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Covered bonds technology: an alternative to existing financing and refinancing techniques

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In the current financial market turmoil, covered bonds appear to be one of the few remaining safe harbours as they continue to appeal to investors and thus offer a source of financing to financial institutions at reasonable cost.

Covered bonds in the broadest sense can be of two types: regulatory covered bonds, issued pursuant to and governed by specific legal mechanisms, and contractual (or structured) covered bonds, which rely on standard bonds and security arrangements.

In France, regulatory covered bonds (*obligations foncières*) were created in 1999 by a law now codified in Articles L515-13 to L515-33 of the Monetary and Financial Code. Contractual covered bonds have been developed more recently in France, due to the implementation of the EU Financial Collateral Arrangements Directive (2002/47/EC), which was transposed in Articles L431-7 and following of the code.

Over the past few months, and despite market difficulties, the main issuers of French regulatory covered bonds launched several issues at a remarkably low cost. In addition, several French banking groups managed to launch contractual covered bonds programmes (eg, the Banques Populaires €25 billion covered bonds programme was launched in January 2008, with a first issue of €1 billion) or tap issues under existing programmes (BNP Paribas Covered Bonds, the contractual covered bonds programme set up by BNP Paribas, issued a tranche of €2 billion in January 2008), while issues of residential mortgage-backed securities (RMBS) through classic securitisation

vehicles have dramatically decreased (it is thought that RMBS issues in Europe have slumped by 80 per cent during the first quarter of 2008).

The discrepancy between two products which are ultimately backed by the same type of asset (ie, residential mortgages) is, at first glance, intriguing, but a review of the covered bonds techniques and their specificities helps to elucidate this trend. It also leads to the more forward-looking question of whether covered bonds technologies may be used over a wider range of assets than they are at present, as an alternative to loan origination and securitisation.

Regulatory covered bonds

Typical structure

French regulatory covered bonds can be issued only by a *société de crédit foncier* (SCF), which is a credit institution licensed for that purpose. The SCF can:

- grant or acquire secured loans;
- acquire risk exposures on certain public entities; or
- acquire transferable securities issued by certain types of vehicle.

Any other objects are prohibited by law.

SCFs are the French equivalent of the German *Pfandbrief*, the Spanish *cédulas* and the Italian *obbligazioni bancarie garantie*.

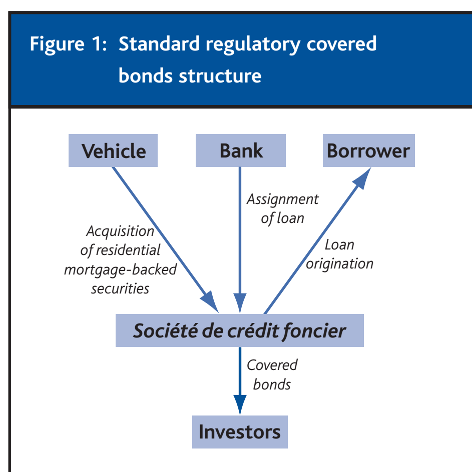


Figure 1: Standard regulatory covered bonds structure

Although the law is not recent, for historical reasons the number of players remains limited (Compagnie de Financement Foncier, Dexia Municipal Agency, CIF Euromortgage and, more recently, Véolia PPP Finance and Société Générale SCF). Over the years, regulatory covered bonds have become one of the highest-quality standards among asset-backed securities, with outstanding historical data and credit quality and high resilience to liquidity and spread crisis. This success is due to the fact that regulatory covered bonds are particularly safe from an investor's point of view as they benefit, directly or indirectly, from a number of advantages provided by law and not available to other issuers.

Reasons for success

Safety of legal framework, even in the event of bankruptcy of the issuer

Legal privileges: The *obligations foncières* issued by SCFs rank ahead of all other creditors, including French treasury and bankruptcy administrators, in the event of bankruptcy of the SCF. In addition, these bonds are not accelerated should such an event occur. Thus, investors benefit from their super privilege until full repayment.

Replacement of the servicer: The SCF is required to enter into a servicing agreement with a credit institution. This is a legal requirement to ensure that the SCF has no employees and is deemed to be bankruptcy remote. In the event of bankruptcy of the servicer, the SCF law provides that, notwithstanding the general principle of bankruptcy law, such agreement may be immediately terminated by the SCF. This enables the SCF to appoint a new servicer and avoid the risks of maintaining a contractual relationship with a service provider subject to bankruptcy proceedings.

Absence of consolidation risks: In the event of bankruptcy of the parent company of an SCF, the law clearly states that this situation does not trigger the

bankruptcy of the SCF. Furthermore, as SCFs are not permitted to have subsidiaries, the risk of bankruptcy consolidation of the issuer in the event of bankruptcy of either the parent or the subsidiary is non-existent.

Protection of future flows: The SCF law provides for a specific assignment mechanism pursuant to which:

- future flows can validly be assigned to the SCF;
- true sale survives the bankruptcy of the assignor; and
- in the event of receivables arising from financial lessees, the underlying contracts cannot be terminated.

It also excludes claw-back risks. As a result, a SCF willing to acquire or finance future flows is protected to the fullest possible extent against the risk of bankruptcy of the originator of such flows.

Friendly regulatory treatment for investors

Capital adequacy treatment: For capital adequacy purposes, covered bonds issued by an SCF are weighted 10 per cent. Similar bonds, linked to the same underlying assets (ie, RMBS), are normally weighted 20 per cent or more. This specific treatment gives a clear advantage to the SCF when compared to standard securitisation products and contractual covered bonds (see Article 4.2.1*bis* of Regulation 91-05 of February 15 1991 of the *Comité de Règlementation Bancaire* relating to the capital adequacy ratio).

UCITS eligibility: Undertakings for collective investment in transferable securities (UCITS) can invest up to 25 per cent (instead of a maximum of 5 per cent for contractual covered bonds) of their assets in a single SCF, since SCFs meet the regulatory covered bonds criteria set by the EU UCITS Directive (85/611/EC).

Protection of contractual third parties

Swap counterparties hedging the *obligations foncières* or the corresponding assets, together with the entity in charge of servicing the assets of the SCF, also benefit from the super privilege granted by law to the covered bonds holders. Therefore, SCFs are attractive not only to investors, but also to contractual third parties.

Highest quality of assets

The SCF can acquire or finance only secured loans which conform to strict eligibility criteria to ensure that their assets are of the highest quality.

Secured loans: In particular, eligible secured loans must be secured by:

- a first-ranking mortgage;
- a real estate security granting to the creditor, in all circumstances, the right to force the disposal of the secured assets and be reimbursed out of the sale price of the assets without having to compete with any other creditors; or
- subject to certain conditions and limitations, loans secured by a guarantee granted by certain third-party credit institutions or insurance companies, provided that this loan is used to finance a real estate asset.

In addition, the real estate assets must be located in the European Union, the European Economic Area or any other country rated at least AA- or Aa3 by Fitch, Standard & Poor's or Moody's, as appropriate.

Transferable securities: SCFs are entitled to acquire or subscribe transferable securities issued by vehicles which hold secured loans, provided that:

- the transferable securities are debt securities issued by French *fonds communs de créances* (FCCs) or similar special purpose vehicles (SPVs) located in the European Union or the European Economic Area;
- at least 90 per cent of the core assets of such FCCs or SPVs are eligible secured loans;
- the transferable securities are not subordinated securities; and

- they are rated at least AA- or Aa3 by Fitch, Standard & Poor's or Moody's, as appropriate.

Public entities: With regard to risk exposure of public entities, the relevant public entities must fall within a list set out in Article L515-15 of the Monetary and Financial Code, which is relatively long but requires quality tests based on the type of entities concerned, their location and, where appropriate, the rating of their home state.

Available cash: Similarly, the law limits the eligible investments in which the SCFs can invest their available cash to low-risk and liquid assets.

Minimum loan to value, overcollateralisation test and other financial safeguards

In addition to the legal requirements applicable to SCFs referred to above, the law provides for a number of financial tools to ensure that SCFs are at all times able to face their financial commitments towards the holders of *obligations foncières*.

Minimum loan to value: When they acquire or finance real estate loans, not only must those loans meet the eligibility criteria referred to above, but SCFs can only finance a portion thereof through the issuance of *obligations foncières* benefiting from the super privilege. In substance, this portion is equal to:

- 100 per cent in the case of social housing loans granted to individuals;
- 80 per cent in the case of residential loans; and
- 60 per cent in the case of other loans.

The portion of the loans exceeding the relevant loan-to-value tests can be purchased (or granted) by an SCF, but cannot be financed by the *obligations foncières*, but only by other types of bond or borrowing which do not benefit from the super privilege.

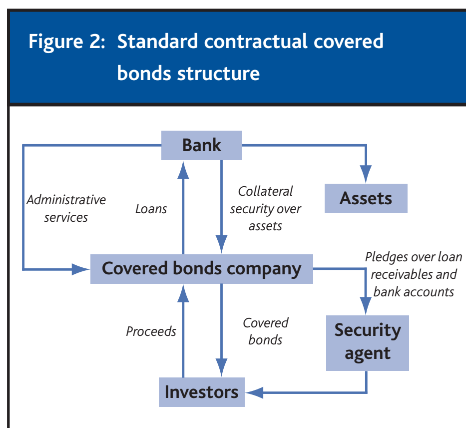
When the SCF acquires or subscribes debt securities issued by an FCC or SPV, similar principles apply in substance to secured loans held by that FCC or SPV, as well as additional non-concentration ratios limiting the percentage of *obligations foncières* that can be issued for the purpose of refinancing such debt securities.

Overcollateralisation test: The SCF law provides for a specific financial test which is to be performed from time to time over all assets and liabilities of SCFs. The test requires that the assets of an SCF be equal to or higher than the *obligations foncières* and the other liabilities benefiting from the super privilege (ie, certain swap counterparties and the servicer), thus creating a statutory over-collateralisation enabling the SCF to fulfil its payment obligations toward the holders of *obligations foncières*.

Asset valuation: In order for the loan-to-value and overcollateralisation tests to be relevant, the SCF law also provides specific rules for valuing the eligible loans, the underlying real estate assets and the SCF's liabilities. The aim of these rules is to ensure prudent valuations and regular updates depending on the value of the loans and/or underlying properties.

Specific external auditor: Finally, SCFs must appoint an independent specific auditor in charge of certifying compliance with the assets' eligibility criteria and the over-collateralisation test.

Figure 2: Standard contractual covered bonds structure



Contractual covered bonds

Structure

A typical French covered bonds structure works as follows. A financial institution wishing to refinance certain of its assets sets up a covered bonds company (CBC) under the form of a credit institution structured as a bankruptcy-remote vehicle with the limited purpose of issuing bonds and granting loans secured by the relevant assets. The CBC grants loans to the existing financial institution and the latter grants to the former a pledge over the assets as security for its obligations under the loans. To refinance such loans, the CBC issues bonds on the financial markets and pledges its own assets in favour of the bondholders. These bonds are classic bonds issued under a medium-term note, euro medium-term note or other debt issuance programme.

Contractual covered bonds programmes are fairly recent in France and have been set up in a relatively short period of time by a number of major banking groups (eg, BNP Paribas, CIC-Crédit Mutuel and Banques Populaires). They are a great success and existing programmes have shown a certain degree of resilience to liquidity and spread crisis.

Their success is due to the fact that, unlike SCFs, CBCs are not governed – and therefore not limited - by any specific legislation, but nevertheless the underlying collateral security arrangements are particularly safe from an investor's point of view.

Reasons for success

Safety security interest, even in the event of bankruptcy of the issuer

The key specificity of French contractual covered bonds programmes is that they essentially rely on the Financial Collateral Arrangements Directive, which was implemented to provide a specific legal regime for security arrangements and to safeguard for their survival in the event of bankruptcy of the pledgor. When collateral arrangements are entered into between financial institutions, French law provides that the parties may pledge certain assets according to simplified procedures and that in the event of bankruptcy of the pledgor, netting close-out provisions remain applicable and the pledgee may foreclose the security interest immediately and without any formalities. This is a major exception to the French general insolvency rules, pursuant to which security interests cannot be enforced after the commencement of insolvency proceedings against a debtor (Article L622-21 of the Commercial Code).

Thus, combined with the bankruptcy remoteness of the CBCs and the other structural aspects of the programmes, this is usually sufficient for rating agencies to reach an AAA/aaa level of comfort.

Absence of statutory financial ratios

Although the contribution of the Financial Collateral Arrangements Directive to the development of the CBC market has been significant, the initial reason for such development is to be found in the law governing SCFs. This law provides for many statutory financial ratios and limitations necessary to ensure the highest quality of assets and liabilities. In particular, the SCF law provides that the eligible residential loans secured by a guarantee shall not exceed a determined threshold. This threshold is maintained relatively low as a guarantee is deemed to be less protective than a mortgage, but has proved to be too low in light of the high number of guaranteed residential loans originating in France. As CBCs are not specifically regulated, such thresholds are applicable.

Flexibility

As CBCs are not specifically regulated entities, the composition of the portfolio underlying the contractual covered bonds and the relevant collateralisation tests and other financial ratios, as well as the eligibility criteria, can be determined on a purely contractual basis, without reference to any legal or regulatory provisions. This is an important factor for potential players, as it enables CBCs to encompass a wider variety of assets and structural features than SCFs.

In addition, the law implementing the Financial Collateral Arrangements Directive makes it possible to manage the assets dynamically as part of the collateral security. The relevant provisions permit releases,

substitutions or additions of collateral assets, depending on the outstanding amount of the loans to be secured or the quality of the collateral assets, without being subject to claw-back risks.

Another significant contribution of the directive is that it allows two different types of pledge of assets: either the ownership of the pledged assets is transferred by the pledgor to the pledge or such ownership remains vested in the pledgor. However, in both cases, in the event of bankruptcy of the pledgor, the rights of enforcement of the pledgee are substantially the same. Therefore, in most contractual covered bonds programmes, the ownership of the collateral assets is not transferred to the pledgee. As a result, the IT and accounting systems, and more generally the level of tracking and reporting of the assets, are significantly less cumbersome than in the case of a true sale of assets, as is the case with an SCF or a classic securitisation.

Common features

Despite some major differences, the SCF and the CBC share common features.

Credit institutions

An SCF is a credit institution by law. A CBC must be a credit institution because lending is a regulated activity in France and this status is necessary to benefit fully from the Financial Collateral Arrangements Directive.

In practice, both entities must be licensed by the French banking authorities and comply with all the relevant minimum capital requirements and other regulatory and prudential requirements applicable to all credit institutions.

Bankruptcy-remote vehicles

Covered bonds issuers are bankruptcy-remote vehicles. Again, this situation is implied by the SCF law, which requires that an SCF have a servicer and eliminate the risk of bankruptcy consolidation. It is contractually organised in the context of a CBC, in accordance with the guidelines elaborated by the rating agencies for structured finance vehicles. As a result, in both cases the day-to-day operational management of a covered bonds issuer is delegated to a credit institution.

On-balance sheet financings

None of these instruments achieves off-balance sheet treatment easily. As far as a CBC is concerned, the structure does not normally entail a true sale of assets. SCFs can achieve a true sale, but in most cases the originator is the parent company of the SCF; thus, the SCF is consolidated in the accounts of the originator.

New paths and opportunities

In the current market unrest, covered bonds programmes should be considered by financial institutions and corporates as a serious alternative to traditional techniques of asset origination and/or asset refinancing: SCFs and CBCs are well equipped for that purpose.

Wide scope of assets

SCFs and CBCs are entitled to acquire or refinance a wide variety of assets. Despite the fact that the SCF is regulated, its object remains extensive, as follows:

- The term 'real estate loans' includes residential loans and are the main asset of SCFs at present. It also includes any other type of real estate loan and in particular commercial loans. Commercial loans are eligible assets to the extent that they meet the eligibility criteria detailed above. Their loan to value may not comply with the maximum limit set forth in the SCF law, but it is possible to tranche the loans and create senior, mezzanine and subordinated pieces, as is often the case in commercial mortgage-backed securities. In any event, the portion of commercial loans exceeding the maximum loan to value can be purchased by an SCF, the only consequence being that such portion will be funded not by the issuance of *obligations foncières* benefiting from the super privilege, but by classic unsecured funding sources.
- The concept of 'risk exposures against public entities' is also very wide. It includes not only

loans, but all types of receivable against such entities, and potentially all payment obligations guaranteed by an eligible public entity. This can include a variety of project finance transaction and public-private partnerships.

The assets that can be refinanced through a CBC are even larger, the only limitation being the scope of application of the Financial Collateral Arrangements Directive. In France, the directive has been implemented in a generous manner and includes securities, financial instruments, bills, receivables, agreements or sums of money, which is vague and goes far beyond the purpose of SCFs. At present, CBCs in France have been set up with the sole view to refinancing residential loans, but in theory it is possible to imagine automotive contractual covered bonds programmes refinancing auto loans, lease receivables or lease contracts, as well as other asset-type CBCs.

International capabilities

One notable feature of both SCFs and CBCs is their capability to acquire or refinance assets located in a number of countries, thus making these entities suitable for an international financing/refinancing platform.

CBCs rely on the Financial Collateral Arrangements Directive; therefore, in theory, the same principles should apply in all EU member states and the favourable security mechanisms should be recognised for assets located in these jurisdictions. However, particular attention is necessary in this respect as the directive has not been interpreted and implemented uniformly across all EU member states. In particular, the range of assets eligible as collateral security may differ from one country to another. Therefore, setting up a pan-European CBC programme requires a prior detailed legal (and tax) analysis.

The international capability of SCFs is even wider and clearer. Assets are eligible to a SCF if, in addition to the criteria mentioned above, they are located in an eligible country or, in the case of risk exposures against public entities, such entities are located in an eligible country. As far as real estate assets are concerned, the list of eligible countries is long and requires no legal analysis as it includes all member countries of the European Economic Area, as well as any other country rated at least AA- or Aa3 by Fitch, Standard & Poor's or Moody's, as appropriate. The location of the originator and the applicable law are irrelevant.

Financing and refinancing tool

At present, SCFs and CBCs are structured as refinancing vehicles – that is, they tend to acquire assets already originated and funded – but they can directly originate and funds such assets.

In particular, as the SCF can grant or acquire secured loans and acquire transferable securities issued by FCCs or SPVs, an SCF is suitable to refinance an existing book of eligible loans, owned either directly by the originator or indirectly through the holding of asset-backed securities, and to finance new loans directly.

Similarly, as credit institutions CBCs can purchase and grant loans and acquire or subscribe asset-backed debt securities.

Financial crisis compliant

Both SCFs and CBCs are simple instruments, relying on clear-cut legal mechanisms which are particularly safe: a criterion likely to be valued even more in the near future by capital market investors, and particularly applicable to SCFs protected by a comprehensive legal environment.