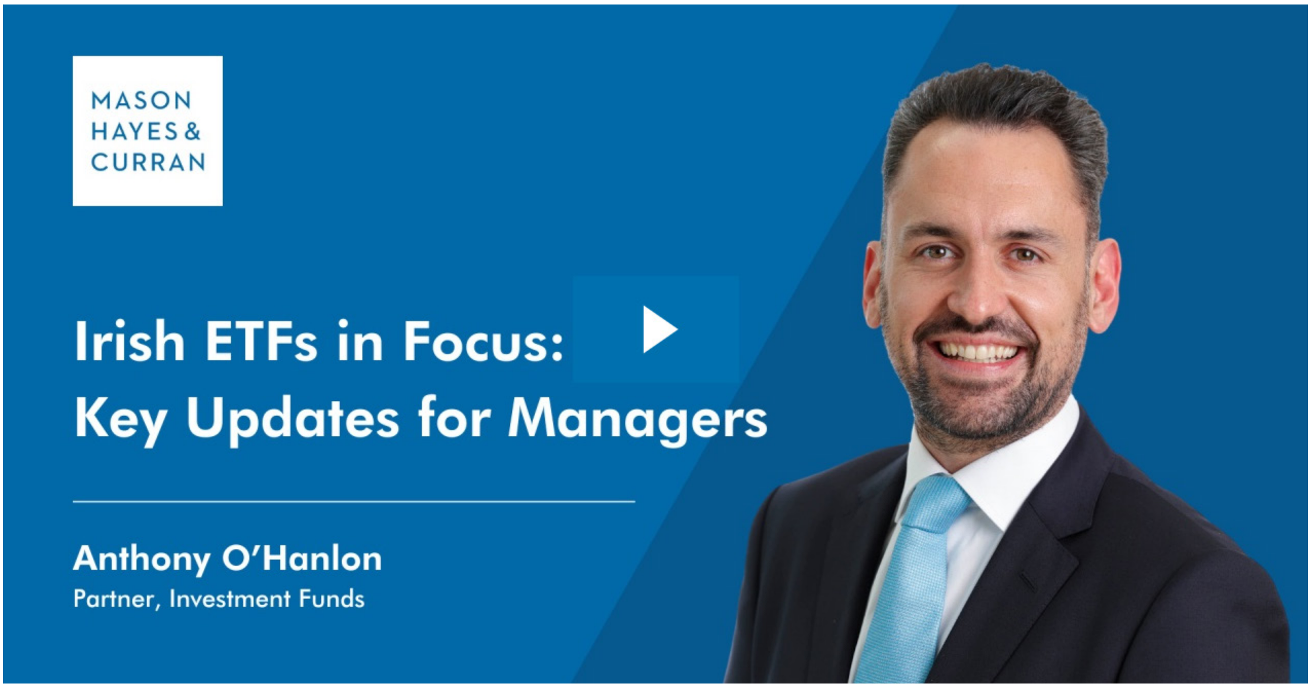
Financial Services Sector Update

In Brief

June 2024

Welcome



Welcome to the summer edition of our Financial Services Sector Update series. In this issue, we examine a selection of topics and trends impacting our clients.

First up, in the above video, new partner Anthony O'Hanlon considers the latest updates which are topical for Irish ETFs. Other popular insights featured in this edition include:

- How "Green" are Green Loans?
- Private Credit: The Risks and Rewards
- DORA – Where are the Legal Risks for You?
- Statutory Charges and Sales by Mortgagees
- The Adoption of the EU's Corporate Sustainability Due Diligence Directive

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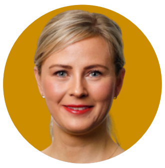

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How "Green" are Green Loans?

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The European Banking Authority (the EBA) published its report on green loans and mortgages (the Report) in December 2023. This was done in response to an earlier call for advice from the European Commission. We discuss the main themes of the Report and the EBA's proposals.

Green loans defined

According to the Report, credit institutions' green loans are on average accounting for 4.5% of their total loans. Lack of a common definition and rules on credit institutions' green lending are two of the main obstacles to the growth of green loan markets.

Although there is no widely used standard or label applying specifically to green loans, the EBA note the Loan Market Association's 'Green Loan Principles'. These principles have become a leading framework in green lending among credit institutions. There is also a plethora of legislation at EU level, most notably the EU Taxonomy. This provides "*a classification system for environmentally sustainable activities to ensure the environmental integrity and sufficient ambition to achieve the EU objectives*". However, the EBA stresses that the absence of a common EU definition of green loans poses a risk of mis-selling. The absence of such a definition means it is difficult for consumers to identify and compare different 'green loan' products. Introducing a common EU definition would ensure that consumers are aware of the variety of products available. It would also introduce standardised criteria to access the market, providing clarity and certainty to lenders.

Proposal for a common framework on green loans

The EBA explains that a green loan definition should not be based solely on the EU Taxonomy. The technical screening criteria of the EU Taxonomy are strict and exclude a large volume of activities contributing to the transition of the economy. Also, the framework does not capture the existing large volume of economic activities improving the existing conditions and supporting the transition but not aligned with all the relevant screening criteria. For this reason, a green loan definition based solely on the EU Taxonomy would exclude a large number of loans that credit institutions identify as green.

Therefore, the EBA recommends that the European Commission consider two options when introducing a definition for green loans:

1. A recommendation for credit institutions on the processes and criteria to define green loans based on the EU Taxonomy, or

2. A legislative proposal for credit institutions on the processes and criteria to define green loans based on the EU Taxonomy, mirroring the structure and features of the regulation on EU green bonds.

The second option is supported by the EBA. The Report explains how a green label based on the legislation could be structured, namely through a tiered approach:

- The first tier would categorise loans for which the proceeds are allocated to economic activities in line with the EU Taxonomy and its technical screening criteria, at the point of origination of these loans.
- The second tier would cover loans where the proceeds are not aligned with the technical screening criteria of the EU Taxonomy at the point of origination. Instead, they would be allocated to economic activities with a dedication transition purpose.

Green loan origination and monitoring process

To complement the EBA's existing *'Guidelines on loan origination & monitoring' (EBA/GL/2020/06)*, the final section of their Report provides policy suggestions to credit institutions. These suggestions focus on their green loan origination and monitoring processes.

The EBA advise that:

- The Mortgage Credit Directive integrate the concept of green mortgages. It should also incorporate the sustainability features of properties. For example, the Energy Performance Certificate (EPC) could be used to secure loans as part of their requirements.
- Pre-contractual information could include information on the EPC in addition to other relevant information about the property to secure the loan. The pre-contractual information would aid the consumer in understanding their obligations. This understanding is necessary in order to benefit from special conditions under the green mortgage such as discounted rates.

The EBA explains that the pre-contractual information would improve transparency. It would also provide an open dialogue between prospective borrowers and credit institutions. This dialogue would help determine whether further investment is required to increase the energy efficiency of the borrower's property.

Conclusion

The EBA's report highlights the need for increased regulation to provide clarity and consistency regarding green loans. This increased clarity and certainty would likely facilitate the further growth of the green loan market. While the Loan Market Association (LMA) has introduced draft provisions for documenting sustainability-linked loans, no provisions have been introduced for greens loans. This is despite green loans having a much more limited application. We would expect that the implementation of the EBA guidance on green loans would facilitate the LMA in introducing draft provisions for green loans also.

For more information contact a member of our Banking or ESG teams.

Private Credit: The Risks and Rewards

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Private credit has seen remarkable growth, with global assets skyrocketing from $310 billion in 2010 to $1.52 trillion in 2024. This sector's resilience and steady returns have attracted investors amid economic uncertainties. As private credit continues to expand, it brings new opportunities and challenges. This article delves into the IMF's concerns about this shift from traditional banking, the impact on ESG-driven building renovations, and the transition from private equity to private credit.

Regulation

The International Monetary Fund (IMF) has raised concerns about the shift from regulated banks to private credit markets. Private credit borrowers can be smaller companies, making them vulnerable to economic downturns and rising interest rates. The IMF's analysis shows that one-third of these borrowers now face interest costs exceeding their current earnings.

Unlike leveraged loans that trade in transparent markets, private credit loans see smaller valuation markdowns during stress, despite lower credit quality, due to the lighter regulatory regime in which they operate. Institutional investors' exposure to private credit is growing and therefore this interconnectedness with other financial sectors could pose future systemic risks. A severe downturn could erode credit quality, causing defaults and significant losses.

This could in turn impact public markets, forcing institutional investors such as insurance companies and pension funds to sell more liquid assets. These concerns have prompted calls for stricter regulatory oversight and supervision of the private credit market. Ensuring adequate monitoring and assessment of risks is crucial for maintaining financial stability.

Recent amendments to the alternative investment fund managers directive (AIFMD) have mitigated the potential risks of this growing space. The new rules seek to improve the liquidity management tools available to fund managers and provide an EU framework for loan-origination funds. Data sharing and cooperation between authorities are improved under the rules. These changes collectively address the need to alleviate risks posed by private credit to the financial system and introduce additional investor protection.

ESG

In a recent article, we discussed how the fast-approaching maturity wall for commercial real estate (CRE) loans coupled with the regulatory restraints placed on traditional lenders following the 2008 financial crisis have created a debt funding gap in the sector. This debt funding gap presents an opportunity for alternative lenders in the form of increased demand for private credit finance.

Through a combination of regulatory requirements and increased tenant and investor demand, the green transition to more energy-efficient buildings is well underway. Under the Energy Performance of Buildings Directive, Member States are required to renovate the 16% worst-performing buildings by 2030. By 2033, the 26% worst-performing buildings must meet certain energy performance standards.

According to Lisney, this will result in a quarter of commercial buildings in Ireland needing upgrades over the next ten years. Funding this green transition, whether through new developments or refurbishments, will be a huge challenge for the financial sector but also a great opportunity for private credit.

Private credit can take a forward-looking approach and invest in retrofitting and refurbishing older assets. Pillar banks are often prevented from doing this due to minimum loan to value (LTV) or capital adequacy requirements. This gives private credit an edge in supporting the green transition.

Shift from private equity to private credit

Private credit has delivered consistent and reliable returns to investors through the current interest rate cycle. This is in contrast to the volatility of the private equity market, which is highly reliant on the performance of portfolio companies. Private equity has long relied on low borrowing costs and consistent asset appreciation.

Uncertain global economic conditions have led investors to pivot towards private credit. This period of turbulence has forced private equity funds to keep their chips off the table, resulting in a record accumulation of dry powder in the sector. By December 2023, this dry powder totalled $2.5 trillion.

The post-financial crisis regulatory restraints introduced for traditional lenders have created a lending vacuum. Private credit has flourished in this environment, becoming the natural home for investor capital that previously would have gone to private equity.

Conclusion

Both opportunities and challenges have emerged as a result of the rapid growth of private credit. Regulatory scrutiny is essential to mitigate potential systemic risks. ESG initiatives offer a chance for private credit to support sustainable development. The shift from private equity to private credit reflects investors' search for stable returns in uncertain times. Ensuring economic stability amid the rise, and maturing, of private credit is crucial. Private credit's impact on the broader financial sector cannot be underestimated. It is a force that demands careful oversight and strategic management to ensure its continued success.

For more information and expert advice on matters related to private credit, contact a member of our Banking team.

DORA – Where are the Legal Risks for You?

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Regulated firms face an avalanche of change. All eyes were on the Central Bank's IAF/SEAR regime in 2023. Now, just as firms near the end of that implementation project, with most of the SEAR requirements becoming operational from July, attention is turning to the Digital Operational Resilience Act (DORA) with the implementation deadline of 17 January 2025 fast approaching.

In our experience, firms are only at the start of their implementation processes and legal stakeholders are only just beginning to become involved. Here are our five top tips to consider when launching an effective DORA implementation plan:

1. Define and identify your ICT risks

One of the best supports that Legal stakeholders can provide to a DORA implementation team is to ensure that from the outset the scope of the project is clearly defined. What third-party service provider arrangements are in-scope and which are out-of-scope? Where are the grey areas and what methodologies will your firm apply in these areas? To what extent can your firm leverage existing policies and procedures dealing with outsourcing to apply to DORA? What approach will your firm take to proportionality and how can this be best justified?

All of these questions require Legal stakeholder input. Your ICT and Compliance stakeholders can do a much better job of identifying your sources of ICT risk, information and ICT assets, roles and dependencies and interconnections with third-party providers as required by Article 8 of DORA when Legal has helped them to scope the exercise. Approaching this in a pragmatic way that reflects the scale and complexity of your business will make everyone's lives easier down the line.

2. Engage with ICT service suppliers

Start now! Contractual negotiations take time, in particular, if you need to negotiate with a third-country supplier who is not familiar with the scope of DORA. Don't assume that because you have completed a contractual uplift exercise for EBA/EIOPA/Central Bank outsourcing purposes, DORA uplift will be a small task. This entirely depends on your contract landscape and your scope determination.

3. Leverage existing frameworks

Don't create standalone policies and procedures specifically for DORA. It's always tempting to "tick-the-compliance-box" by having a document marked "policy" for every requirement but your stakeholders won't thank you for it later. Look at your existing ICT risk management framework and look to uplift it. And think of your internal governance processes and what will be needed to finalise policy revisions in time for January 2025.

4. Get Board buy-in

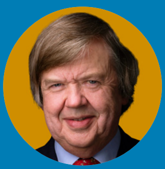
DORA requires full Board engagement for ICT risk management. Get your Board involved now, put DORA implementation plans on the Board and Risk Committee agendas and keep the Board regularly updated on developments. The Board will appreciate a briefing on the legal risks and requirements under DORA, so think about doing this or engaging consultants to do it.

5. Assemble your resources

We offer a range of cost-effective lawyer-led service offerings to provide your leadership team with comfort and assurance regarding your firm's DORA implementation. We are currently advising several regulated firms on their DORA implementation projects, so talk to us if your legal stakeholders need resources and support.

For more information and expert advice on making preparations for the implementation of DORA, contact a member of our Financial Regulation team.

Statutory Charges and Sales by Mortgagees



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Statutory charges can arise as a result of non-payment of certain taxes and payments due to public bodies including commercial rates, local property tax and derelict sites levies. Recently, some public bodies have robustly asserted that such charges take priority over prior mortgages or charges. This resulted in the loss of some sales by mortgagees and price reductions in others.

The issue regarding derelict sites levies has been clarified by a recent Supreme Court judgment.

Mortgages, charges and priority

The traditional position was that a sale by a mortgagee or charge holder left the purchaser with good title freed from all charges created or registered after the mortgage (commonly referred to as overreaching). Therefore, a purchaser did not need to be concerned about any subsequent charges.

Moreover, as regards registered land, the mirror principle applies. This means that a purchaser should be able to see from the register who owns the land. That said, there are some burdens specified in the Registration of Title Act 1964 as affecting land without registration, the most notable of which are rights of persons in actual occupation of the land.

The Supreme Court decision

The Supreme Court decided[1] that derelict sites levies, which had become a charge on land by virtue of section 24 of the Derelict Sites Act 1990, can be overreached by a mortgagee selling the land.

Separately, the Court concluded that a charge under the Derelict Sites Act is registrable. Accordingly, such a charge cannot affect a bona fide purchaser of registered land or obtain any priority until registered.

Other statutory charges

Some more recent statutes have provided for the creation of statutory charges, including:

- section 32 of the Local Government Reform Act 2014 – commercial rates;
- section 123 of the Finance (Local Property Tax) Act 2012; and
- section 47 of the Capital Acquisitions Tax Act 1976 – tax due on a gift or inheritance.

Some of these set out more clearly than the Derelict Sites Act how the charge can continue to bind the land. However, none of them expressly makes provision to disapply the power of overreaching by the mortgagee.

[1] *[2024] IESC14, separate judgments by Baker J. and Murray J.*

The Supreme Court explicitly stated that it would not express a conclusion as regards whether any of these statutory charges affect the power to overreach.

Pending further clarification by the courts, consideration should be given to whether or not it is possible to overreach such charges on a case-by-case basis.

The mortgagee in possession trap

Separately, Ms Justice Baker referred to a trap that a solicitor drafting a contract for sale can fall into. There is no need for a mortgagee to be a mortgagee in possession to overreach subsequent charges. However, if a mortgagee enters into possession, by virtue of being in possession, it may become liable to make certain payments that are payable by an 'occupier'. Accordingly, the safer approach is for the mortgagee to sell simply as mortgagee.

Is it possible to create statutory charges that affect mortgagees?

Interestingly, Mr Justice Murray, gave a strong signal that he would expect any future law seeking to reverse the Supreme Court decision should require the local authority to engage with secured creditors directly in relation to derelict sites levies.

Comment

This decision will be welcomed by secured lenders as it:

- affords absolute clarity as regards charges under the Derelict Sites Act 1990; and
- provides guidance to the approach the courts are likely to take regarding other statutory charges.

It is to be hoped that it will make negotiations with purchasers in mortgagee sales simpler and increase the prices obtainable.

The Adoption of the EU's Corporate Sustainability Due Diligence Directive

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We previously examined the status and scope of the draft Corporate Sustainability Due Diligence Directive (CSDDD or CS3D). In what was the final step in the EU legislative decision-making process, the Council of the EU officially adopted the CSDDD on Friday, 24 May 2024. The step marks a new age of corporate accountability for adverse environmental and human rights impacts within the EU.

We take a look at how the CSDDD will now be implemented and enforced across the EU.

Purpose

The CSDDD introduces obligations for many large companies to identify and address negative impacts on human rights and environmental protection in their own businesses and throughout their chains of activities. An in-scope company may be held liable for the damage caused by any failure to comply with its CSDDD obligations and may also be subject to significant financial penalties.

Timeline

Having now been adopted by both the European Parliament and the Council of the EU, the CSDDD will shortly be published in the Official Journal of the European Union. It will enter into force 20 days after its publication.

Member States will then be required to transpose the CSDDD into their national laws within two years. Within that timeframe, Member States must also establish a supervisory authority to ensure compliance with the CSDDD. Obligations will then begin to apply to in-scope companies one year later. However, the rules will apply on a phased basis as follows:

- Within 3 years of the CSDDD coming into force, expected to be from 2027:
  - EU companies with over 5,000 employees and a net worldwide turnover of more than €1,500 million, and
  - Non-EU companies with over €1,500 million net turnover generated in the EU in the year preceding their last financial year
- Within 4 years of the CSDDD coming into force, expected to be from 2028:
  - EU companies with over 3,000 employees and a net worldwide turnover of more than €900 million, and
  - Non-EU companies with over €900 million net turnover generated in the EU in the year preceding their last financial year
- Within 5 years of the CSDDD coming into force, expected to be from 2029:
  - EU companies with over 1,000 employees and a net worldwide turnover of more than €450 million, and
  - Non-EU companies with over €450 million net turnover generated in the EU in the year preceding their last financial year

Guidelines are expected to be issued by the Commission to help companies to conduct the due diligence required by the CSDDD.

Conclusion

The CSDDD obligations will only begin to apply from 2027 onwards. However, scoping, planning and implementing the necessary level of due diligence will be complex. Preparation in good time will be vital, even for companies with existing sustainability due diligence processes. Early review and updating of current policies and practices will assist companies in identifying gaps and the issues to be addressed to ensure alignment with the requirements of the CSDDD.

In addition, companies outside the scope of the CSDDD are likely to face increasing demand for sustainability information and actions to the extent that they are within the chain of activities of an in-scope company. Those requests will most likely relate to the identification, prevention, mitigation and remediation of adverse impacts associated with the company's operations. As a result, out of scope companies will not be immune from the impact of the CSDDD.

For more information and expert guidance on CSDDD or the Corporate Sustainability Reporting Directive generally and how your business may be affected, please contact a member of our Corporate Governance or ESG teams.

Financial Services Sector

The financial services sector has undergone unprecedented transformation from traditional banking to new developments like ESG and Fintech. Our lawyers are trusted advisors on the optimal adaptations and solutions for clients in responding to industry changes.

Now more than ever the financial services sector needs to respond and evolve. Our team is at the cutting-edge of these developments working in partnership with clients and drawing on our significant expertise in key areas such as insurance, financial regulation and data privacy.

Our objective is to help clients manage transitions and respond to the ever changing regulatory and political environment. We frequently operate at the intersection of law and technology finding the optimal balance between commercial and legal requirements. Our lawyers are renowned for their thorough and pragmatic approach supported by experienced project managers and bespoke systems to streamline the most complex mandates for clients.

Contact our Financial Services Sector team

About Us

We are a business law firm with 120 partners and offices in Dublin, London, New York and San Francisco.

Our legal services are grounded in deep expertise and informed by practical experience. We tailor our advice to our clients' business and strategic objectives, giving them clear recommendations. This allows clients to make good, informed decisions and to anticipate and successfully navigate even the most complex matters.

Our working style is versatile and collaborative, creating a shared perspective with clients so that legal solutions are developed together. Our service is award-winning and innovative. This approach is how we make a valuable and practical contribution to each client's objectives.

What Others Say

Our Financial Services Team

"Continuously demonstrate their capabilities and ability to deliver."

Legal 500

Our Financial Services Team

"The law firm has a superb team, easy to work with, supportive and fully understands the complexity of cases."

Chambers & Partners