

# How French covered bonds work

Christine Van Gallebaert of Gide Loyrette Nouel presents the main features of the legal framework which governs French covered bonds issuers

The concept of covered bonds in France covers two main types of covered bonds: (i) *obligations foncières* issued by specialised credit institutions called *sociétés de crédit foncier* (SCFs) and (ii) *obligations de financement de l'habitat* issued by specialised credit institutions called *sociétés de financement de l'habitat* (SFHs).

The SCF was created by Law 99-532 of June 25 1999 relating to savings and financial security, which implemented the new legal framework for covered bonds in France in lieu of the former regime initially defined by the Decree of February 28 1852.

## SCFs and SFHs are bankruptcy remote by law

The SFH was created by Law 2010-1249 of October 22 2010 and Decree 2011-205 of February 23 2011. It provided a legal regime for the French structured covered bond. These were bonds issued by special purpose credit institutions that, although not governed by any French covered bond legislation, were contractually structured so as to bear all the characteristics of covered bonds governed by the SCF legal framework. The French structured covered bonds issuers created from 2006 to 2008 were converted into SFHs in 2011.

### Segregation of the cover pool

Under the French covered bonds model, assets composing the cover pool for covered bonds are segregated in a dedicated entity, the SCF or SFH, which is also the issuer of the covered bonds.

SCFs and SFHs are created as a wholly owned affiliate of a bank, for the purpose of refinancing the banking group to which it belongs; they are also remote from the bankruptcy of its parent.

SCFs and SFHs have no employees or other resources, and are usually managed by their

parent. To that end, the SCF or SFH outsources services contracts. As a result, to protect the SCF or SFH against the bankruptcy of its parent (which acts as servicer) despite the provisions of the French bankruptcy law, such outsourcing services agreement may be immediately terminated upon the opening of bankruptcy proceedings against the servicer. Further, the servicer must identify the employees and other resources that are necessary for the recovery of the cover pool and describe in a preventive recovery plan submitted to the French banking supervision authority, the modalities of servicing transfer to a back-up servicer.

Despite any legal provisions to the contrary, and notably the provisions of the French bankruptcy law, the bankruptcy of a company holding shares of an SCF or

SFH cannot be extended to the SCF or SFH.

Further, certain hardening-period rules are not applicable to transactions made with the SCF or SFH.

The segregation of the cover pool within the SCF or SFH is achieved by the transfer of eligible assets to the SCF or SFH by the parent (or any other entity of its group). This is achieved through a true sale, by way of a transfer as security to a loan granted by the SCF or SFH to the originator or sponsor (for the SCF, such transfer is only available when the cover pool is composed of exposures to public entities), by subscription, under certain conditions, of asset backed securities issued by a securitisation vehicle whose assets are composed of eligible assets, or by subscription of mortgage promissory notes that are secured by a cover pool composed of eligible mortgage loans.

### Status of the issuer

SCFs and SFHs are French specialised credit institutions licensed by, and under the supervision of, the French banking supervision authority (the *Autorité de Contrôle Prudentiel et de Résolution* –

ACPR). They are credit institutions, but with a limited legal purpose as specified by their specific legal framework; they are a sub-category of credit institution in France.

SCFs and SFHs are subject to prior licensing by the ACPR and therefore they may not commence their activities before having obtained such banking licence.

In their capacity as specialised credit institutions, SCFs and SFHs are governed by different sets of rules:

- (i) the generic rules applicable to all types of French credit institutions set out under Articles 511-1 of the French Monetary and Financial Code;
- (ii) the provisions of the European Regulation (EU) 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (CRR) adopted on June 26 2013 and entered into force on January 1 2014; and
- (iii) the specific rules of the French legal framework for covered bonds set out in the French Monetary and Financial Code, Regulation 99-10 of July 9 1999 issued by the *Comité de la Réglementation Bancaire et Financière* (CRBF) and various instructions from the ACPR.

The French legal framework for covered bonds is designed to satisfy the requirements of Article 52(4) of Council Directive 2009/65/EC of July 13 2009 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities.

Covered bonds issued by SCFs and SFHs also comply with the provisions of Article 129 of the CRR and therefore qualify for the favourable prudential treatment it sets out.

### Exclusive legal purpose

The SCF and SFH legal purpose is limited to grant or purchase assets and hold securities and instruments that comply with certain legal eligibility criteria (see below).

To finance such activity, the SCF or SFH may issue *obligations foncières* or *obligations de financement de l'habitat* that benefit from a priority right of payment (called *privilège*), raise other forms of borrowings benefitting or not from the *privilège* and issue mortgage promissory notes.

The SCF or SFH may also enter into hedging agreements that benefit from the *privilège*, unless they were entered for the purpose of hedging liabilities that do not benefit from the *privilège*. Under the hedging agreement, the SCF or SFH does not post collateral and certain events of default are disappplied.

## About the author

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Christine Van Gallebaert specialises in securitisation transactions, covered bonds and more generally asset-backed financings over any type of financial assets, including public receivables arising from infrastructure projects, trade receivables, residential mortgage loans or commercial mortgage

loans (RMBS and CMBS), consumer loans, revolving credits and doubtful receivables.

She was involved in the establishment of several French covered bonds issuers (*Société de Crédit Foncier* and *Société de Financement de l'Habitat*) for French and foreign banking or corporate groups and on the securitisation of various financial assets. She has also regularly advised sponsors or banks in Public-Private-Partnership financings, most of which being refinanced through the issue of covered bonds. More recently, she was involved in the establishment of loans funds investing in SME financings.

Van Gallebaert has been a partner at Gide Loyrette Nouel Partner since January 2010. She joined the firm in 1999 and was admitted to the Paris Bar in January 1999. She gained a post-graduate degree (DEA) in private law from the university of Paris II (*Panthéon Assas*) in 1997, and a masters degree in private law from the university of Paris-II (*Panthéon Assas*) in 1996.

It may also, under certain conditions, carry out temporary transfers of securities, pledge a securities account and pledge or transfer all or part of its assets to raise temporary funding. Assets used for such transactions drop off from the cover pool.

**Eligible cover pool**

The main difference between SCFs and SFHs consists in the eligible assets composing the cover pool for the covered bonds they issue.

**Eligible core assets**

The eligible assets to an SCF may only be: (i) secured loans, which are secured by a first-ranking mortgage or guaranteed by a credit institution, a financing company or an insurance company (that does not belong to the same group as the relevant SCF and within the limit of 35%). The property must be located in France or in any other member state of the EU or EEA or in a state that qualifies for credit quality step one; (ii) exposures to public entities such as states, central banks, local authorities or state-owned entities located in a member state of the EU or within the EEA, in the US, Switzerland, Japan, Canada, Australia or New Zealand. If not located in those jurisdictions, such public entities must comply with specific limits and levels of credit assessment; (iii) senior units or senior notes issued by French *organismes de titrisation* or other similar foreign vehicles governed by the laws of a member state of the EU or EEA, the US, Switzerland, Japan, Canada, Australia or New Zealand. The assets of such should comprise at least 90% of eligible assets,

provided that the units or notes benefit from a credit quality step one assigned by an external rating agency and are only eligible within a limit of 10% of the nominal amount of the covered bonds and other liabilities benefitting from the *privilege*. Exceptions to this (until December 31 2017) are if: loans composing at least 90% of the assets of the vehicle were transferred by an entity belonging to the same group of affiliated group of the issuer; and the subordinated notes or subordinated units of the vehicle are kept by such an entity; and (vi) under certain limits, mortgage promissory notes secured by eligible mortgage or guaranteed loans.

The eligible assets to an SFH may only be: (i) loans granted to any credit institution and secured by the transfer, the assignment or the pledge of eligible home loan receivables (as defined below); (ii) units or notes issued by securitisation vehicles in the same limits and conditions as an SCF (see above); (iii) under certain conditions, mortgage promissory notes secured by eligible home loans; and, (iv) eligible home loans financing, in whole or in part, residential real property located in France or another EU or EEA member state or a state that qualifies for credit quality step one assigned by an external rating agency and that is secured by a first-ranking mortgage or a guarantee granted by a credit institution, a financing company or an

insurance company complying with certain legal requirements.

SCFs and SFHs must keep an up-to-date list of the loans they have granted or acquired containing information on the nature and the value of the guarantees.

**Eligible substitution assets**

Permitted investments are limited to securities, instruments or deposits which are sufficiently secure and liquid (ie, which are due or guaranteed by credit institutions or investment companies that qualify for the credit quality step one or credit quality step two if the maturity is less than 100 days).

While SCFs may hold exposures to public entities as core assets, SFHs may invest in debt securities issued or guaranteed by eligible public sector entities and deposits within the books of a central bank of an EU member state which complies with certain eligibility criteria, as substitution assets only.

The total amount of such substitution assets may not exceed 15% of the liabilities benefitting from the *privilege*, subject to some limited legal exemptions.

**Prohibition**

SCFs and SFHs are not allowed to hold equity participations or other forms of equity interest issued by other companies.

**Reinforced prudential obligations****General prudential rules**

Like all other credit institutions, the SCF or SFH must comply with the general prudential ratios such as the solvency ratio, the liquidity ratio, the large exposure limit, and the new

## SCFs and SFHs are French specialised credit institutions licensed by the French banking supervision authority

liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) created by CRR.

In addition, the SCF or SFH must comply with specific prudential rules provided in the French legal framework for covered bonds.

**Cover ratio**

The SCF or SFH must at all times maintain a minimum legal cover ratio between its assets and its liabilities benefitting from the *privilege*. This minimum cover ratio is at the time of writing at least 105%.

The ratio's denominator is comprised of the covered bonds, as well as any other resources benefitting from the *privilege*, ancillary costs, sums due to the servicer under the servicing contract set out in Article L 513-15 of the French Monetary and Financial Code and the sums due under the hedging agreements benefitting from the *privilege*.

The ratio's numerator is made up of the assets of the SCF or SFH for their applicable weighting percentage.

### Coverage of liquidity needs

The SCF or SFH must ensure, at all times, the coverage of its liquidity needs for the next 180 days, taking into account expected inflows under their assets and net flows under hedging agreements. The liquidity needs must be covered by eligible substitution assets or by assets that are eligible as collateral to credit transactions with the *Banque de France* in accordance with the monetary policy and intra-day credit operations rules of the Eurosystem.

To mitigate liquidity risk between its assets and its liabilities, the SCF or SFH must ensure that the average life of its cover pool, up to the minimum amount required to comply with the cover ratio, does not exceed the average life of its liabilities benefitting from the *privilege* by more than 18 months.

If the SCF or SFH is not able to cover its cash needs with other means available to it, it may also subscribe for its own covered bonds. This must be for the sole purpose of granting them as collateral security to credit transactions with the *Banque de France* in accordance with its monetary and intraday credit policy.

For the calculation of the cover ratio and liquidity needs, when the assets of the SCF or SFH comprise loans secured by eligible assets, the SCF or SFH must take into account the assets received as collateral rather than the secured receivables (look-through).

### Special public supervision Supervision by the French banking authority

The ACPR is in charge of the licensing and oversight of SCFs and SFHs. It monitors the compliance by SCFs and SFHs of their prudential and reporting obligations. It exercises administrative police authority, disciplinary authority and has broad powers regarding resolution measures.

SCFs and SFHs must submit to the ACPR various reports (annually and quarterly) on the quality of its assets. They must also provide a statement (to be sent on March 31, June 30, September 30 and December 31 of each year on their cover ratio) showing their liquidity needs, spread between the average life of its assets and liabilities and other elements relating

to the assets and liabilities in accordance with Regulation 99-10 of the CRBF.

Certain reports are publicly available in the *Bulletin des annonces légales obligatoires*, or are published elsewhere (websites for instance).

### Special supervision by a specific controller

The SCF or SFH must appoint a specific controller from the list of registered auditors, with prior approval of the ACPR for a four-year period.

The controller must be independent: it cannot be the auditor of the SCF or SFH, of any company controlling the SCF or SFH, or of a company controlled directly or indirectly by another company controlling the SCF or SFH.

The tasks of the controller mainly consist in ensuring that the SCF or SFH conducts its activities in accordance with the French legal framework for covered bonds. In particular, it must verify the eligibility of the assets composing the cover pool, compliance with the cover ratio and adequacy of rate and maturity matching level between the assets and the liabilities.

The controller certifies, on a quarterly basis, compliance with the cover ratio in connection with the issuance programme and for any issue of covered bonds (or other funding which benefits from the *privilege*) for more than €500 million (\$685 million).

The controller reports annually to the directors and board of directors of the SCF or SFH, a copy of which must be provided to the ACPR and informs the ACPR of any facts or decisions which could threaten the conditions or continuity of the SCF or SFH's business.

In case of bankruptcy of the SCF or SFH, the controller will be responsible for filing claims on behalf of the holders of the covered bonds, and other creditors benefitting from the *privilege*.

The controller attends all shareholder meetings and, on his request, may be heard by the board of directors of the SCF or SFH. It is liable for any error or negligence committed in the exercise of its functions.

For the performance of its duties, the controller has access to all information from management, internal control data, and internal audit data. The specific controller is entitled to undertake, at any time, any necessary control that it deems appropriate and to review the SCF or SFH's books and records.

### Privilege

Under the French legal framework for covered bonds, any sums due under the covered bonds benefit from a *privilege*.

Such *privilege* consists in the following rules, despite any legal provisions to the contrary (including French Bankruptcy law):

- (i) all amounts payable to the SCF or SFH for the cover pool and the replacement assets and forward financial instruments entered into by the SCF or SFH, after any applicable set-off and available cash are allocated with priority to the payment of any sums due in respect of the covered bonds and other resources benefitting from the *privilege*; and
- (ii) in the event of conciliation (*conciliation*), safeguard (*sauvegarde*), judicial reorganisation (*redressement judiciaire*) or judicial liquidation (*liquidation judiciaire*) of the SCF or SFH, all amounts due regularly under the covered bonds and other resources benefitting from the *privilege*, will continue to be paid on their contractual due date, and with priority over all other debts, whether or not preferred, including interest resulting from agreements whatever their duration. Accordingly, as long as the creditors (including the covered bonds holders) benefitting from the *privilege* have not been fully paid, no other creditor of the SCF or SFH may exercise any right over their assets and rights; and
- (iii) the judicial liquidation of the SCF or SFH does not trigger the acceleration of payment of the covered bonds and other resources benefitting from the *privilege*.

The aim of the French legislator was to ensure continuity of payment to covered bonds despite the bankruptcy of the SCF or SFH.

It should be noted that such *privilege* also benefits *pari passu* with covered bonds to claims over the SCF or SFH: (i) under any other resources raised, the issuance or subscription agreement of which mentions the benefit of the *privilege*; (ii) under forward financial instruments entered into by the SCF or SFH to hedge its interest rate and currency risks on its assets or liabilities (other than liabilities under any resources that do not benefit from the *privilege*), after the set-off as applicable; (iii) under any sums due under the servicing and recovery contract provided for in Article L 513-15 of the French Monetary and Financial Code; and (iv) under any ancillary costs defined in Article R 515-9 of the French Monetary and Financial Code.

### Designed to protect investors

The French legal framework for covered bonds is designed to protect investors. Since covered bonds are usually rated, SCFs and SFHs also comply with the rating agencies' requirements for counterparty risks, which lead the SCFs and SFHs to put in place contractual arrangements and undertakings to procure additional credit enhancement for investors.

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