France: Ground breaking reform to revamp the securitisation regime

by Hervé Touraine and Olivier Bernard, Orrick, Herrington & Sutcliffe (Europe) LLP

France recently adopted a reform which constitutes a major milestone in the development of the French finance sector.

Why a reform?

This reform pursues different complementary goals and makes the new legal environment comprehensive and highly efficient.

Making the French securitisation vehicles the ultimate monetisation tool

The initial goal of the reform was to modernise the securitisation framework to ensure that French securitisation vehicles benefit from the most efficient legal and financial tools and be considered by French, European and other international originators, arrangers, asset managers and investors as the ultimate vehicles to monetise all types of asset classes.

The new vehicles resulting from the reform are based on the existing features of the French securitisation regime, including comprehensive bankruptcy remoteness provisions and the option to select a tax transparent fund structure or a corporate structure subject to corporate tax. Their efficiency is further enhanced by the reform and they now benefit from an unrivaled creditor-friendly legal regime, including extended protections against the insolvency of the vehicle’s counterparties, lockbox mechanisms and protection of future flows.

Introducing a new type of financing vehicle designed to finance the real economy

Since the financial crisis and considering, on the one hand, the criticism towards the concept of “securitisation” and, on the other hand, the general recognition that securitisation techniques are valuable to the economy, the need to create a vehicle based on those techniques but not qualifying as a securitisation vehicle appeared obvious to many market players. Thus, the reform introduced a new category of vehicles, named organismes de financement (literally, financing vehicles), encompassing the existing organismes de titrisation (securitisation vehicles) and the newly introduced organismes de financement spécialisé (specialised financing vehicles).

These two types of vehicles share a common regime based on the existing and enhanced features of the French...
securitisation regime but the specialised financing vehicles are not securitisation vehicles, and therefore not subject to the regulatory treatment of the latter. In essence, their purpose is to finance the “real economy” as proper banks but without being subject to regulatory capital requirements.

Relaxing the banking monopoly to allow direct lending and alternative financing solutions
Long a cornerstone of the French banking system, the “French banking monopoly” largely prevents non-bank entities from lending money to French borrowers. Although French securitisation vehicles have been regularly used as vehicles by alternative capital providers in the past, transactions could not be structured easily and without the involvement of borrower-facing credit institutions as intermediaries, or complex bond structures. In this respect, the reform constitutes a “French revolution” as it substantially exempts the financing vehicles (securitisation vehicles and newly created specialised financing vehicles) from the French banking monopoly and allows direct lending transactions with the same ease and security as banks (but without any regulatory capital requirement).

Complying with EU regulations
Lastly, the reform ensures that France complies with the latest European developments as both types of financing vehicles financing vehicles can benefit from the “European Long-Term Investment Fund” EU label.

This reform is set forth in an ordinance, which was executed by President Macron on October 4, 2017. It is now in force but subject to a series of decrees that are finalised and which should now be published at any time.

Which business opportunities for domestic and international players?
Depending on their exact form, the financing vehicles resulting from the reform are particularly attractive to various market players in the following areas.

Direct lending, including leasing
Before the reform, the French banking monopoly was such that, subject to a limited number of exceptions, entities not duly licensed as credit institutions were not allowed to make funds available, to lend, to enter into sub-participations (funded or unfunded), to carry out leasing activities or to grant guarantees as a principal activity.

Thanks to the reform, financing vehicles can offer all types of financing transactions listed above to industrial and commercial companies, holding companies and natural persons acting in a professional framework. However, as the underlying idea is to ease the financing of the “real” economy, those financing cannot be extended to financing companies within the meaning of UE Regulation n° 2015/760 and to collective undertakings.

In addition, it is worth noting two elements which make financing vehicles particularly attractive as alternative lenders:

- First, since the reform, financing vehicles can benefit directly from a security interest known as the “Dailly assignment” and from the related a “Dailly acceptance”. The Dailly assignment is one of the most efficient security interests in France. In substance, such security transfers title (either as a true sale or by way of security) of the claims secured to the benefit of the creditor and it does survive bankruptcy of the borrower. In addition, the underlying debtor of the claim may “accept” the Dailly assignment, in which case the debtor cannot raise against the secured creditor the defence it could have raised against the borrower. Before the reform, only credit institutions could benefit directly from a Dailly assignment. Securitisation vehicles could benefit from the same but only indirectly, i.e. after having acquired a bank loan secured by a Dailly assignment – thus requiring the involvement of a credit institution as a fronting bank. In addition, there were legal uncertainties as to whether, in such a situation, a Dailly acceptance was transferred indirectly to the securitisation vehicle as an accessory to the bank loan.

With the reform, and the possibility to benefit directly from a Dailly assignment and a Dailly acceptance, financing vehicles can therefore grant secured
financing with the same level of security as proper banks, and without involvement of an intermediary credit institution.

• Second, although financing vehicles can act as proper banks in the lending sphere, they are not subject to any regulatory capital constraints, which should allow competitive financings.

**Private debt and/or equity funds**
Financing vehicles are extremely versatile and can invest in debt instruments (subscription of bonds or direct lending), equity instrument or hybrid securities.

As such, they can act as long-time partners to their corporate clients, ranging from start-ups to SMEs and large caps.

Not only can they provide for initial funding by way of bonds, equity or convertible, but they can also accompany their clients in their business development through committed or uncommitted facilities and, if need be, in stressed scenarios requiring injection of new money, additional equity or debt for equity exchange.

In addition, they can enter into currency and interest rate hedging agreements and repo transactions and take the form of a corporation (as opposed to the form of a tax transparent fund) to benefit from international tax treaties to eliminate or mitigate tax hurdles in case of international investments and/or investors.

As a result, the new financing vehicles are likely to become one of the favourite vehicles for asset managers, private equity houses and investment funds willing to set-up private debt and/or equity funds with a domestic or international investment strategy.

**Real assets finance solutions: Real estate financing and energy/infrastructure projects**
Securitisation vehicles are already often used in the context of financing and/or refinancing of commercial real estate assets and energy or infrastructure projects. They are established in the context of one-off transactions, or to constitute a portfolios of assets (debt funds), or as a mean to access to capital markets for refinancing purposes.

The new features introduced by the reform should make financing vehicles even more appealing to finance and/or refinance real assets. In particular:

• As explained above, they can benefit from the Dailly assignment. As such, depending on the type of assets to be financed, this can be an element sufficient in itself to opt for a financing vehicle. For example, commercial real estate financings are frequently secured by an assignment of the rents by way of security through the Dailly mechanism. Financing vehicles can also benefit from mortgages and own the underlying assets upon foreclosure. Similarly, major energy and infrastructure project finance transactions in Europe often rely to a significant extent on the assignment of financial claims against public bodies. Here again, the most frequently used security assignment in such a context is the Dailly assignment. From the reform, financing vehicles can benefit directly from the same security and can finance or refinance real assets, on their own – or alongside banks in the context of syndicated or club deal transactions – and act on an equal footing with the latter.

• Furthermore, because they are now allowed to directly lend and make available moneys and they can directly benefit from a Dailly assignment, financing vehicles can invest new money in real assets financing during the course of their life. This can be required, for example, in the case of financial restructuring of real estate financings or in the case of the financing of new milestones in the context of the construction of infrastructures.

**Special situations: non-performing loans and financial restructuring**
The acquisition of non-performing loans is an activity which is still relatively confidential, except in specific countries and situations, i.e. Italy where the market has been extremely active for a number of years.

In France, the non-performing loan market is still fairly small because financial institutions holding such loans are not yet willing to dispose of such assets on a large scale. This will change as EU regulations are now putting
pressure on European banks to dispose of their non-performing assets to free-up capital and inject new money in the real economy.

As at August 2018, most of the non-performing loan financing transactions in France have been implemented through securitisation vehicles and it is clear that the reform gave the financing vehicles the appropriate legal and financial tools to be used by international investors and credit institutions as the European platform for acquiring or disposing of European portfolios of non-performing financial assets.

The new financing vehicles are also the perfect tool for international alternative capital providers holding debt participations in syndicated bank financings initially granted to French debtors which suffer financial restructuring thereafter. In such a case, the outcome of the restructuring process might require injecting new money and/or taking additional guarantees to secure existing and/or new money financings. In many instances, due to the French banking monopoly, such international capital providers are not allowed to grant new money or to take the benefit of certain new security packages (i.e. a Dailly assignment).

Entering into a sub-participation with an eligible bank as part of the financial restructuring might be a solution but it is not entirely satisfactory for the ultimate investors for a number of reasons. Transferring those participations into a new financing vehicle dedicated to “special situations” allows the latter to act on behalf of the investor with the same flexibility as the other banks part of the syndication and is a smart way to solve those issues.

Innovative and non-conventional financings: Tech, fintech, arbitrage, commodities and third-party financing

Certain financing activities, for historical, regulatory, operational or practical reasons are often carried out through special-purpose vehicle or fund structures and provide for composite or hybrid services to their clients, including pure lending products, forward instruments, risk sharing arrangements or other services which sound familiar in essence to the “financial sphere” but which do not fall within well-established legal categories of “financial activities”.

The new financing vehicles have inherited from all the legal and financial features of the securitisation vehicles which have been designed over the last 30 years so as to benefit from maximum flexibility. Those features include the ability to acquire virtually all types of financial assets (and liabilities), to issue all types of transferable securities, to grant all types of guarantees and to enter into all types of forward financial instruments or contracts. As a result, the new financing vehicles can offer all types of financial and related services necessary to finance and/or refinance new technologies, fintech and commodities. They can also act as arbitrage vehicles.

But more interestingly, they can easily act as a platform to run innovative or non-conventional new lines of businesses (such as third-party finance), whose definition from a legal point of view is uncertain and debatable, without taking any risk that the underlying arrangements be qualified at some stage as regulated activities performed without having the appropriate regulatory consents, authorisations or licences.

Regulatory capital and risk transfer transactions

The reform considerably eases the use of regulatory capital and risk transfer transactions.

Before the reform, securitisation vehicles could only enter into credit default swaps to perform those transactions. Since the reform, financing vehicles can also enter into sub-participation arrangements and grant financial guarantees.

Innovative risk transfer structures using financing vehicles are already in the course of being structured to take advantage of the reform.

Classic securitisation and monetisation of financial claims

Last but not least, the new financing vehicles have been modernised in such a way that they can compete with all other European and international securitisation vehicles. In
substance, they can acquire all types of assets, including those referred to in the above sections but also leasing receivables and sovereign exposures and they can be the pivotal structuring tool in many financing transactions, including whole business and project bonds.

The legality of the financing vehicles is optimum in a number of respects that translate into financial efficiency of the transactions. The main creditor-friendly features of the new financing vehicles relevant to securitisations transactions are set out below:

- total bankruptcy remoteness by law;
- true sale provided by law;
- lock-box mechanisms bankruptcy-remote by law;
- total segregation of compartments by law;
- enforceability of waterfall by law;
- enforceability of flip-clauses by law;
- assignment of future flows bankruptcy-remote by law;
- and
- protection against hardening period voidness and claw-back by law.

It is important to insist on the fact that the law governing financing vehicles provides all the above items expressly, so that their efficiency and enforceability are hardly questionable.

Conclusion

Is the reform in force?
The ordinance mentioned above is in force. Decrees and other administrative regulations are to be adopted at any time. Meanwhile, financing vehicles can be structured.

What are the differences between a securitisation vehicle and a specialised financing vehicle?
The main difference is that securitisation vehicles can issues different tranches of bonds or other equity or debt instruments. This is not allowed for specialised financing vehicles. Securitisation vehicles can also grant guarantees (including financial guarantees) as their main business purposes. On the other hand, specialised financing vehicles (i) can invest into equity whereas this possibility is limited for securitisation vehicles; (ii) can provide for repurchase mechanisms over their shares and/or debt instruments; and (iii) such shares can be invested in by their managers.

Why opt for a financing vehicle incorporated with a corporate structure rather than a fund structure?
Both types of financing vehicles (securitisation vehicles and specialised financing vehicles) can be created with a transparent tax fund structure or with a corporate structure subject to corporate tax. In the latter case, the financing vehicle should be able to benefit from international tax treaties and this is helpful to establish multi-jurisdictions transactions. The French tax regime of financing vehicles incorporated as corporate, is however unclear and unsatisfactory; and although it should evolve, at today’s date, this situation is not ideal to develop these structures. Fund structures are therefore more common and it must be said that they are also efficient in the context of multi-jurisdictions transactions, although these structures require more attention from a tax point of view.

Can a specialised financing vehicle be managed by a non-French management company?
No, for securitisation vehicles: they must be managed by a French company duly licensed by the French stock exchange authorities as portfolio management company. Yes, for specialised financing vehicles, but only if the management company is established within the EU and is duly licensed by the local relevant authorities to manage alternative investment funds.

Contact us:
Orrick, Herrington & Sutcliffe (Europe) LLP
31 avenue Pierre 1er de Serbie
75782 Paris Cedex 16, France
tel: +33 1 53 53 75 00
web: www.orrick.com