- ▶ Securitization is the only asset class which has a regulatory requirement for its investors to perform due diligence (DD).
- ▶ Non-compliance risk: Non compliance with the DD requirements could lead to hefty sanctions.
- ▶ The DD is not a one-off exercise, and it should be reconsidered if there is a change in the risk profile.

Securitization Regulation 2017/2402

Due diligence

Even with the revision of the EU-wide securitization framework, the investor still has to demonstrate a thorough knowledge of the securitization position prior to acquisition and during the holding period

Due diligence requirements for institutional investors

Investments in securitizations or in risk-exposures created by securitizations do not only expose the investor to the credit risk associated with securitized loans or exposures; the structuring of securitizations could also entail additional risks, such as agency and model risks, legal and operational risks. It is therefore essential that the **institutional investors have due diligence policies and procedures in place that ensure, in the interest of the ultimate investor, the proper assessment of the risks arising from all types of securitization positions.**

The highlights in terms of due diligence requirements* are briefly described below:

	CRR	SEC-AM
Requirements for sound and well-defined lending criteria, risk retention criteria and transparency. An extension to originators from third countries is now possible.	408, 405 (1), 409	5 (1)
For fully supported ABCP transactions, the sponsor must check that the originator meets the requirements for the lending criteria before investing.	-	5 (2)
Investors should understand the risk position, structural securitization characteristics (including payment priority, triggers, definition of default) as well as fulfillment of the STS requirements.	406 (1)	5 (3)
Investors need to continually assess the performance of the securitization exposures other than fully supported ABCP programs by performing stress tests on the cash flows and collateral values supporting the underlying exposures and on loss assumptions. For fully supported ABCP programs, investors are expected to perform stress tests on the solvency and liquidity of the sponsor, and report on this to internal risk-setting/management bodies	406 (1), 406 (2)	5 (4)
Investors managing other institutional investors' securitization positions are now exposed to sanctions by NCA's when they fail to fulfil due-diligence requirements.	-	5 (5)

* This must be done before holding the securitization position

Voting question

To what extent are you compliant with the new due diligence requirements as per the securitization regulation 2017/2402 ?

1. Implementation not started
2. Ongoing implementation
3. Fully compliant
4. N/A

DD best practices in asset management industry – Experience sharing

- ▶ From a general perspective, before investing in any type of asset or financial product, DD is commonly carried out by investment managers in order to assess the pros and cons stemming from such an investment.
- ▶ Under the CSSF Circular 18/698, issued in August 2018, DD is needed where the Investment Fund Manager (IFM) sets up a delegation framework whereby one of its functions is delegated to a third party (intra Group or external), as authorized by the law.

DUE DILIGENCE BEST PRACTICES

APPROACH	One-sized fits all approach versus tailored-approach	<ul style="list-style-type: none"> • Limited possibility to apply the “one-sized fits all approach” to organize the DD process in the asset management industry, though the regulation sets specific requirements and guiding principles such as proportionality, transparency, and substantiality • Asset managers recurs to a case by case tailored-approach, in relation to their book of business and risk appetite
	Project management	<ul style="list-style-type: none"> • The third party to whom a function is delegated must be subject to DD phased with initial DD (IDD) and ongoing DD (ODD), but also to an ongoing monitoring activity. Based on day-to-day business or periodic review, both type of oversight require project planning and ad-hoc resources (FTE and skills) • An effective DD process is usually achieved through a multi-year plan (as per the CSSF Circular 18/698, generally three years), where ODD occurs in line with DD scoring • The results of the DD can impact the day-to-day oversight activity and vice-versa. Remediation plan can be enabled to maintain an efficient business relationship
	Flow of information	<ul style="list-style-type: none"> • Effective DD is usually realized when there is an iterative good and swift exchange of information and data among the parties • Commitment of both parties is key

DD best practices in asset management industry – Experience sharing (cont'd)

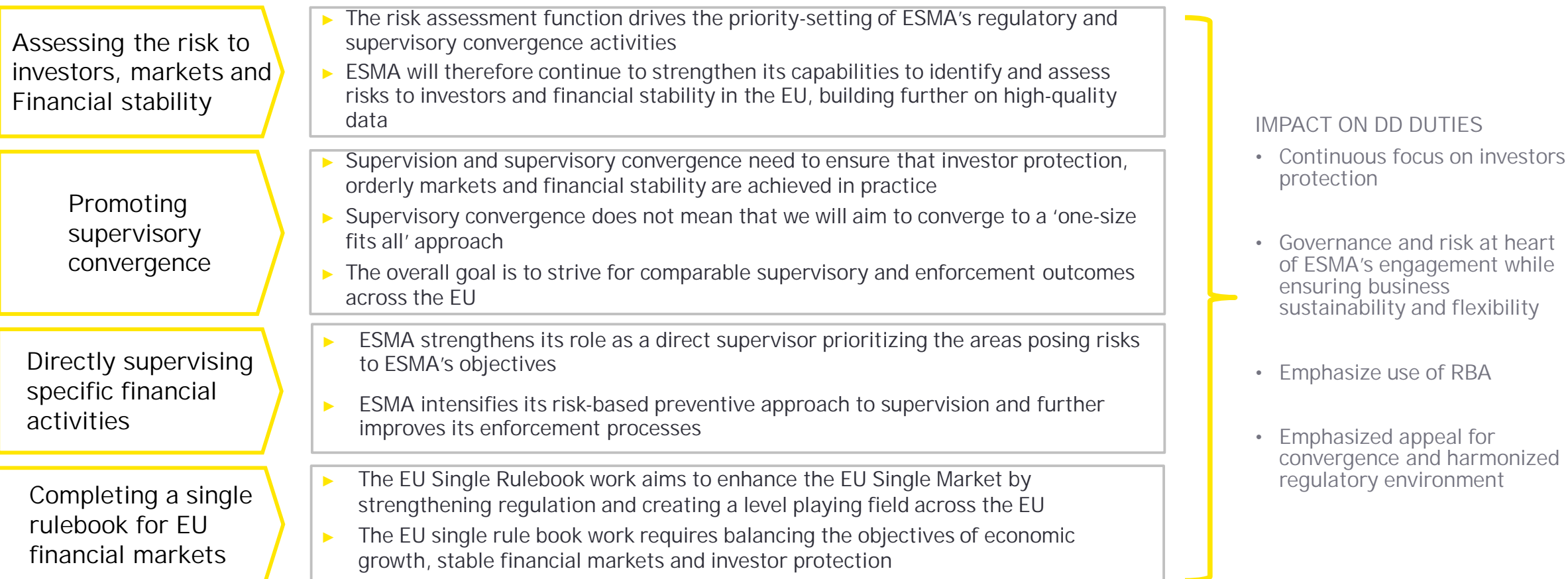
DUE DILIGENCE BEST PRACTICES (cont'd)

METHODOLOGY	Risk-based approach	<ul style="list-style-type: none"> The DD activity is strictly related and dependent to the risk-based approach (RBA). The frequency, scope of the DD and final rating shall be in line and compliant with the risk-based approach set by the IFM
	Understanding of the scope of business and delegated entity capacities	<ul style="list-style-type: none"> The DD is usually structured around the understanding of stability, capacities (e.g., admin, IT, FTEs, skills, operations) and processes to render the services, while remaining compliant with relevant regulation and having proper control in place Also, the DD should demonstrate adherence of delegates to IFMs expectations and compliance duties at a sub-delegation level
RISK FRAMEWORK	DD policy and procedures	<ul style="list-style-type: none"> To have in place DD policies and a procedures manual which will serve as a minimum standard and point of reference and can be requested by the CSSF if needed The risk documentation is to be reviewed to remain accurate with the activity
	Questionnaire and checklists	<ul style="list-style-type: none"> The DD activity is most often substantiated by the use of written questionnaires and checklists The practice could not lead to define industry-wide harmonized templates for conducting the DD, though some attempts have been observed for some functions
	Good documentation	<ul style="list-style-type: none"> To maintain a good documentation of the DD questionnaires, checklist and other files. All the DD evidences shall be kept available at request of the CSSF and to document DD process in the view of supporting the board of directors decision making

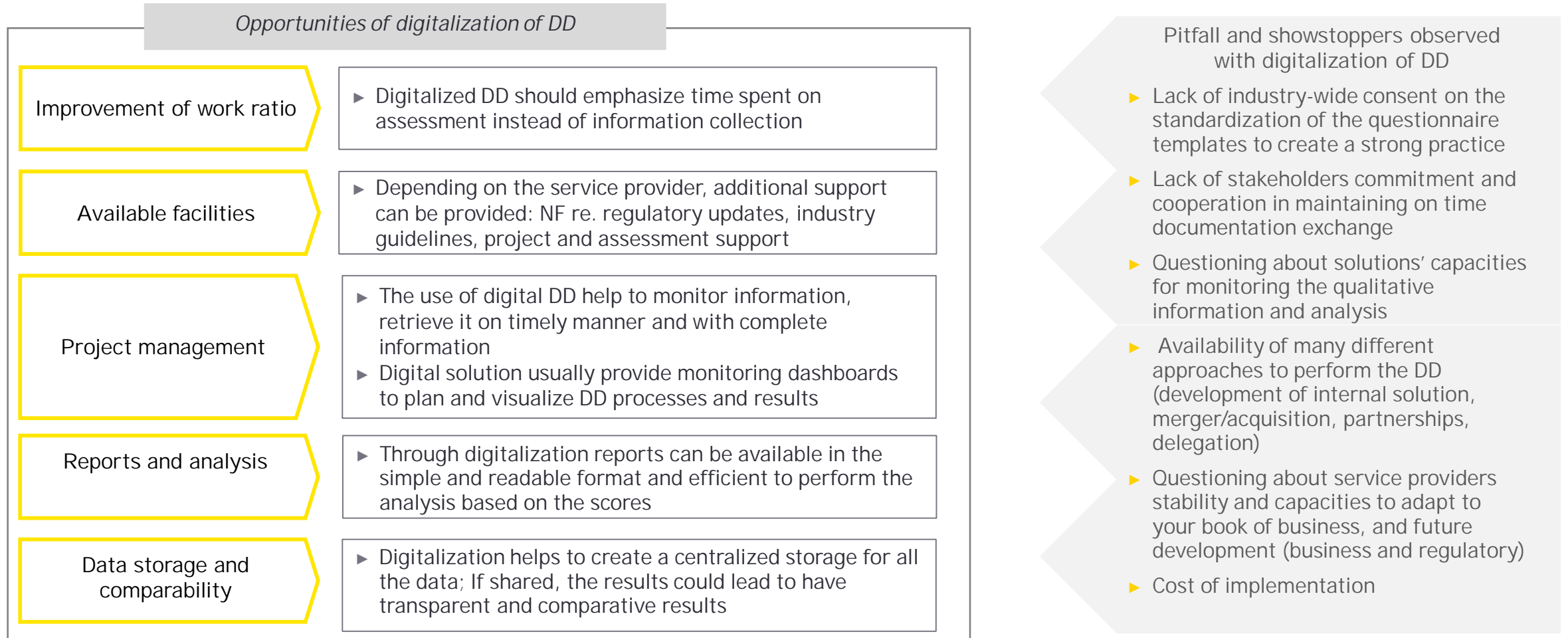
ESMA Strategic orientation 2020-2022 – key takeaways

- ▶ As the largest capital market left the EU, ESMA's needs to reinforce the EU capital markets, promoting economic growth and innovation
- ▶ There is an increasing priority for ESMA to ensure the consistent implementation of the EU single rulebook across the EU

ESMA achieves its mission through the four activities



Implementation of digital solution: pitfalls and real opportunities



Good digital solutions should have reached a certain maturity in terms of development and support. Effectiveness of the solutions available to stakeholders now are mainly linked to the stakeholders capacities in developing EU / industry-wide branded practice.

IBOR transition considerations for the Securitization market



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IBOR in the News...

Libor switch spells trouble for loan systems

As the end of Libor draws closer, banks are making plans to upgrade their vendor-provided risk management systems to be able to handle backward-looking rates. But overhauling creaky loan systems is no simple task, as firms are discovering. Third-party platforms for loans can be up to 30 years old. Some firms are running old versions that could take many months to change, given the extensive testing needed.

Source: *Risk.Net* 5th September 2019

FCA ups call for Libor 'pre-death' trigger in swaps

Regulators are piling pressure on the derivatives industry to hardwire so-called pre-cessation triggers into swaps fall-backs. The move would see Libor contracts automatically switch to alternative risk-free rates if the discredited benchmarks are deemed unrepresentative of underlying funding markets. Major swaps clearing houses have already signalled they may unilaterally shift all cleared Libor portfolios to the new risk-free rates if the benchmark produces anomalous prices.

Source: *Risk.Net* 22nd November 2019

Global regulator ratchets up pressure on banks and markets to ditch Libor

The Financial Stability Board (FSB) said on Wednesday it will survey national regulators, many of them FSB members, to measure their progress in persuading banks and companies to stop using the London Interbank Offered Rate or Libor. The FSB wants markets to use overnight interest rates compiled by central banks like the Federal Reserve, Bank of England and the ECB. The overnight rates are based on verifiable market transactions unlike Libor, which is derived from quotes submitted by banks.

Source: *Thomson Reuters* 19th December 2019

€STR swap trading gets under way

HSBC and JP Morgan have struck what is thought to be the first interest rate swap trade linked to the new euro short-term rate (€STR) – a one-week transaction that allowed the two parties to check their ability to execute swaps using the new benchmark. Swap volumes in the new reference rate are expected to grow rapidly once the products are available for clearing from October 21.

Source: *Risk.Net* 1st October 2019

First all-RFR cross-currency swap traded

Goldman Sachs and Morgan Stanley are believed to have transacted the first cross-currency swap to use new risk-free rates for both legs of the trade. The euro/dollar trade was reported to the Depository Trust & Clearing Corporation's (DTCC) repository on November 21... The two-year, \$11 million (€9.9 million) notional swap references three-month compounded versions of the secured overnight financing rate (SOFR) and the euro short-term rate (€STR).

Source: *Risk.Net* 26th November 2019

Giant £174bn Sonia swaps trading day may be biggest ever

Swaps trades referencing the Sterling Overnight Index Average (Sonia) soared to at least four year highs last week, according to data from the Depository Trust & Clearing Corporation's (DTCC) trade repository. The £174 billion (\$226 billion) and £154 billion in notional traded, which made the days the largest single and largest consecutive trading days for Sonia-referencing swaps since at least the start of 2016, and possibly all-time for trades reported to the DTCC.

Source: *Risk Magazine* 14th January 2020

ARRC welcomes publication of SOFR

The Alternative Reference Rates Committee (ARRC) welcomed a consultation about the publication of Secured Overnight Financing Rate (SOFR) averages and a SOFR index, issued by the Federal Reserve Bank of New York (New York Fed), in cooperation with the Treasury Department's Office of Financial Research (OFR). The ARRC released recommended contractual fall-back language for new U.S. dollar-denominated closed-end, residential adjustable-rate mortgages (ARMs). These provisions were developed with the goal of reducing the risk of serious market disruption in the event that LIBOR is no longer available

Source: *ARRC Newsletter* 19th November 2019

BMR rift fuels zombie Libor Uncertainty

Debate on whether the swaps industry should embed pre-cessation triggers into trades referencing doomed benchmark Libor is snagging on a difference of opinion over how European regulation affects the rate's final days. Under the European Union's Benchmarks Regulation, a rate that is deemed unrepresentative of underlying markets can continue to be published for a "reasonable time period" during which the benchmark operator attempts to patch it up..

Source: *Risk.net* 9th December 2019

Judgement day looms for dealers in swap shift to Sonia

A senior UK regulator has urged banks to switch interdealer swaps activity to reference Sonia, the sterling market's alternative risk-free rate, in the first quarter. The move is a key part of phasing out Libor before the rate's anticipated demise at the end of 2021.

Much short-dated trading is already fixed to Sonia, but the longer end of the curve is proving harder to change. Observers also raise concerns that not all market participants have updated their systems and infrastructure to handle the changeover.

Source: *Risk.Net* 15th January 2020

Background to changes foreseen in the markets

Interbank Offered Rates (IBORs) impact over \$350 trillion of dollars notional value of financial instruments across the globe. Several cases of manipulation by banks of major benchmarks and indices including IBORs have led to considerable censoring and initiation of reform by regulators globally to restore confidence in the reliability and robustness of benchmark rates.

Drivers underpinning IBORs reform



Systemic risk due to the uncertainty surrounding the durability of IBORs



Decline in the liquidity within the interbank unsecured funding markets



Reluctance from LIBOR and EURIBOR panel banks to **submit quotes**



Charges of attempted Manipulation and false reporting

Key reform initiatives by regulators globally and resulting outcomes

- Wheatley review of LIBOR >2012
- G20 asked the FSB to reform major interest rate benchmarks
- The Official Sector Steering Group (OSSG) established 2013
- IOSCO principles published 2013
- IBOR Market Participants Group (MPG) established 2014



- The outcome of these reviews was a recommendation to enhance existing IBORs and promote the development and adoption of alternative nearly risk-free reference rates (RFRs).
- Working Groups have convened across several jurisdictions to better understand challenges and propose alternative RFRs.
- Based on the proposals, market participants have begun mobilizing programs to assess the impacts to their organizations.

Why the urgency?



EU Benchmark Regulation (BMR) which is fully applicable from 1 January 2018 and covers LIBOR, does not permit the FCA to compel banks to contribute to LIBOR indefinitely.

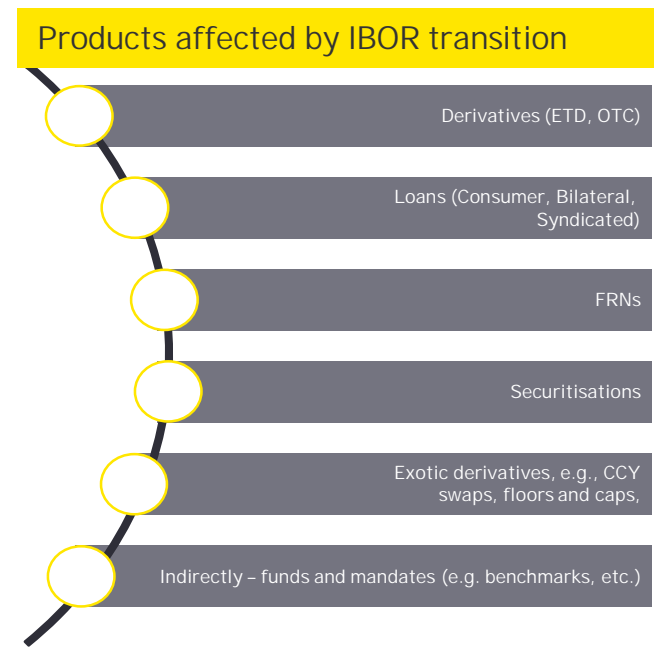
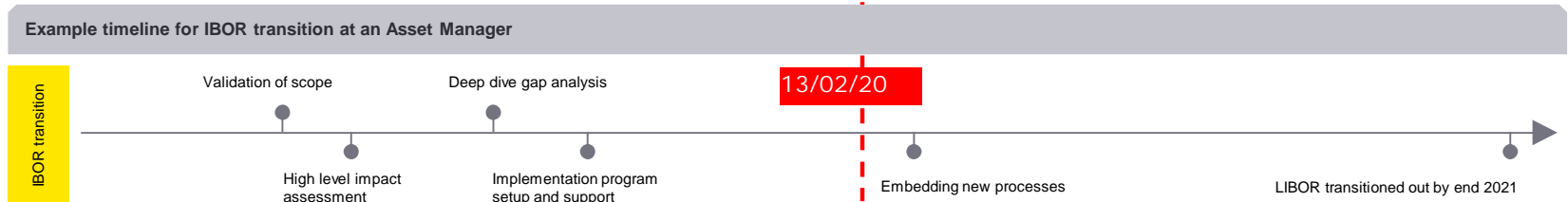
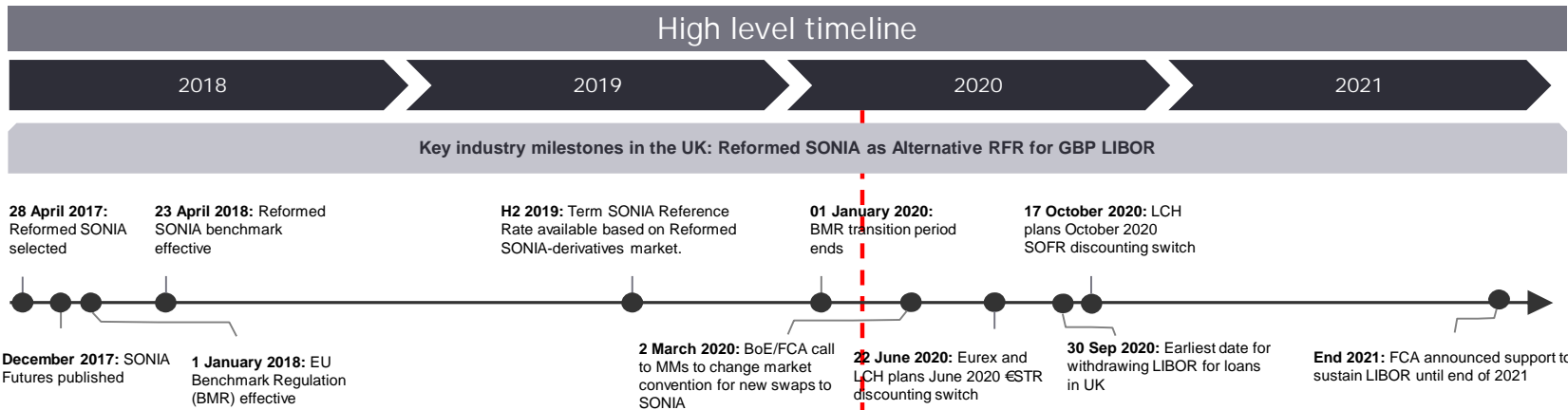


Edwin S Latter announced in Jan 2019 the FCA believes the best transition from LIBOR will be one in which contracts that reference LIBOR are replaced or amended before fall-back provisions are triggered.



In Sept 2018, the PRA sent a letter to CEOs of supervised institutions requesting information related to their preparation to transition from (L)IBORs to alternative reference rates (ARRs), with responses due Dec 2018.

Situation in Europe - Only 22 months to go...?



Key recent updates

Fall backs and updates across markets:
 Proposed fall back language: Published for derivatives by ISDA (Nov'18), and for FRNs, Syndicated Loans, bilateral business loans and securitisations by the Alternative Rates Reference Committee (May'19)
 UK: Focus on credit spread adjustments
 EU: Dear CEO letters issued in July (similar to the UK)

In Luxembourg, CSS letters sent august 2019 to inquire about IBOR transition plan

Sell side focus and priorities:






- ▶ Monitoring exposure to LIBOR - ongoing, not static
- ▶ Reducing new LIBOR issuances
- ▶ New product (non-LIBOR) strategy and launches
- ▶ Strategy for back book: repapering or fall back
- ▶ Conduct risk governance
- ▶ Client outreach

Buyside focus and priorities:

- ▶ Exposure monitoring
- ▶ Document inventory of legacy positions
- ▶ Strategy
- ▶ Infrastructure to implement: Valuation and tax impact overlay to strategies

Summary of transition progress

Working Groups in each jurisdiction have recommended robust, alternative RFRs to transition away from existing IBORs. The RFR benchmarks are overnight whereas current use of IBORs is largely in term rates.

Jurisdiction					
IBORs	GBP LIBOR	USD LIBOR	EURIBOR, Euro LIBOR	CHF LIBOR	JPY LIBOR, JPY TIBOR, EUROYENTIBOR
Working Group	Working Group on Sterling Risk-Free Reference Rates <i>Dear CEO Letter</i>	Alternative Reference Rates Committee	Working Group on Euro Risk-Free Rates	National Working Group on Swiss Franc Reference Rate <i>Dear CEO Letter</i>	Study Group on Risk-Free Reference Rates
Alternative RFR	Reformed Sterling overnight index average (SONIA)	Secured overnight financing rate (SOFR)	Euro short-term rate (ESTER)	Swiss average rate overnight (SARON)	Tokyo overnight average rate (TONAR)
Description	<ul style="list-style-type: none"> ▶ Unsecured ▶ Fully transaction-based ▶ Overnight, nearly risk-free reference rate ▶ Includes a volume-weighted trimmed mean 	<ul style="list-style-type: none"> ▶ Secured ▶ Fully transaction-based ▶ Overnight, nearly risk-free reference rate that correlates closely with other money market rates ▶ Covers multiple repo market segments, allowing for future market evolution 	<ul style="list-style-type: none"> ▶ In Sept 2018 ECB has announced that ESTER is chosen as ARR. ▶ Reflects the wholesale euro unsecured overnight borrowing costs of euro area banks. 	<ul style="list-style-type: none"> ▶ Secured ▶ Became the reference interbank overnight repo on August 25, 2009 ▶ Secured rate that reflects interest paid on interbank overnight repo 	<ul style="list-style-type: none"> ▶ Unsecured, transaction-based ▶ Uncollateralized overnight call rate market ▶ The Bank of Japan calculates and publishes the rate daily using information provided by money market brokers, Tanshi ▶ As an average, weighted by the volume of transactions corresponding to the rate
ARR v.s. IBORs IRD Market	<ul style="list-style-type: none"> ■ GBP LIBOR \$2.4tn ■ SONIA OIS \$2.1tn ■ SONIA BASIS \$55.3bn 	<ul style="list-style-type: none"> ■ USD LIBOR \$2.7tn ■ SOFR BASIS \$3.6bn ■ SOFR OIS \$1.1bn 	<ul style="list-style-type: none"> ■ EUR IBORs \$5tn 	<ul style="list-style-type: none"> ■ CHF LIBOR \$109.7bn ■ SARON OIS \$1.3bn 	<ul style="list-style-type: none"> ■ JPY IBORs \$920bn ■ TONAR OIS \$39.5bn ■ TONAR BASIS \$1bn
Rate administrator	Bank of England	Fed. Res. Bank of New York	ECB	SIX Swiss Exchange	Bank of Japan

IBOR Transition potential impacts

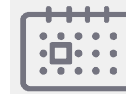
Assets liabilities and swaps can each have different



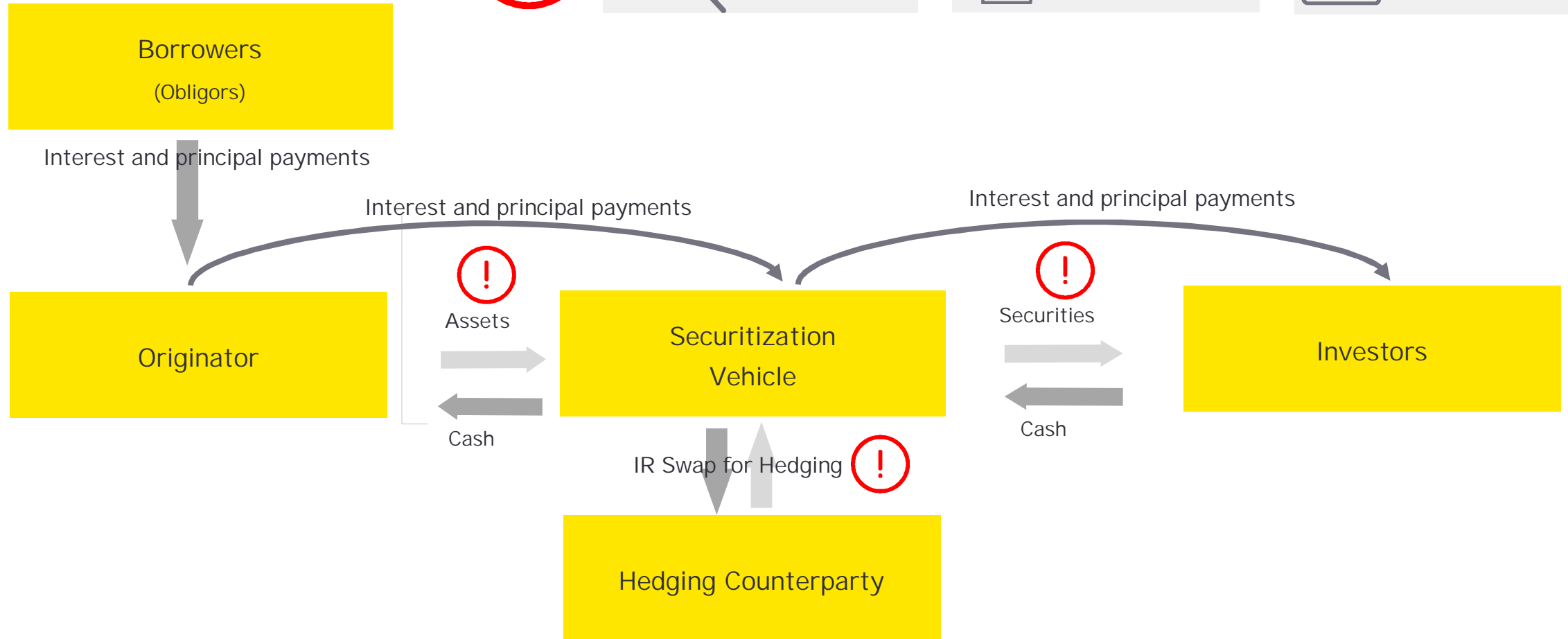
Reference rates



Fallback clauses



Transition timings



What are the considerations for securitizations?

- ▶ The complexity and scale of the transition from USD LIBOR to ARR is expected to be a significant transformation effort for market participants. The inherent complexities of securitizations further compound the already substantial valuation, legal and reputational, operational and financial reporting considerations associated with the LIBOR transition.

Valuation considerations

- ▶ Uncertainty around the future liquidity of IBOR markets and the value of any IBOR-based product
- ▶ Other fallback rates may cause significant changes to the valuation of LIBOR-based portfolios
- ▶ Need to consider the impact of potential mismatches in timing and the fallback language for the securities and underlying collateral of a transaction

Legal and reputational considerations

- ▶ Increased risk of litigation, fines or reputational damages due to different perspectives
- ▶ Mitigation of legal and reputational impacts via a clear communication between parties to avoid misunderstanding.
- ▶ Assessing fallback provisions within legacy products and managing the repapering process require significant effort due to the volume and complexity of the securitization contracts

Operational considerations

- ▶ IBOR deeply embedded across the business and technology infrastructure of most securitization market participants.
- ▶ Operational impact can be sized by assessing the dependencies to LIBOR within current processes, systems, data and models.
- ▶ Detailed analysis across risk and pricing models required to understand the depth of impact as models will need to be redeveloped, recalibrated and revalidated for ARR.

Financial reporting considerations

- ▶ Transition to ARR requires firms to analyze accounting treatments that may have a direct impact on an instrument's fair value and related hedging strategies
- ▶ Financial reporting and disclosures may be impacted

What should securitization market participants do now?

The transition to ARR is expected to be a multiyear effort requiring constant monitoring of market developments and an approach that can evolve as progress is made by the industry.

Actions that market participants should undertake include :



Appointing senior executives to be accountable for assessing, planning and coordinating transition activities



Mobilizing an enterprise-wide IBOR transition program office with dedicated resources to own and execute all project activities across lines of business and control functions



Updating contract documentation for new transactions to include fallback language based on the recommendations from the ARRC and other industry groups



Conducting an enterprise-wide IBOR transition impact assessment to inventory IBOR-linked products, legal contracts, risk exposures, models, business processes and infrastructure



Developing a IBOR transition road map based on the results of the impact assessment that describes the prioritized plans, resources and activities required for the adoption of ARR



Participating in or monitoring working groups so that the latest market developments, leading practices and market dependencies are reflected within IBOR transition planning



Defining and executing a communication and education strategy for issuers, investors and other key parties to increase awareness and help to avoid the perception of conflicts of interest

Voting question

Are you ready for the IBOR transition on the Securitization market?

1. Yes, we have a fully developed action plan
2. Partially, we are on the way
3. Not at all
4. I don't know

Panel discussion: How main stakeholders should act differently to help better position the securitization market ?



Papa Saliou Diop

Associate Partner, Securitization Leader,
EY Luxembourg

Panel discussion: How main stakeholders should act differently to help the securitization market better positioned?

Panelists:

- ▶ Michael Zahn, *Executive Director, Solutions structuring, UBS Investment Bank*
- ▶ Vadim Totskyy, *Managing Director, Head of Cross-Product Structuring, Deutsche Bank*
- ▶ Rafaël Aguilera, *Principal, Due diligence-expert, EY Luxembourg*
- ▶ Vincent Galand, *Associate Partner, Risk Management, EY Luxembourg*

Moderated by

Papa Saliou Diop, *Associate Partner, Securitization Leader, EY Luxembourg*

Wrap-up



Papa Saliou Diop

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