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NEW FRENCH LEGAL FRAMEWORK ON COVERED BONDS

The French Parliament adopted on October 11, 2010, the law on banking and financial regulation (‘*loi de regulation bancaire et financière*’) which (i) creates a new type of covered bond issuer, the *Société de Financement de l’Habitat* (the '**SFH**') to exist beside the existing *Sociétés de Crédit Foncier* (the ‘**SCF**’) and (ii) improves liquidity management for both categories of covered bond issuers. This law has been published on October 22, 2010.

The SFH will exist alongside the other current issuance entities: SCF (*Société Crédit Foncier*) and CRH (*Caisse de Refinancement de l’Habitat*). SFH will be a credit institution licensed and supervised by the French regulator (*Autorité de Contrôle Prudentiel*, ‘**ACP**’).

A new category of French legislative covered bonds is now created under the name of ‘*Obligations à l’Habitat*’ (‘**OH**’) to be issued by SFH.

The recent legislative changes are primarily based on the rules governing German *Pfandbriefe* and will soon be codified under Articles L.515-13 *et seq*. of the French Monetary and Financial Code for the SCF, with a new Section 5 of Chapter V of Book 5 of the French Monetary and Financial Code created for the SFH).

Background

Created for the first time in December 2006 by BNP Paribas, structured covered bonds in France are based on the general French legal framework and use the collateral directive for the transfer of legal title on the home loans to the issuer of the covered bonds. This structure prevents any operational issues linked to the true sale of the underlying home loans.

The main reason for the current French legislative reform is to allow the general French law-based covered bonds to become legislative covered bonds and, therefore, fully compliant with the UCITS-directive.

The existing ‘structured’ covered bonds issued by various French retail banks to refinance French home loans are all expected to be converted into OH after the implementation of the recently approved legislation. This conversion must be notified to the ACP within 12 months following the law’s publication.

From now on, under French law, SCF and SFH will both be considered as issuing legislative covered bonds and will satisfy the requirements of Article 22 (4) of the UCITS Directive of December 20, 1985. This will allow certain investors to increase the amount of assets they can invest in OH from the current 5% limit to 25% (UCITS) or 40% (insurers).

These law changes are expected to further improve the already strong perception of French covered bonds in the market.

Key points of the reform

IMPROVEMENTS OF LIQUIDITY MANAGEMENT

Various improvements are implemented in the law and will be valid for both SCF and SFH. This includes improving liquidity instruments such as:

- a requirement to cover all liquidity needs for next 180-day period on an ongoing basis;
- a minimum 2% level of over collateralization; and
- possibility for issuers to use up to 10% of covered bonds issued for ECB repo operations.

CREATION OF THE SFH LEGAL FRAMEWORK

As is already the case with the SCF, the future SFH will be licensed and supervised credit institutions. Unlike the SCF legislation which limits the percentage of guaranteed home loans (currently 35% of total assets), the SFH legislation has been drafted to reflect the development of the French home loan market and will not limit the percentage of guaranteed home loans in the issuer's assets.

Once the law enters into force existing issuers will have a 12-month period to apply for a license as an SFH and convert their existing covered bonds into OH. One of the key requirements for this legal status conversion is that each SFH must appoint a specific controller to replace the existing asset monitor.

SFH will be subject to the same strict criteria in terms of asset eligibility, supervision, control and license requirements as already existed in the 1999 French covered bond law. The control over cover pool assets and guarantors will be further tightened under the SFH regime with the appointment of the specific controller.

Investors in OH issued by SFH will benefit from the same statutory privilege ('*legal privilège*') regarding the assets that investors in OFs already have over assets of the SCF.

The main differences between SFH and SCF will be that:

- only residential home loans are eligible for cover pool assets of SFH while SCF can also refinance public sector exposures, alongside residential home loans (with a limit of 35% for guaranteed home loans);
- the transfer of legal title to the SFH will be based on the EU Collateral Directive, as opposed to transfer by true sale or securitization law used in SCFs; and
- the risk weighting under the CRD standard approach of OHs will remain at 20% (vs. 10% for OFs) as SFH will not be compliant with the current CRD due to the level of guaranteed home loans.

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The new framework at a glance

<table>
<tr><th rowspan="2">MAIN FEATURES</th><th>Structured Covered Bonds Issuers</th><th>SFH</th><th>SCF</th></tr>
<tr><td></td><td colspan="2">NEW LEGAL FRAMEWORK</td></tr>
<tr><td rowspan="2">Legal form</td><td colspan="3">specialized credit institution with an exclusive purpose</td></tr>
<tr><td>licensed as financial company</td><td>licensed as ’société de financement de l’habitat’</td><td>licensed as ’société de crédit foncier’</td></tr>
<tr><td>Supervision</td><td>supervised by the ACP; controls by an asset monitor; reviews by external auditors</td><td colspan="2">supervised by the ACP; controls by a specific controller; reviews by external auditors</td></tr>
<tr><td>Composition of the asset pool</td><td colspan="2">Only residential home loans, without limitation for guaranteed home loans</td><td>Residential home loans and commercial real estate loans (with 35% limitation on guaranteed loans) and public entity exposures</td></tr>
<tr><td>Transfer of the assets to the issuer</td><td colspan="2">collateralized loan agreements, home loans are granted as financial collateral security to secure the loans
(securitisation and true sale also possible)</td><td>(i) true sale or securitization and (ii) possibility of collateralized loan agreements for public entity exposures only</td></tr>
<tr><td>Ring fencing</td><td>contractual ring fencing mechanism
non recourse – non petition clauses</td><td colspan="2">legal ring fencing mechanism expressly stating that the opening of insolvency proceedings against a company holding shares in an SCF/SFH may not be extended to the issuer.</td></tr>
<tr><td>Priority of payments</td><td>common pledge</td><td colspan="2">legal privilege (senior ranking priority) over all of the assets of the issuer to the benefit of the covered bond holders and swap counterparties on a pari passu basis</td></tr>
<tr><td>Risk weighting</td><td colspan="2">20%</td><td>10%</td></tr>
<tr><td>UCITS compliance</td><td>No</td><td colspan="2">Yes</td></tr>
<tr><td>Liquidity</td><td>contractual requirements</td><td colspan="2">(i) legal requirement to cover all liquidity needs for next 180-day period on an ongoing basis – (ii) minimum 2% level of over-collateralization – (iii) possibility for issuers, if need be, to use ECB repo facilities</td></tr>
<tr><td>Issuance program</td><td colspan="3">AAA rated EMTN issuance programs</td></tr>
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Further regulations pending

Attention is also drawn to the fact that a forthcoming decree and regulations are expected in the near future.

Contacts

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