Securitization in Luxembourg

Market and regulatory updates

11 February 2021

Webcast

Agenda

1. Securitization main regulatory updates
2. Market trends and insights
3. Tax regulatory updates
4. Key valuation challenges in the current COVID-19 context
5. Wrap-up

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Securitization main regulatory updates

Presented by

Papa Saliou Diop
Associate Partner, Assurance, Banking & Capital Markets, Securitization Leader

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Securitization main regulatory updates

2008

New framework applicable since 1 January 2019:

2021

2008 - Financial crisis reminder

Main triggers:

- Overly complex structures
- Mechanistic reliance on external ratings
- Ineffective maturity transformation
- Misalignment of interests between originators and investors
- Insufficient risk sensitivity due to the negligence of certain risk drivers

- Agency and modeling risks
- Insufficient supervision
- Excessive leverage

Securitization Regulation (EU) 2017/2402:

- Credit granting criteria
- Risk retention requirements ("skin in the game")
- Transparency requirements
- Due diligence for Institutional investors
- Ban of re-securitization
- Sales to retail investors
- STS securitizations (Simple, Transparent and Standardized)
- Privileged treatment for capital and solvency requirements for STS

- Transparency
- Eligibility criteria for STS
- Strong supervision
- Protection of investors

Securitization main regulatory updates

EU commission response to this COVID-19 pandemic leads to the amendments published on 24 July 2020 on:

Regulation (EU) 2017/2402 – The Securitization Regulation and Regulation 575/2013 (the “CRR”).

EU commission work has been based on the 2 following reports:

EBA Synthetic report on synthetic securitization

EBA opinion on the regulatory treatment of NPE Securitizations

Amendments on the (EU) 2017/2402

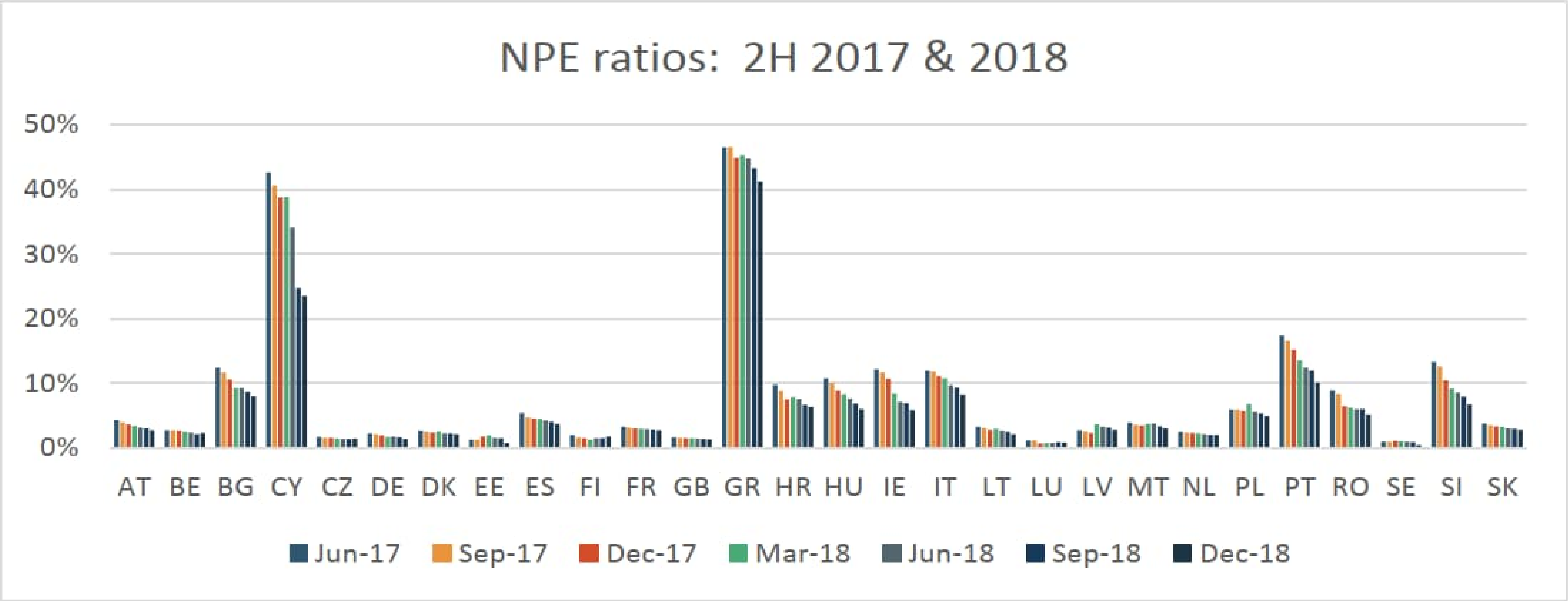
- The removal of some regulatory obstacles to the securitization of non-performing exposures (“NPEs”)
- Extension of the framework for simple, transparent and standardized (“STS”) securitizations to balance-sheet synthetic securitizations

Amendments on the Regulation 575/2013

- To extend the benefits of lower capital treatments to the senior tranche of balance-sheet synthetic securitizations that satisfy the STS framework
- To provide for specific capital treatment for positions in NPE securitizations

Securitization main regulatory updates

Ratios of NPE levels in Europe and pace of reduction of NPEs in Europe



Source: EBA

Securitization main regulatory updates

Main proposed amendments of the EU Regulation impacting the securitization market:

Non performing Exposures (NPE)

- "Non performing Exposures": Securitizations backed by a pool of exposures meeting art. 47(3) of the CRR conditions. The value of these NPE makes up at least 90% of the pool's value at origination (art. 2)
- Risk retention: At least 5% of the net value of the securitized exposures qualified as NPE as per art 47(3) of the Regulation 575/2013. Discounted value of the exposures transferred to SPV to consider as basis of calculation
- Possibility for the independent servicer to take on the risk retention slice because it has substantive interest in the workout of the assets and value recovery
- The credit granting criteria applied on performing exposures are not applicable to NPE at the time the originator purchased them from a 3rd party (art. 9 (1))
- A due diligence on the quality and performance of the NPE during onboarding remain possible in order to make a sensible, well-informed investment decision

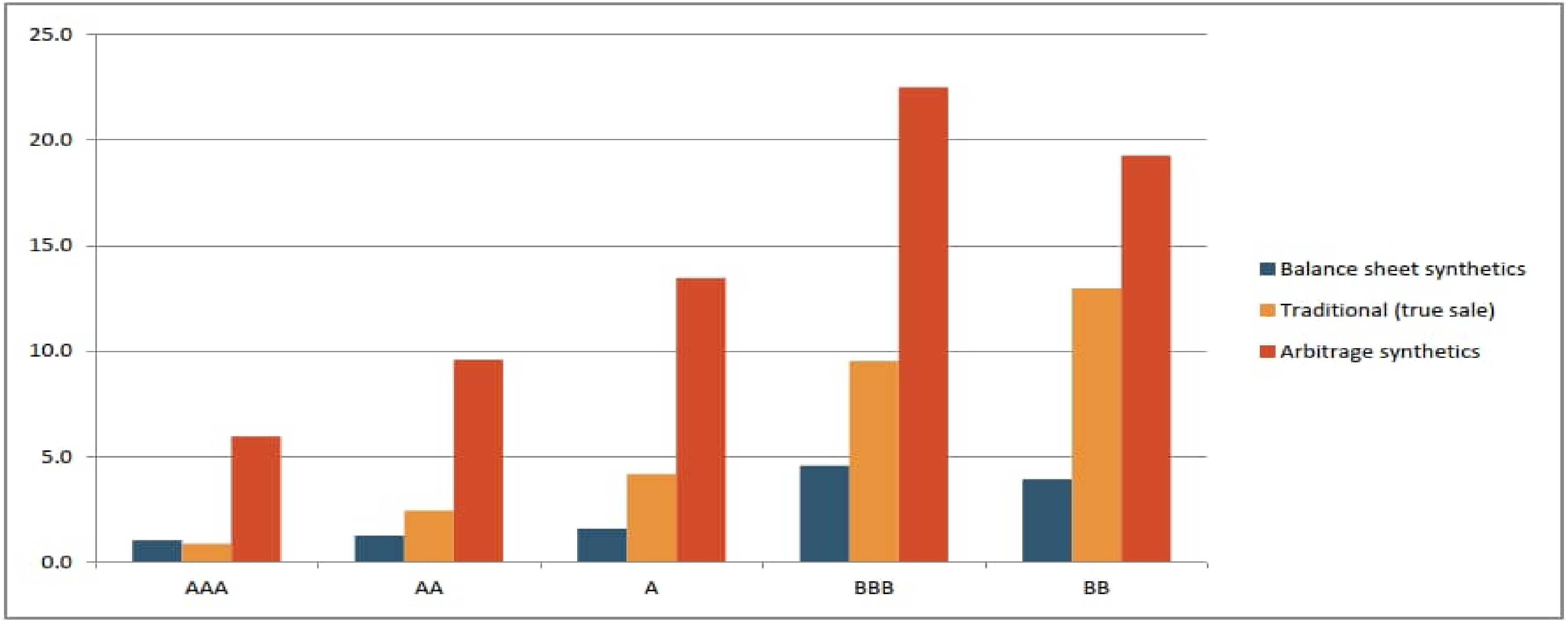
Treatment of the NPE securitizations in the CRR:

- Calibration of the Capital requirements calculation by considering the net value approach instead of NPEs nominal value to avoid disproportionate capital charges and higher funding and transaction costs
- Use of the Net value when determining losses allocation approach (attachment point and detachment point) when setting up capital requirements
- Caps for NPE securitizations using the full net basis approach i.e. the Exposure value and Expected losses should be net of NRPPD when calculating the Caps to better capture the characteristics of NPEs
- Ensure that the NFPPD is adequately sized to cover all underlying assets and to address the risk of incorrect valuation of the NPEs

Securitization main regulatory updates

Lifetime default rate comparison synthetic balance sheet versus true sale securitizations

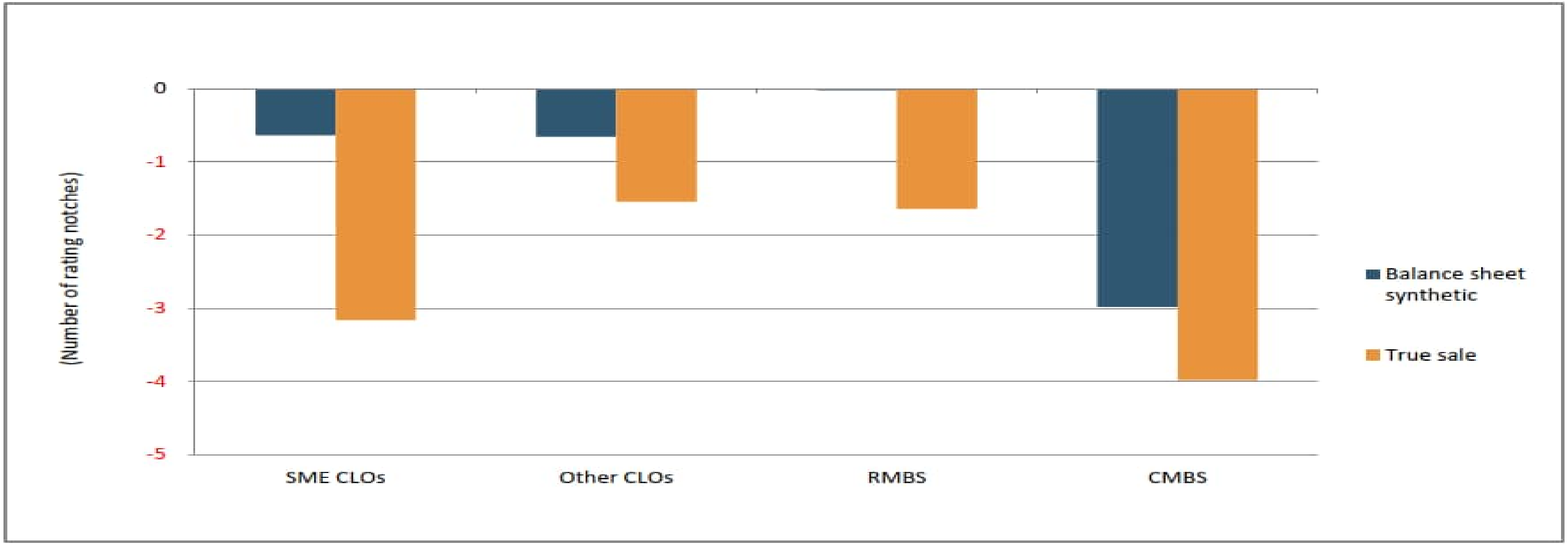
Figure 7: Lifetime default rate (%): balance sheet synthetic tranches, arbitrage synthetic tranches, traditional tranches, per rating grade (source: S&P, as of 2014 and the EBA calculations)



Securitization main regulatory updates

Average change in credit quality - Synthetic balance sheet versus true sale securitizations

Figure 8: Average change in credit quality (notches) synthetic securitisation vs. true-sale securitisation per asset class (Source: S&P as of 2014)



Securitization main regulatory updates

Main proposed amendments of the EU Regulation impacting the securitization market:

Synthetic securitizations

STS balance sheet synthetic securitizations:

- Synthetic securitizations on balance sheet should comply with STS criteria (art. 26b to 26 e)
- Transfer of credit risk should relate to exposures originated or purchased by EU regulated institutions within its core lending business activity and held on its balance sheet
- Credit risk should not be hedged more than once in addition to the protection already provided by the synthetic securitization
- Credit protection should only depend of the outstanding size and credit risk of the protected tranche
- Non-contingent premiums should not be allowed to avoid undermining the real risk transfer
- Up-front premium payments, rebate mechanism or overly complex premium should be prohibited
- Early termination of the credit protection by the originator is limited to well defined circumstances that could not be anticipated at inception (legislation or taxation events with negative impact on CR or economics)
- Use of short-term calls mechanisms with the aim of self-monitoring the level of own funds is prohibited
- Ensure full disclosure of the use of synthetic excess spread and the definition of strict criteria to guarantee an effective transfer of risk
- Only high quality credit protection arrangements should be eligible. For unfunded credit protection, eligible providers should have 0% RW. For funded credit protection, eligible collaterals should have 0% RW.
- Cash collateral should be held at 3rd party CI or on deposit with the protection buyer
- Reference obligations on which credit protection is purchased should be clearly identified at all times via a reference register and kept up to date
- Ensure a transparent and sound documented payment process for the determination of actual losses in the reference portfolio
- Nomination of a third-party verification agent to enhance legal certainty in the transaction for all parties involved and the occurrence of disputes and litigations in relation to loss allocation process

Securitization main regulatory updates

Main proposed amendments of the EU Regulation impacting the securitization market: (continued)

Extension of the STS framework to Balance-Sheet Synthetic Securitizations:

- Incentive for banks to use this type of assets and to improve their capital treatment with higher quality of STS securitization structure
- Release of additional capital to lend to enterprises and households
- Investors will benefit from more simplicity, standardization and transparency in their investments

Registration of SPV on certain jurisdictions (art. 4 and art. 44):

- 3rd country listed as a high-risk third country with strategic deficiencies in its regime on AML
- 3rd country listed in Annex I or II of the EU list of non-cooperative jurisdictions for tax purposes (art. 4)
- Rationale behind SPV jurisdiction choices will be reviewed by the ESA joint committee by 1 January 2021 (favorable tax or regulation regime?) – art. 44

Sustainability reporting and securitization framework:

- For residential loans, auto loans or leases, the publication of available information related to the environmental performance of the assets financed by such residential loans or auto loans or leases is currently required
- From 1 June 2021: Publication of principal adverse impacts on sustainability factors of the assets financed by the underlying exposures (art. 22. (4))
- From 1 November 2021: The EBA, in cooperation with ESMA and EIOPA to publish a report on developing a specific sustainable securitization framework for the purpose of integrating sustainability - related transparency requirements into the Securitization Regulation (art. 45a)

These standards are required to “mirror or draw upon the regulatory technical standards” drawn up for the Sustainability Financial Disclosure Regulation.

Securitization main regulatory updates

At Luxembourg Level

- 2004 Securitization Law:
  - Remains unchanged
  - Update still under review and discussion
- FAQ 2020-10 – Conseil de l'IRE du 17 Septembre 2020:
  - Guidelines on the nature of AML diligence to perform securitization vehicles.

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Market trends and insights

Presented by

Oliver Cloess

Associate Partner, Assurance, Banking and Capital Markets, Securitization & Structured Finance

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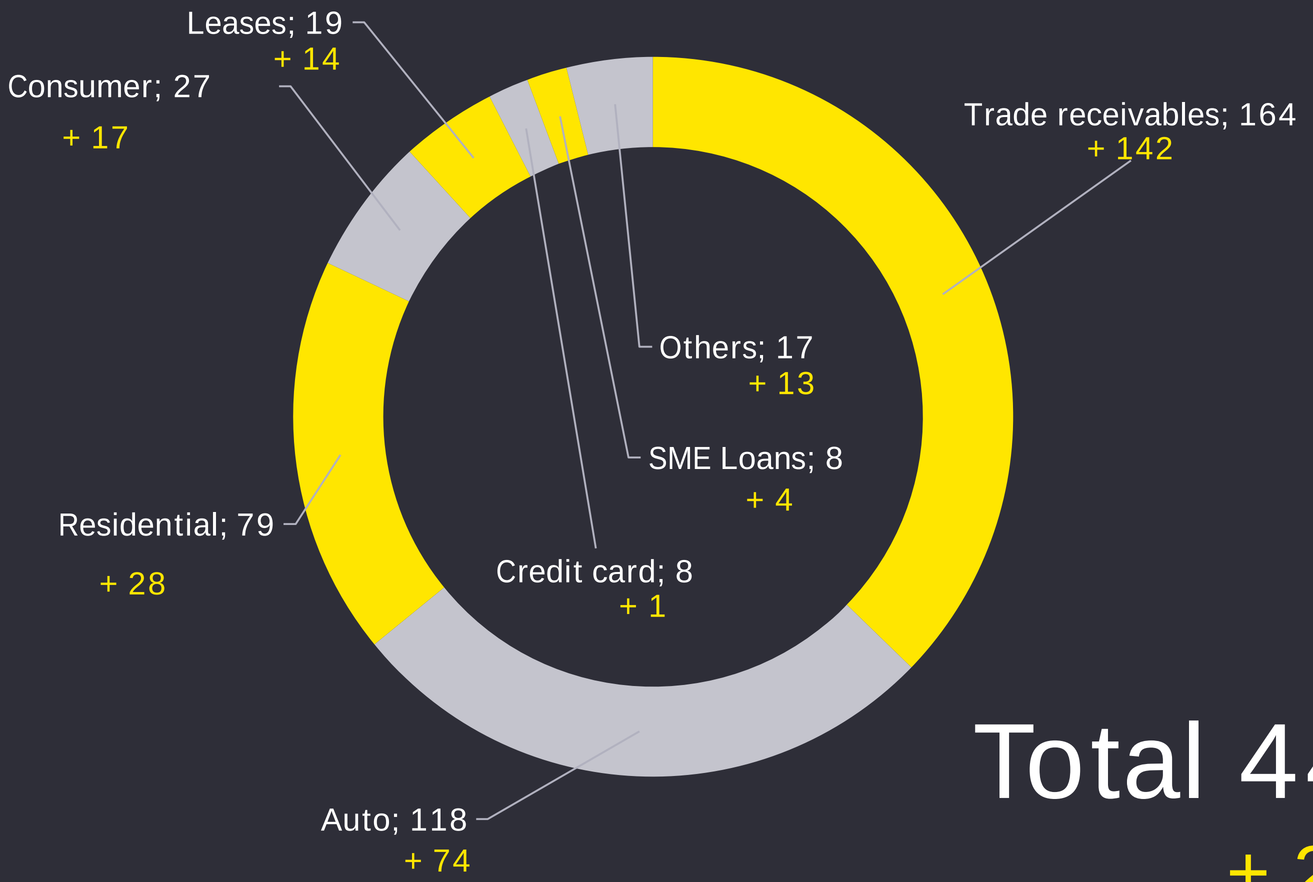
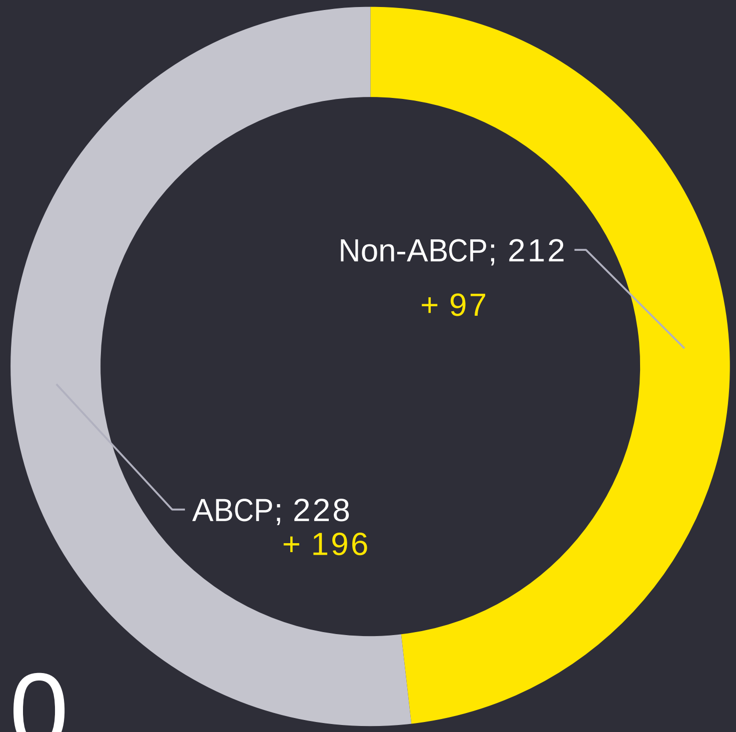
European Securitization Regulation – ESMA STS Notifications 2020 vs 2019

ASSET CLASSES



ABCP versus NON-ABCP

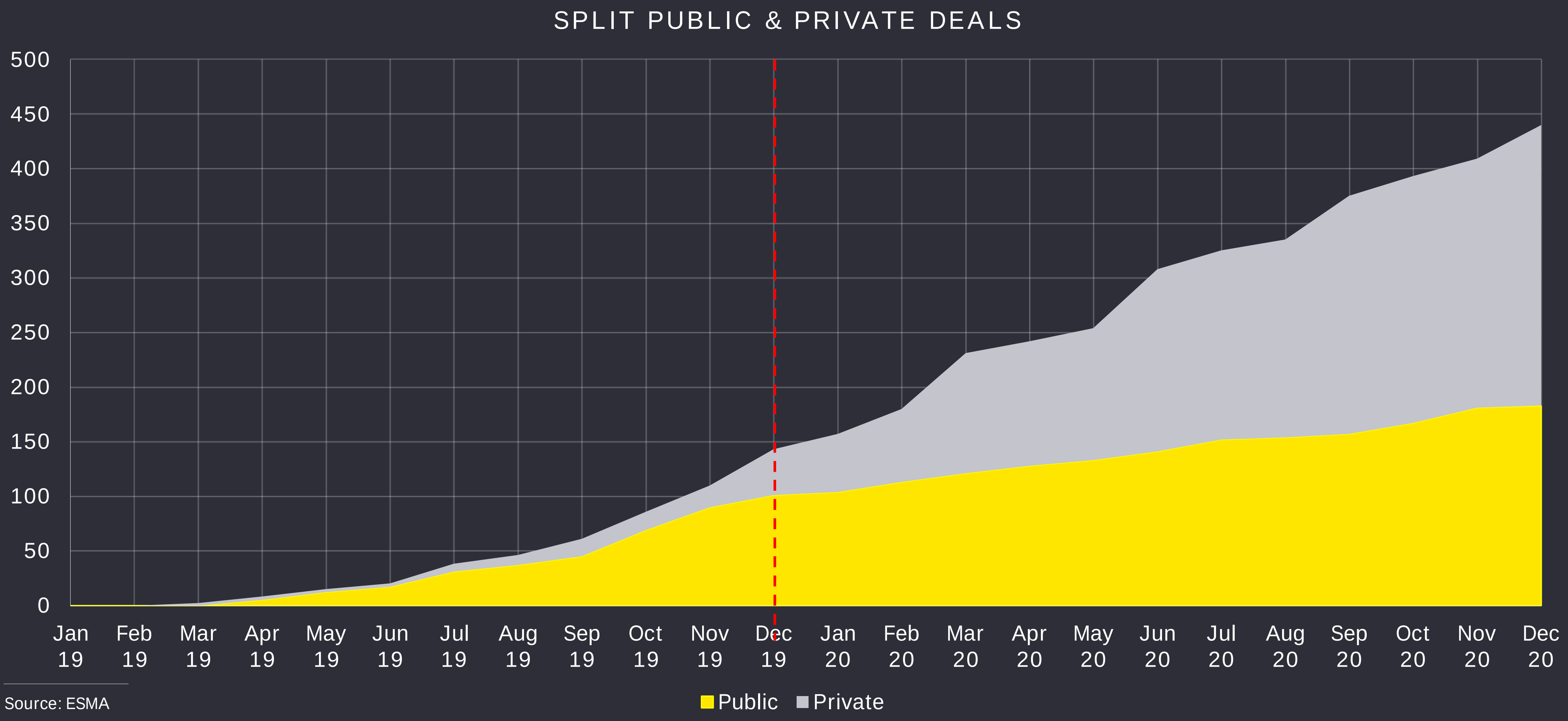


Total 440

+ 293

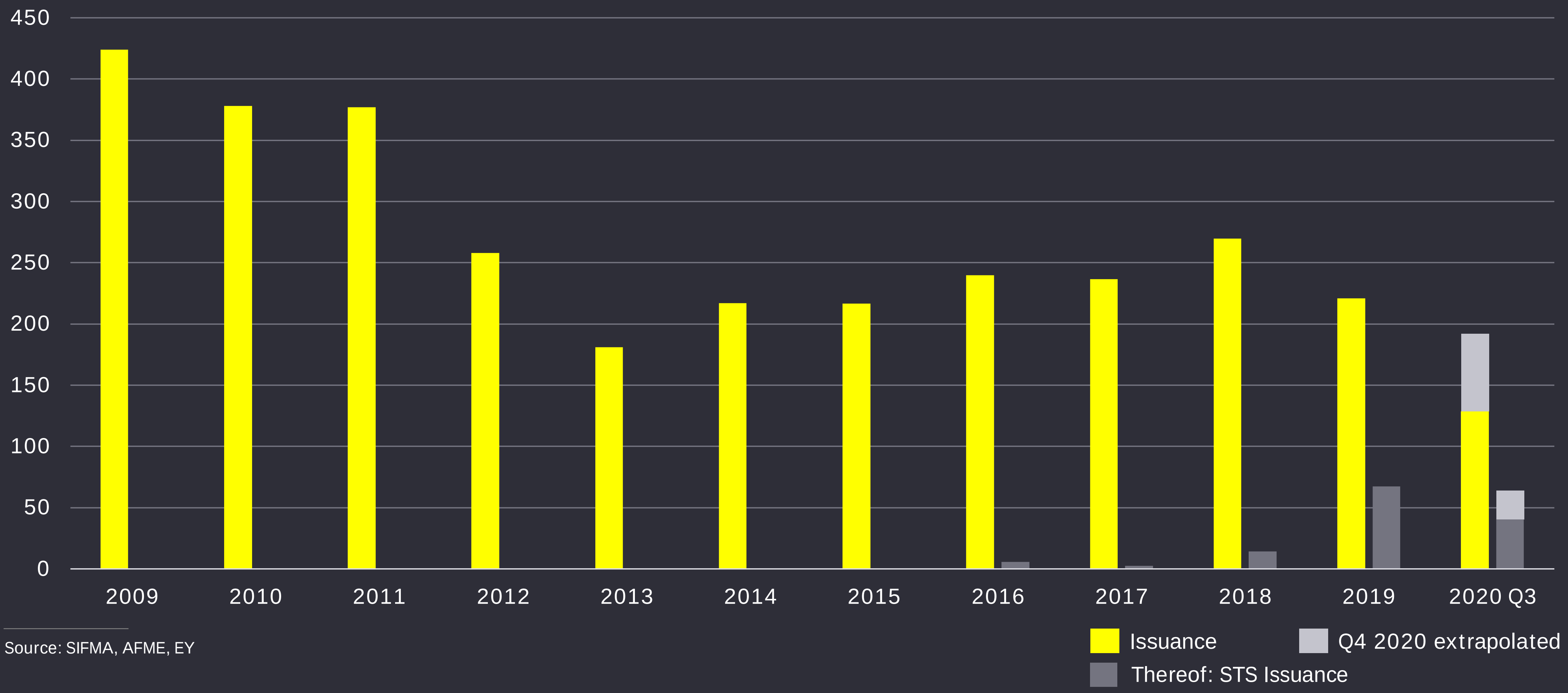
Source: ESMA

European Securitization Regulation – ESMA STS Notifications



Source: ESMA

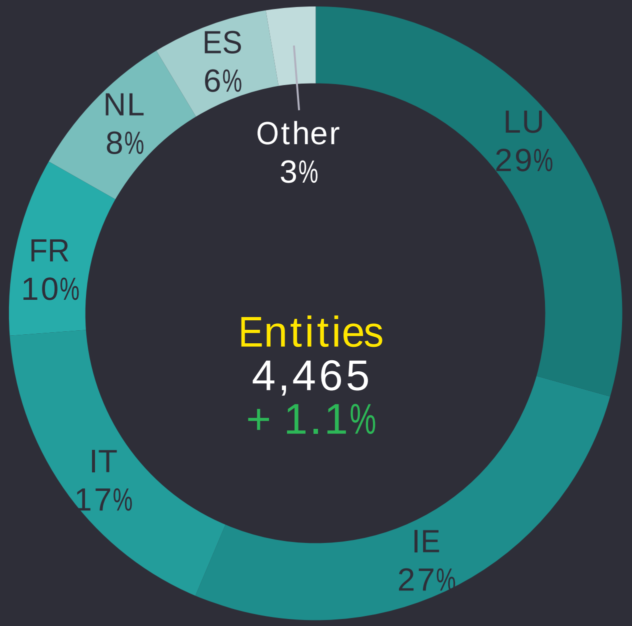
SIFMA / AFME - Historic European Issuance Volumes (EUR billion)

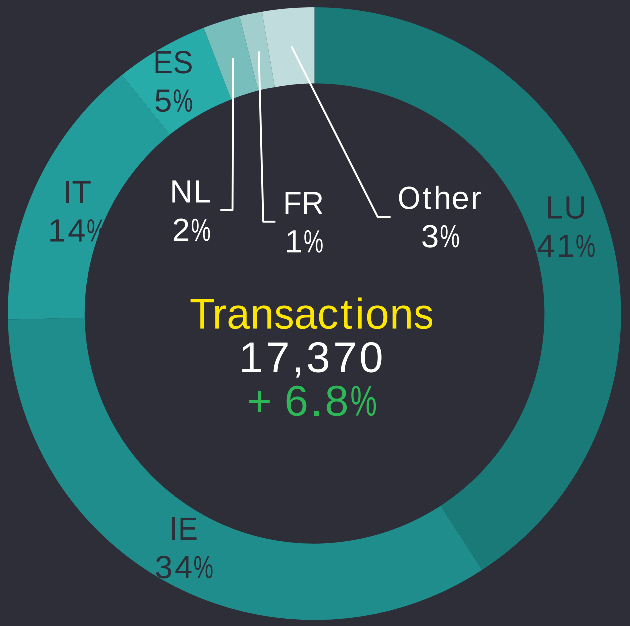


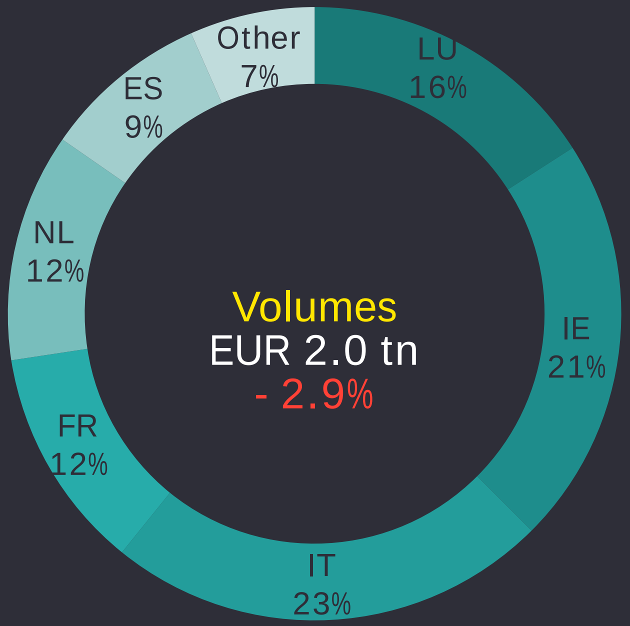
Source: SIFMA, AFME, EY

ECB FVC - Market overview – Euro Area

Market share Luxembourg Securitization within the Euro Area as at 30 September 2020





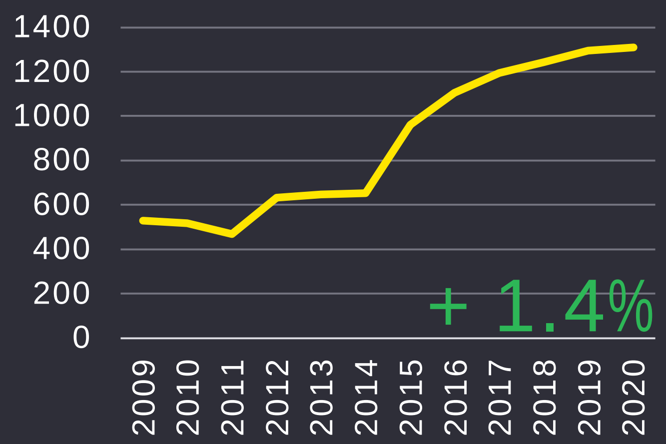


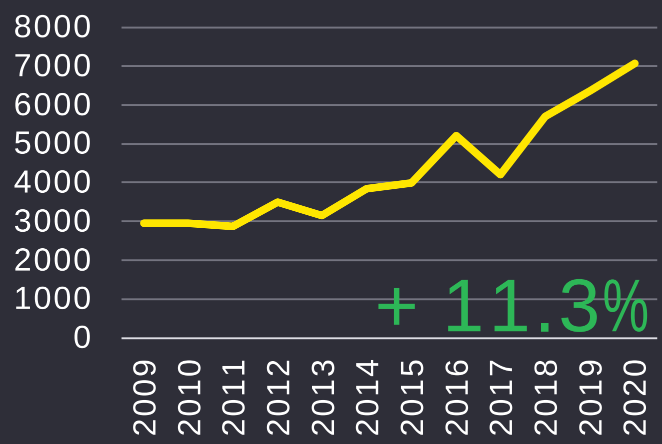
Source: ECB FVC statistics

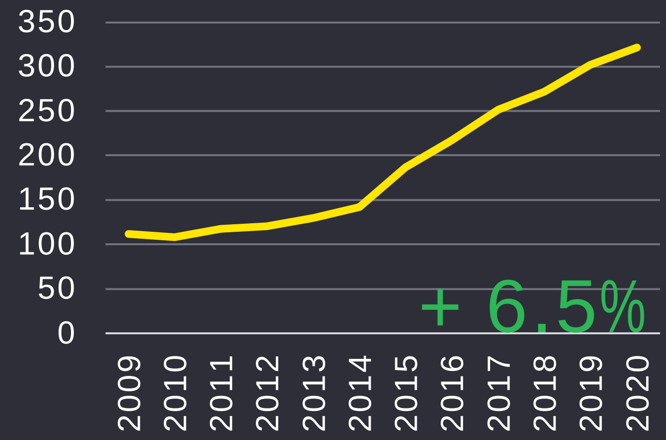
ECB FVC – Relative movements Luxembourg vs Ireland (Q3 20 vs Q4 19)

Entities (no.) | Transactions (no.) | Volumes (EUR billion stock)

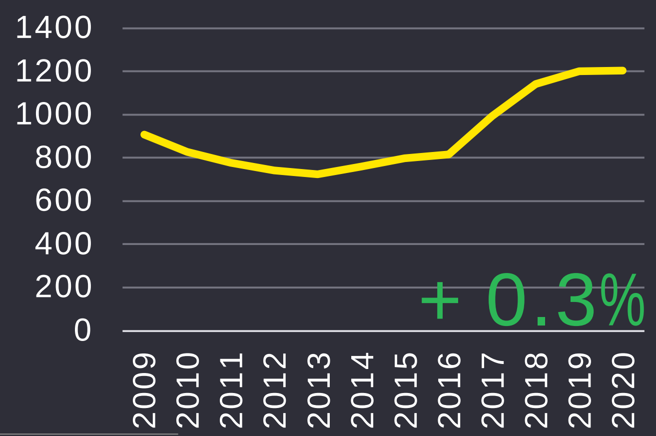
Luxembourg

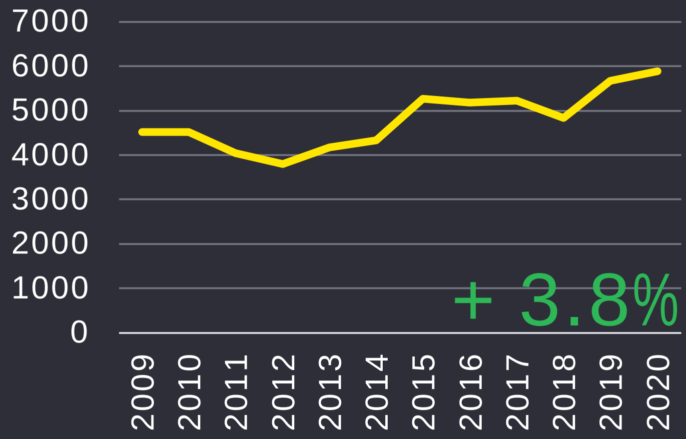


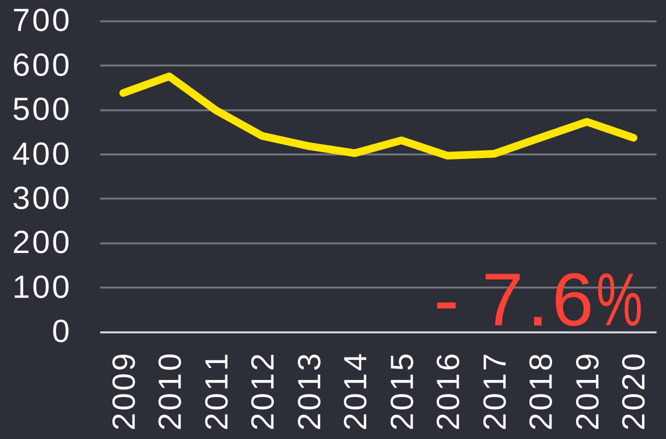




Ireland

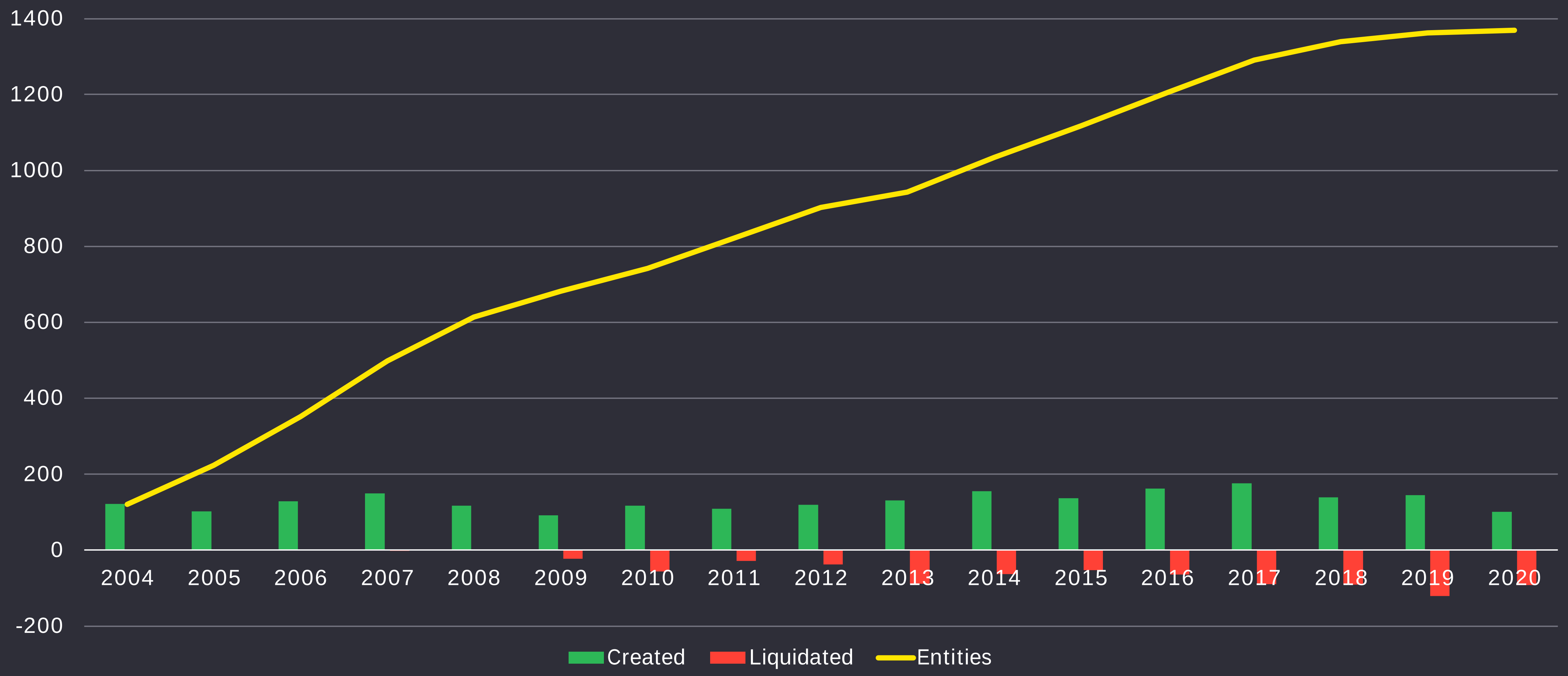






Source: ECB FVC statistics

EY research – Historic Movements in Securitization Entities

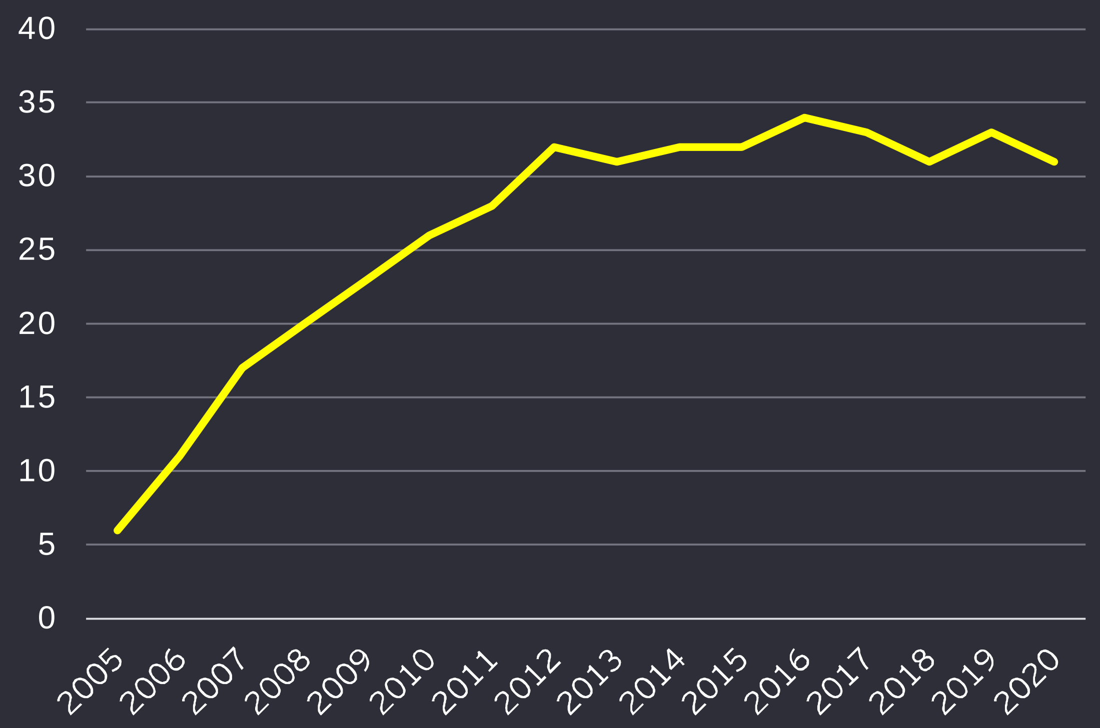


Source: ECB FVC statistics, EY, www.rbl.lu

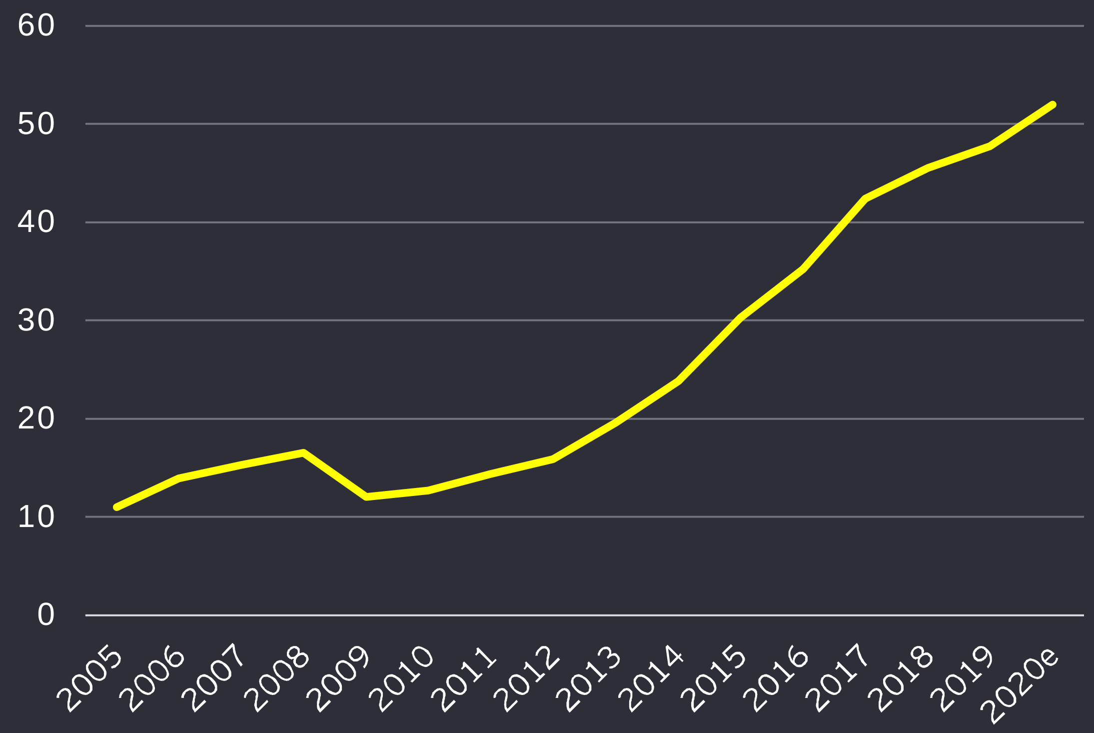
CSSF – Number and Issuance of Authorized Securitization undertakings

Historic number and issuance of regulated Luxembourg SV entities as at 31 December 2020

Historic number



Issuance in Euro billion



Source: CSSF

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Tax regulatory updates
ATAD 1, DAC 6, DAC 7

Presented by

Anja Taferner
Executive Director, Tax

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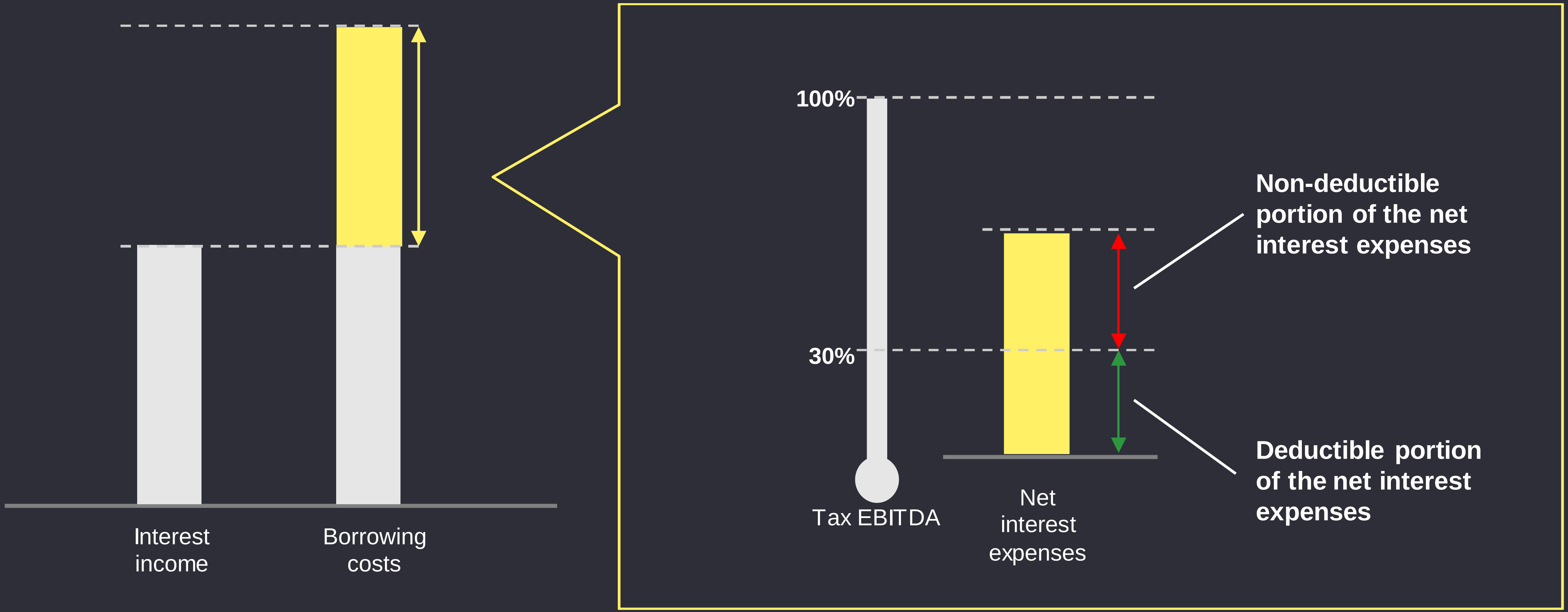
Interest limitation rules - mechanics



Luxembourg tax authorities circular on interest limitation rules

- Stand-alone entities definition clarified.
- Interest definition includes:
  - Profit participating interest on notes
  - Issue discounts
  - Reimbursement premiums
  - Expenses incurred in connection with the raising of finance
  - Interest calculated on the basis of a notional under derivatives (e.g., forwards, futures, swaps) or hedging agreements
- Does not include impairments.
- Symmetrical approach confirmed
  - Including for income earned in connection with raising of finance
- No statement regarding non-performing loans
- Only foreign exchange gains/losses on interest is covered, not on principal amounts
- Clarifications in relation to grandfathering clause

Tax considerations for securitization companies and service providers

- 2019 tax returns due by 31 March 2021:
  - Have you analyzed the impact of ATAD 1?
  - Have you decided what position to take in relation to equalization provisions?

- 2020 tax returns due by 31 December 2021:
  - Could there be hybrid mismatches that would result in expenses being denied (ATAD 2)?

- Do you have reporting obligations under the mandatory disclosure regime (DAC6)?
  - First reports were due 31 January 2021
  - Reports have to be filed within 30 days

What to expect in the field of direct tax?

- Clarifications of some open questions on interest limitation through private letter rulings.

- More administrative cooperation directives by EU:
  - Reporting obligations for digital online platforms, crypto-assets and e-money (DAC 7).

- Will SVs covered by EU Regulation 2017/2402 become subject to interest limitation rules?

4

Key valuations challenges in the current COVID-19 context

Presented by

Christophe Vandendorpe
Partner, Strategy and Transaction Leader

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Valuation of Assets

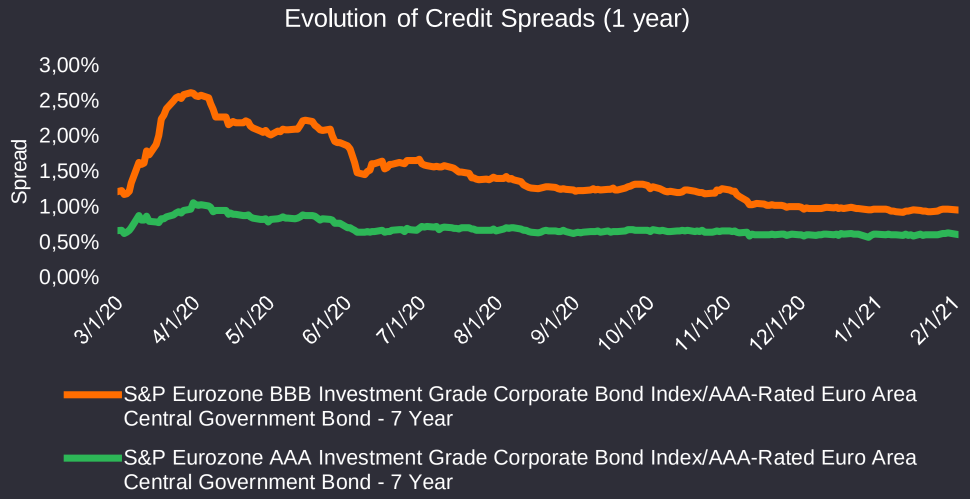
- May we hear from you?

  - Question: Please specify the portfolio valuation requirement of the securitization vehicles you are dealing with?

    - Valuation at lower of cost or market value (LCOM)
    - Valuation using an amortized cost approach
    - Valuation at fair value (FV)
    - Do not know or not in charge of valuation of securitization vehicles

Valuation of Assets

Valuation in the context of COVID-19



- As per S&P, we may expect the following in 2021:
  - More credit downgrades
  - Recouping COVID-19 costs may take time
  - Defaults will continue to rise

- What does that mean for (debt) securitization portfolios?
  - Review the credit quality of your debt portfolios with increased scrutiny:
    - Are your credit quality assessments regularly updated?
    - Do you perform your reviews based on recent financial information?
    - Is such information reliable and/or audited?
  - Assess whether the valuation parameters (e.g., spreads) need to be revised:
    - Re-calibrate your valuation models?
    - Need to more fundamentally adapt the valuation approach?

Valuation of Assets

Portfolio Valuation

- Usually guided by accounting framework
  - Valuation at lower of cost or market value (LCOM)
  - Valuation at fair value (FV)

- Stakeholders request for enhanced valuation transparency
  - Investors require FV for their own internal requirements
  - CSSF Q&A
  - Board of Directors managing own responsibilities (e.g., use of complex models)

Valuation of Assets

Portfolio Valuation (continued)

- Valuation standards and guidelines
  - Increasing sophistication and case specific
  - More scrutiny on valuations

- Market volatility and challenges

- An increasing number of our clients are enquiring
  - Independent portfolio valuations
  - Independent financial model reviews
  - Assistance with valuation oversight responsibilities, including adequate technical tools
  - Appropriate valuation policies

Valuation of Assets

Valuation oversight responsibilities for Board of Directors

- Increasingly time-consuming due to:
  - Growing portfolios
  - Deteriorating asset quality (e.g., COVID-19)
  - Increasing complexity of valuation standards
  - Complex financial models

- Need for experienced teams and technology
  - In-house vs outsourced solutions
  - Independent model reviews

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Wrap-up

Presented by

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Associate Partner, Assurance, Banking & Capital Markets, Securitization Leader

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