Helaba

Focus on: Covered Bonds
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Bpifrance issues a European Secured Note



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If more than ten years pass between an idea and its implementation, one is entitled to reach for the adjectives from the very top shelf upon completion – and this is precisely what is happening these days. We generally welcome this development: firstly, because we have no intention of arguing with Harry Markowitz (Diversification), and secondly because, in the current geopolitical and fiscal environment, financial institutions must find ways to stabilise their funding.

Amidst all the enthusiasm, we should not miss the opportunity to take a closer look at the structure of the transaction and examine the mechanics and direction of its credit enhancement mechanisms. Following the advice of our old mentors, we went looking for imperfections – and found a few.

Understanding the Basics: "What Is the Legal Nature of Bpifrance?"

Bpifrance is an Établissement Public à caractère Industriel et Commercial (EPIC). Under French administrative law, an EPIC is governed by the principe de spécialité (principle of specialty), meaning that it may only carry out activities that serve its specific public-interest mandate (mission d'intérêt général). In the case of Bpifrance, these include innovation financing, SME support and export guarantees.

Under French administrative law, EPICs cannot be subject to ordinary insolvency or liquidation proceedings. Should their capital prove insufficient, the French State ultimately bears financial responsibility as the residual guarantor. The operational entity carrying out the public mandate (the "Borrower" in the chart) is Bpifrance S.A., a licensed credit institution supervised by the ECB. EPIC Bpifrance acts as the official financial backstop for the operating bank. For Bpifrance S.A.'s major funding programmes, the EPIC provides an autonomous, unconditional and irrevocable first-demand guarantee.

The Basic Structure of the European Secured Note – Or: "Who Is Securing Whom?"

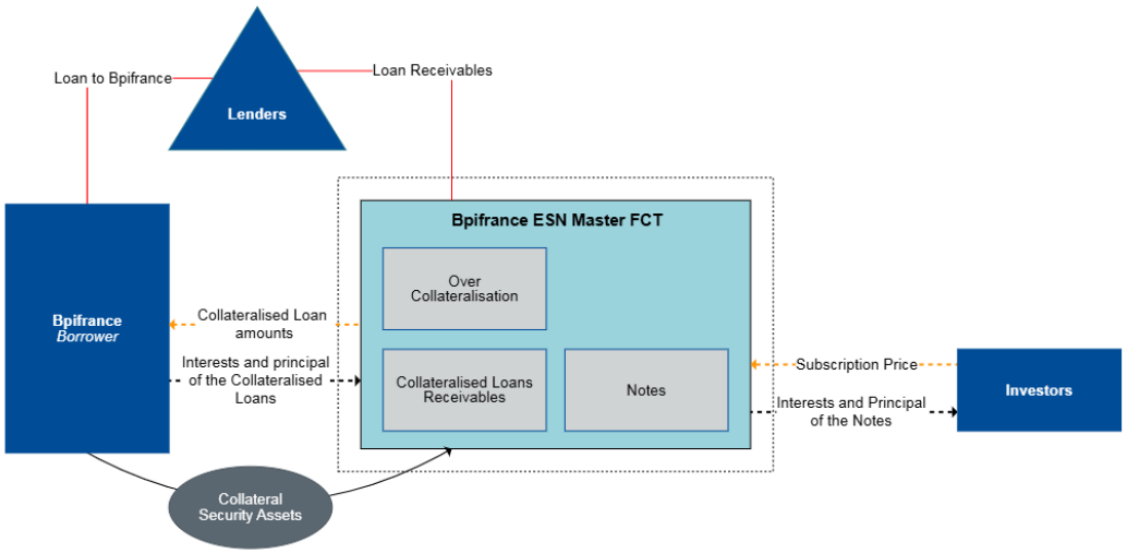
The issuer of the instrument is the Bpifrance ESN Master FCT, a financing vehicle (organisme de financement) established in the form of a securitisation fund.

The vehicle purchases cover assets from Bpifrance S.A., financed through the issuance of debt securities. These cover assets consist of either (i) medium- and long-term loans secured by mortgages or other forms of collateral, or (ii) loans granted to small and medium-sized enterprises (SMEs) that do not benefit from any direct security interest over the borrower's assets but are covered by a guarantee provided by Bpifrance on behalf of the French State. The latter category must account for at least 75% of the cover pool.

From the investor's perspective, the primary claim is against the vehicle itself, whose ability to meet its obligations depends on the cash flow generated by the acquired loan portfolio. The credit quality of the portfolio is determined both by the underlying borrowers and, more importantly, by the support provided through state guarantees and other security mechanisms.

From Bpifrance's perspective, the structure creates a funding source secured by assets that simultaneously define Bpifrance's own credit quality. Anyone reminded of specific wrong-way risk under Article 291 CRR would not be entirely mistaken.

Structure of Bpifrance's European Secured Note



Sources: Bpifrance, Helaba Research

Managing Specific Wrong-Way Risk – Or: "How Do You Get the Cow Off the Ice?"

Specific wrong-way risk cannot be eliminated, but it can be structurally mitigated.

The first mitigating factor is the bankruptcy-remote segregation of the cover assets through the securitisation vehicle. If the French State or Bpifrance were to encounter severe financial difficulties and impose a payment moratorium on public debt, the cash flows within the FCT – namely the repayments made by the SME borrowers – remain legally protected. Cash flows move directly from the SMEs via the account bank to the FCT investors without passing through the balance sheet of Bpifrance.

The second mitigating factor is the overcollateralisation of the ESNs. The transaction documentation requires a minimum overcollateralisation level of 20%, or such higher level as may be required to maintain a Moody's Aaa rating. A ratchet mechanism has been incorporated to ensure that the minimum overcollateralisation remains fixed at the highest level ever required to preserve the Aaa rating. Overcollateralisation requirements of around 20% are not unusual among Spanish and Portuguese public sector covered bond issuers. By comparison, Caffil, France's largest public sector covered bond issuer, maintains a minimum requirement of 12%. In the event of a payment moratorium, the FCT would therefore not only remain unaffected but would also benefit from a cushion of at least 20%.

Should this cushion nevertheless prove insufficient to meet payment obligations, the structure allows for the **extension of bond maturities by up to one year (soft bullet mechanism).**

A further key element mitigating wrong-way risk is the existence and bankruptcy-remote segregation of cash collateral. Bpifrance requires each borrower to provide a **cash deposit equal to 5% of the loan amount**, irrespective of the ESN transaction. The amount of the deposit remains unchanged as the corresponding loan amortizes. Consequently, the credit support associated with each individual loan increases over time. Upon the occurrence of predefined credit events or a severe downgrade of Bpifrance, the cash collateral is immediately segregated and ring-fenced. Bpifrance cannot use these funds for its own operational purposes. The fact that the cash collateral forms part of the minimum 20% overcollateralisation should not be seen as a weakness. On the contrary, from the perspective of the cover pool it is arguably the most valuable asset, given that it is immediately liquid, unlike the ordinary cover assets.

Finally, it should be noted that if, following a default of Bpifrance, the transferred cover assets together with the cash deposits prove insufficient to repay the ESNs in full, the issuer retains a claim against Bpifrance for the remaining unpaid amounts. The FCT would then have to enforce this claim outside of any insolvency proceeding.

Overall, in our view, the structure significantly mitigates the underlying wrong-way risk and therefore justifies a credit quality assessment that is materially higher than that of an unsecured obligation of Bpifrance.

Economic, Structural and Historical Perspective – "Is the Structure New, or Just the Name?"

It is telling that a French state-related issuer is the one setting the ESN ball rolling. France's current fiscal position and the associated rating pressures have placed increasing strain on state-related entities. While banks already have access to rating-stable funding instruments through *obligations foncières*, *obligations à l'habitat* and traditional securitisations, comparable solutions have been largely absent for public-sector affiliated institutions. We therefore strongly welcome the development of this funding format, which ultimately supports the long-term fulfilment of the underlying public policy mandate. The current lack of explicit regulatory recognition is, for the time being, a secondary consideration.

We would not, however, be surprised if future issuers attempted to create the best of all worlds: marketing the product as a covered-bond-like instrument while simultaneously benefiting from the regulatory treatment of securitisations, including the recently proposed regulatory improvements. We therefore view with some scepticism Moody's description of the transaction as "Bpifrance ESN Master FCT – Covered Bonds; Pre-Sale – French covered bonds". We are equally critical of Bpifrance's debt investor presentation, which portrays the European Secured Note as a "covered-bond-like instrument" distinguished only by its use of alternative cover assets. The extensive body of requirements applicable to covered bonds is conveniently omitted, reducing the Covered Bond Directive from 34 articles to effectively one.

Historically, similar products have existed before in the sense that dual-recourse structures were developed using unconventional cover assets. The term "covered bonds", however, was generally treated with somewhat greater restraint. In 2013, Commerzbank issued an "SME Structured Covered Bond". In 2016, Italy introduced the legal framework for OBCs (Obbligazioni Bancarie Collateralizzate). Since 2021, Switzerland has seen structured covered bonds backed by auto lease receivables. Because banks acted as the issuers in all these cases, those structures were arguably one step closer to traditional covered bonds than the Bpifrance ESN.

In our view, the continued development of European Secured Notes is not helped by constantly comparing them to covered bonds. Instead, ESNs should establish their own identity, cultivate their own brand and develop a common market understanding. Otherwise, there is a risk of continually having to downplay structural and regulatory differences on the one hand, while diluting the carefully cultivated image of the covered bond product on the other.

The current geopolitical and fiscal environment creates a genuine need for rating-stable funding, while investors possess both the demand and the experience required for dual-recourse instruments. We are therefore convinced that the Bpifrance ESN is merely another step in a much longer development and that the concept of secured funding has reached an important turning point. For, as Victor Hugo famously observed:

"Nothing in the world is so powerful as an idea whose time has come." (Victor Hugo)



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