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Covered Bonds

France
Presale Report

Société Générale SCF Obligations Foncières

Expected Ratings*

Covered Bonds	Amount (EURbn)	Maturity	Rating
Series 1	1.5	April 2013	AAA (EXP)

Key Data

	Feb 08
Cover assets (EURbn)	2
Covered bonds (EURbn)	1.5
Nominal overcollateralisation (%)	33
Residual weighted-average asset maturity (yrs)	9
Residual weighted-average liability maturity (yrs)	5
D-factor (%)	10.9

* Expected ratings do not reflect final ratings and are based on information provided by the issuer as of April 2008. These expected ratings are contingent on final documents conforming to information already received. Ratings are not a recommendation to buy, sell or hold any security. The offering circular and other material should be reviewed prior to any purchase

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Related Research

- *"Fitch Launches New Covered Bonds Rating Methodology"*, dated 19 February 2007
- *"Covered Bonds Rating Criteria - Stop or Continue?"*, dated 13 July 2006
- *"Counterparty Risk in Structured Finance Transactions: Hedge Criteria"*, dated 1 August 2007
- *"Commingling Risk in Structured Finance Transactions: Servicer and Account Bank Criteria"*, dated 9 June 2004
- *"Counterparty Risk in Structured Finance: Qualified Investment Criteria"*, dated 27 September 2007

Rating Rationale

Société Générale (SG, rated 'AA-' /Stable/'F1+') has created a 99.99% owned subsidiary, Société Générale Société de Crédit Foncier (SG SCF), to issue Obligations Foncières (OFs), the French legislative covered bonds, under a EUR25bn programme.

SG SCF is a financial institution regulated by the Commission Bancaire (the French banking regulatory body) and licensed to issue OFs. SG SCF is fully integrated within its parent bank and benefits from a strong support of SG. As a consequence, the SG SCF's Long-term Issuer Default Rating (IDR) mirrors that of SG at 'AA-'.

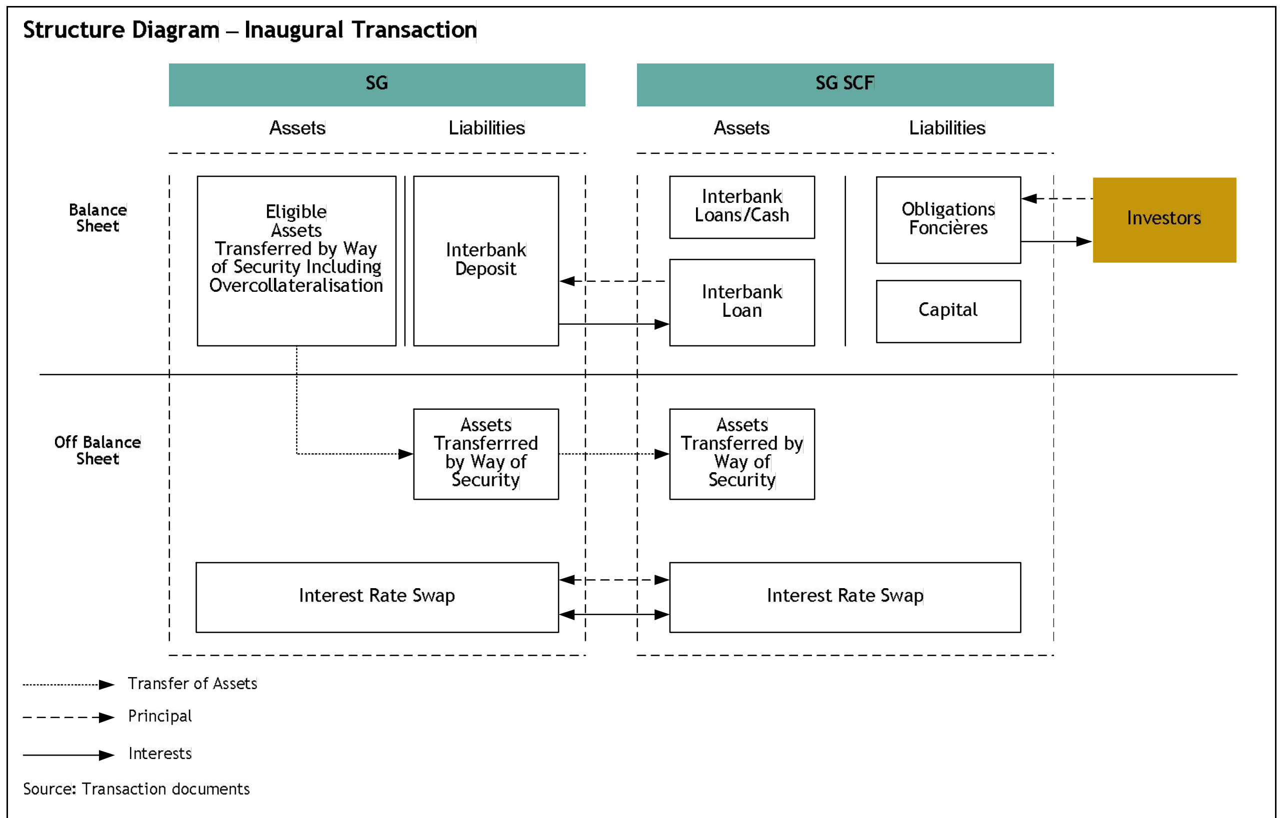
Fitch Ratings has assigned an expected rating to the first series of OFs issued by SG SCF based on: (i) SG SCF's Long-term IDR; (ii) the discontinuity factor (D-Factor) of 10.9% assigned to the OFs programme; and (iii) the overcollateralisation (OC), which compensates for identified credit and market risks in a 'AAA' scenario; the combination of these three elements enables the OFs to be rated 'AAA' on a probability of default basis.

Fitch D-Factors measure the likelihood of interruption of payments on the covered bonds upon the failure of the main debtor, on a scale from 0%, for perfect continuity, to 100%, which equates the covered bonds' probability of default with that of the main debtor. The D-Factor assigned to SG SCF 's programme reflects: (i) the satisfactory segregation of the cover assets from the bankruptcy estate of SG; (ii) the solution to overcome liquidity gaps through a EUR5bn liquidity line to fund the principal on OFs coming due within 180 business days (for bullet OFs) or 90 business days (for OFs redeemable in instalments); (iii) the feasibility of a transition to an alternative cover pool manager; and (iv) the regulation applicable to SCFs and the supervisory role of the French banking authorities.

SG SCF assets consist initially of a single floating-rate loan advanced to SG (the "secured loan"), collateralised by a cover pool of EUR 2bn loans to French public entities or guaranteed by such entities and originated by SG. Beneficial title over the receivables (remise en pleine propriété à titre de garantie) is transferred at inception to SG SCF according to article L431-7-3 of the French Monetary and Financial Code (see Structure Diagram). Enforcement will take place upon occurrence of certain events, which will trigger notification of the underlying debtors to the change of ownership and new payment instructions.

SG will maintain a minimum coverage ratio of 105% on the public-sector collateral backing the OFs (see *Appendix* 2). This level is sufficient to ensure that SG SCF repays fully and timely the OFs in Fitch's 'AAA' wind-down scenario, following a default of SG. In its cash flow analysis, Fitch has stressed the following risks: (i) the credit and concentration risks of the cover pool. The top 10 obligors represent 38.4% of the cover pool. Fitch has tested that the issuer would be able to withstand the default of the four largest obligors; (ii) the interest-rate mismatch between the cover assets and the outstanding OFs. About 78% of the public loans bear a fixed rate of interest while the OFs are swapped into floating rate at inception. Fitch has taken into account that the collateral assets will be swapped into floating rate if SG is downgraded below 'F1+'; (iii) the maturity mismatch between the cover assets and the outstanding OFs. The cover pool weighted-average maturity is nine years, compared to five years for the OFs. Fitch has assumed that assets will have to be liquidated at a discount to par.

Fitch will monitor the coverage ratio as more collateral is added and additional OFs are issued.



Highlights

In the future, other assets (residential mortgages originated by SG retail network and other public exposures) will be transferred to the SCF. Fitch will then undergo a renewed analysis of the SG SCF OF programme, including a review of its D-Factor and the supporting OC.

All else being equal, the rating of the OFs could be maintained at 'AAA' provided SG SCF is rated at least 'BBB'.

Background

SG is one of Europe's largest banking groups. It is a diversified French banking group with a presence in 77 countries. Its activities are split between three major divisions: Retail Banking and Financial Services, Corporate and Investment Banking, and Global Investment Management and Services.

Key Information

Issuer: SG SCF
Borrower: SG
Servicer: SG
Issuer Administrator: SG
Principal Paying Agent: SG
Calculation Agent: SG
Issuer Account Bank: SG

The Issuer

SG SCF is a wholly owned subsidiary of SG. It is a société de crédit foncier, ie a société financière licensed to issue Obligations Foncières. It received its license from the CECEI (Comité des Etablissements de Crédit et des Entreprises d'Investissement) in December 2007. Before that date, it was a pure dormant entity. It is constituted as a société anonyme (limited company), and is managed by a conseil d'administration (board of directors). SG SCF has no employees and subcontracts all operational tasks to SG.

In addition, SG commits itself to fully support SG SCF by ensuring its solvency and its liquidity.

Origination

SG has an 8% market share of the public sector lending in France. The public sector segment in SG represents EUR15bn of loans to 2,500 French customers (900 of which

have long-term commitments with SG). Public sector customers are split as following: regions (15%); départements (or French counties) (30%); municipalities (20%); hospitals (15%); and inter-municipal bodies (20%). In addition, SG lends to some mixed companies (public and private) and social housing companies, mostly with guarantees granted by local authorities.

SG originates public loans through a network of 80 local branches in France, each employing one public sector relationship officer. They are in direct relation with the public entities and establish the lending process.
Each officer is backed by a Pôle Service Clients (PSC) at the regional level. In total, 23 PSCs are controlled by one main PSC for the public sector, located at Val de Fontenay, in the Greater Paris area. PSCs are responsible for drafting and checking loan documentation and also manage the operational risks on the contracts. Currently, 17 people are in charge of checking contracts. Contracts are archived in each PSC, as well as stored in digital copy.

For each contract, SG requires:

- last three years of financial statements, including debt figures obtained either from the local authorities directly or from the Ministry of Finance (through its on-line database);
- budgets and forecasts;
- management rules.

In addition, before originating any loan, the loan's purpose is checked, including a review of the project characteristics and the expected benefits.

All public entities are assigned an internal rating, updated annually. A new rating system, compliant with Basel 2 Internal Rating-Based Approach was introduced in 2007. This model was tested on 900 entities and has been certified by SG internal audit. The rating scale ranges from 1 to 10 (from best to worse). Currently, 90% of the portfolio is rated 3+ and better.

The ratings are first assigned at the commercial department level (Direction Exploitation Commerciale, DEC). A risk controller assigns a rating to each individual public entity within the limits of his/her credit delegation level, pursuant to a credit committee written process. Delegation to approve different loan amount per contract and per year apply depending on the hierarchical level, local level approval only applies to internal ratings of 1 to 3+. Maturities longer than 32 years require board approval.

Continuity Analysis

Covered bonds are assigned a D-Factor between 0% (best) and 100% (worst), which expresses the likelihood of the covered bonds defaulting in the immediate aftermath of a default by the debtor of recourse. The D-Factor has four weighted components, which are analysed below in the context of the specific aspects of the SG SCF programme.

> **Continuity Analysis**
> *D-Factor Components*
> - Asset segregation (50%)
> - Liquidity gaps (30%)
> - Alternative management (15%)
> - Covered bonds oversight (5%)

Asset Segregation (50%)

This section focuses on the legal framework that protects cover assets from the claims of unsecured creditors and ensures that covered bond holders have full, priority access to such assets.

Fitch asset segregation analysis first addresses the validity of the transfer of assets from their originator to the SCF. The beneficial title is transferred at inception (remise en pleine propriété à titre de garantie) in accordance with article L431-7-3 of the French Monetary and Financial Code. Upon the occurrence of an event of default under the secured loan, the debtors will receive notification of the assignment. Among others, the insolvency of SG constitutes an event of default.

According to French law, OF holders and other privileged parties have a priority claim over all the assets of the SCF. In the event of an SCF's bankruptcy, principal and interest payments to the non-privileged creditors will cease until the privileged resources are fully redeemed; these will not be accelerated but will remain payable when due. In addition, the law prohibits a parent company's bankruptcy from being extended to the SCF. In Fitch's opinion, the asset segregation in the French OF law is very strong. Furthermore, Fitch has analysed the four following points:

Existence of Other Privileged Creditors

According to the French law on SCF, no other creditors will be paid until privileged creditors have been fully repaid. Preferential claims will also be given to swap counterparties whose swaps hedge the assets or the privileged debt, and they will therefore rank pari passu with OF holders. The management contract of the SCF also benefits from this privilege and costs related to the management, operation, collection and sale of the cover pool were modelled by Fitch in its cash flow analysis. The law clearly states that other priority creditors, such as tax authorities, will rank behind the privileged creditors.

Availability of Overcollateralisation (OC)

The OF law stipulates that the SCF assets must exceed the privileged liabilities at all times, without prescribing any minimum level of overcollateralisation. The legal opinion received by Fitch supports the view that the transfer of the assets is valid and the collateral, including OC, will be available for the issuer at the time of a default by SG, provided the assets have been properly identified.

SG SCF commits itself to a minimum coverage ratio of 105% for public-sector collateral (see *Minimum Coverage Ratio* in Appendix 2 for the calculation of the ratio, which includes a weighting of the underlying assets). Should a new type of collateral be added, a new minimum coverage ratio for the new type of collateral will apply.

Set-Off Risk

Since SG does not take deposits for public sector entities, the risk of borrowers' potential right of set-off does not currently apply to SG SCF. Should new types of assets be included in the cover pool, Fitch will undertake a new analysis of the Asset Segregation section.

Commingling Risk

In the event of SG's insolvency, the issuer would face a short-term shortfall of funds. Indeed, it would not receive any further payment from SG under the secured loan and would only access instalments paid by the final debtors after they had been notified of the transfer of their debt to SG SCF. To bridge this liquidity shortfall, SG must, upon being downgraded below 'F1', fund a cash reserve up to an amount equal to scheduled interest and principal payments received from the collateral during the two calendar months following such downgrade.

Liquidity Gaps (30%)

As with most covered bonds, the maturity of the cover assets does not match the bullet maturities of the OFs. This can create a need for liquidity, especially just before the maturity of an OF, notably in a wind-down situation. In this case, the substitute manager may not have time to raise enough funding against the cover pool to repay the covered bonds on a timely basis.

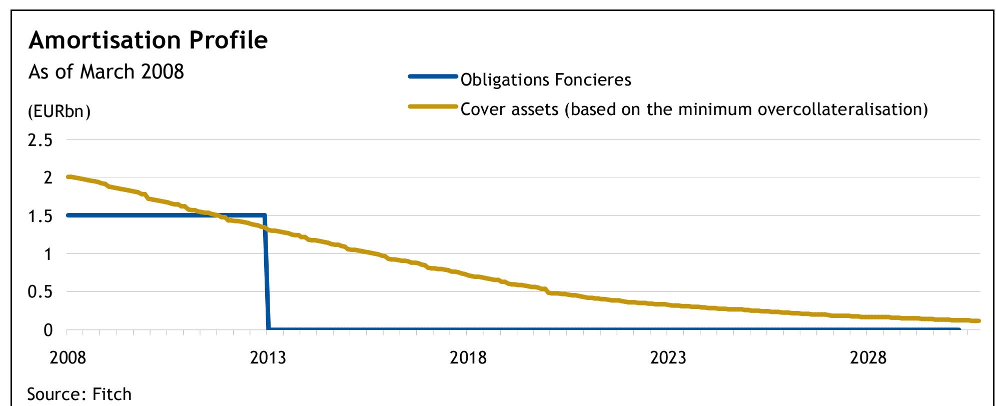
According to its internal management guidelines, the SCF will make sure that sufficient liquidity is available at all times to meet repayments under its privileged debt for the following 180 business days. This will be done either by benefiting from a liquidity facility with a counterparty rated 'F1+', or by maintaining sufficient liquid assets or assets that can be used for repurchased agreement ('repo') with the European Central Bank (ECB).

From day one, SG will provide a EUR 5bn liquidity facility to its subsidiary in order to cover the payments of principal becoming due within 180 business days from the OF maturity (90 business days for an OF redeemable in instalments). The liquidity facility is a 364 days commitment, renewable at the discretion of SG. Should SG not renew the liquidity facility within 10 business days from its termination date, the issuer would be entitled to make a drawdown equal to EUR5bn reduced by any amounts previously drawn and not yet repaid. The liquidity facility does not benefit from the privilege and will be subordinated to the OFs. Also, if the liquidity provider is downgraded below 'F1+', it will have to find a guarantor rated 'F1+', a replacement liquidity provider or post an amount of cash sufficient to meet principal payments due at the next upcoming repayment date.

In addition, if SG's short-term rating is below 'F1+', the secured loan must be prepaid 180 business days ahead of its initial maturity, unless the SCF and SG agree otherwise. In the case of prepayment of the secured loan, the losses of interests that would arise for the SCF must be compensated by SG. Unless the SCF agrees that the secured loan be not prepaid, a failure from SG to prepay the secured loan will constitute an event of default and lead to the notification of the borrowers to pay the SCF directly. The SCF would then have 180 business days to raise liquidity from the cover pool in order to meet the future payments on its privileged debt. In its liquidity gaps assessment, Fitch has assumed that it would be possible during that period to refinance plain vanilla loans to French local authorities. In addition, all the assets in the pool are currently eligible for repo transactions with the ECB.

The SCF's liquidity rules assume that the collateral assets given under article L431-7-3 could be used for repo transactions by the SCF (if eligible for such transactions), even before enforcement of the collateral security. However, though theoretically possible, entering into repo agreement of assets given as security has never been tested and the implementation of such repo transaction would require the intervention of third parties. It would also be cumbersome in practice to use this technique, as a lot of assets would need to be mobilised in order to meet a payment on an OF. Therefore, even if all the cover pool is currently eligible for ECB repo transactions, Fitch takes greater comfort from the existence of the liquidity facility to face short-term liquidity needs.

Fitch will undertake a new analysis of the *Liquidity Gaps* section when new types of assets are included in the cover pool.



Alternative Management (15%)

This section addresses the risk that the transition to an alternative manager does not occur sufficiently smoothly to ensure all payments are made in the event of a default of the incumbent manager. This could happen if the alternative manager were appointed too late or if the IT systems of the SCF's manager made it too difficult for the new manager to retrieve the necessary information about the cover pool, the OFs and the privileged swaps.

Table 1: Cover Pool Summary
(As of February 2008)

Pool characteristics	
Outstanding principal balance (EURbn)	2.01
Average current loan per borrower (EURm)	19.3
Number of assets	158
Number of debtors	104
WA remaining maturity of assets (years)	9
Maximum exposure (%)	6.3
Top ten exposure (%)	38.4
Total amount of publicly-rated assets (%)	22.5
Exposure breakdown (%)	
Municipalities-related	40.9
Département	26.3
Region	17.4
Hospital	13.7
Other	1.7
Performing loans (%)	100
Fixed rate loans (%)	78

Source: Fitch

An SCF must subcontract all of its operational tasks to a third-party credit institution, and it is the task of the board members of the SCF to renew or replace the management contract. Compared with other covered bonds frameworks, the French law on OF does not explicitly provide for the replacement of the original manager; rather it specifies that, in case the institution managing the SCF becomes bankrupt, the management contract can be revoked immediately (unlike in the normal French bankruptcy law whereby the insolvency administrator of the managing institution could insist on the management contract staying in place). Generally, the French banking authorities have the power to nominate a provisional administrator in the event of a breach of the duties of the incumbent management of any regulated financial institution; however, there is no certainty that this would occur in time to prevent a default under the OFs. The role of the cover pool monitor (le contrôleur spécifique) is not designed to fulfil any management function. Nevertheless, the fact that the assets backing the covered bonds are already segregated in a separate legal entity, rather than being part of the balance sheet of a larger institution, should facilitate the task of an alternative manager.
SG has agreed to carry out all operational and administrative tasks on behalf of SG SCF in exchange of a fee, and a new manager will have to be found should SG default. The likely scenario in this case is that a new manager will be appointed by the board of SG SCF. The IT systems of SG would be used and presumably the same employees would still work for SG SCF during the transition period necessary to migrate the systems to the IT systems of the new manager.

Consequently, in practice, a smooth transition to an alternative manager is also dependent on the quality of the issuer’s systems.

Loans will be identified through their unique number in SG’s back-office system. After their suitability for OF funding has been checked, all eligible loans will be individually flagged via an off-the-shelf software solution. This process provides evidence of transferred assets by way of security and allows the monitoring of SG SCF cover pool.

On or before each settlement dates, SG’s back-office systems generate settlement instructions which ensure that the incoming cash flows from debtor accounts can be identified and segregated on a line-by-line basis.

Fitch is comfortable that the systems can clearly differentiate SG SCF’s cover pool and privileged liabilities, including swaps, from the assets and liabilities of SG. Cash flows can be extracted and future payments from the cover assets are easy to model, as well as those due on the privileged debt.

Fitch will undertake a new review of the IT systems when new asset types are included in the cover pool and, if needed, will amend the D-Factor accordingly.

Covered Bonds Oversight (5%)

The Commission Bancaire exercises a specific supervision of SCF on top of the usual banking supervision to which credit institutions in France are already subject (see *Appendix 2*). In addition, a specific controller, selected from the list of certified auditors and approved by the Commission Bancaire, is responsible for ensuring that the SCF complies with the rules established by the law, the decrees and the Commission Bancaire’s instructions on overcollateralisation, asset and liability management, the eligibility of the assets, the valuation of the underlying assets and risk monitoring. The specific controller reports quarterly to the management board of the SCF and annually to the Commission Bancaire. The controller is liable for any errors made in the performance of his duties.

Fitch regards the French regulator’s willingness to monitor and enhance the safety of OF for the benefit of OF investors as being less pronounced compared with countries where the regulations are more prescriptive and where the covered bonds market is more important to the overall funding of domestic banks. In particular,

the content and frequency of the reporting required by the Commission Bancaire is generally less substantive than in other countries, where a legislative framework supports the rights of covered bond holders.

Overall, SG SCF has been assigned a D-Factor of 10.9% for its OFs. Combined with the issuer's own default likelihood, this D-Factor leads to a maximum achievable rating for the OFs on a probability of default basis of 'AAA'. Fitch has tested whether the minimum 5% OC level that will be maintained by the issuer passes 'AAA' stress levels in both the agency's static default model and its covered bonds cash flow model (See *Cash Flow Analysis* below).

Cover Pool

Portfolio Description

The French Constitution defines local authorities ("collectivités locales", which refers to municipalities, departments and regions) as administrative structures independent of the national administration, which take care of residents living in a given land area. France is divided into 26 regions, 100 departments and more than 36,000 municipalities ("communes"). In addition to these three types of local authorities, the administration has created municipal groupings, which do not have the same status. Local governments in France have administrative autonomy, their own responsibilities, executive powers and, since 2003, financial autonomy.

SG SCF's loan to SG is exclusively secured against French public-sector exposures, either to public-sector entities (including states, regional and local authorities and public-sector bodies such as hospitals) or fully guaranteed by such entities. As at 15 February 2008, the underlying cover pool amounted to approximately EUR2bn and consisted of 158 loans granted by SG to 104 obligors. The current pool is broken down as follows: municipalities-related (40.9%), including also the inter-municipal groupings (EPCI as per the French appellation); départements (26.3%); hospitals (13.7%); regions (17.4%); and others (1.7%).

Only a few entities benefit from a public rating (from A+ to AAA), representing 22.5% of the total exposure. On average, French départements and regions tend to have a better credit quality than the average rating of French municipalities. This has translated in practice with the fact that no départments or regions have ever defaulted, and the few such entities that are rated benefit from a very high rating. As for the French municipalities, very few defaults have occurred and the major players in French public-sector financing have never experienced any losses of principal. A lender could lose penalty fees on delinquent borrowers and may lose some interest payments, but the debt is in practice rescheduled and the full principal recovered. Lastly, public hospitals can be considered to be close to sovereign risk; indeed, as stated in Fitch's special report on French hospitals "Post-reform solvency public hospitals" dated 7 December 2006, French public hospitals would receive generally high ratings, thanks to the role of the Central Government in the very protective supervision and funding system public hospitals have enjoyed so far.

For the above reasons, the credit quality of the cover pool is high.

Checking the internal rating of SG for the cover pool assets, 83% fall in the best category (internal rating of 1). This is also explained by the fact that the assets are exposures to rather large entities that tend to have a better credit quality.

The top 10 obligors represent 38.4% of the cover pool, the highest exposure in the portfolio being 6.3%. Also, about 48% of the exposures are concentrated into two geographical areas (the Paris and Rhône-Alpes areas), whose economies are the two most dynamic among French regions. Fitch has taken into account the concentration risk of the cover pool in its 'AAA' scenario by testing that the OFs can withstand the default of the four most concentrated obligors. Fitch also modelled that the defaulted assets were re-performing after a period of lost interests, and that 100% of principal were eventually recovered.

Cash Flow Analysis

On an ongoing basis, SG SCF will issue further OFs, subject to compliance with the minimum coverage ratio (see Appendix 2). Fitch's cash flow analysis is conducted in a wind-down scenario where, following an SG event of default, borrowers will be notified of the transfer and no new loan would enter the cover pool to replace those that have matured or are non-performing; further issuances of OFs would be suspended.

Fitch's covered bonds cash flow model tests whether the cover assets, under the management of a third party, would be sufficient to service interest and principal payments on the covered bonds in a full and timely manner. The agency has also taken into account the additional credit enhancement provided by the issuer's share capital of EUR50m, the level of which SG intends to maintain. The expected cash flows from the underlying assets were modified to reflect prepayment, delinquency, default and recovery assumptions in a 'AAA' scenario. In addition, the cost of replacing SG as administrator and servicer was modelled. The potential negative carry arising from holding funds at sub-Euribor rates in the issuer's account was stressed. Furthermore, liquidity and market risks arising from the different profiles of the stressed assets and privileged liabilities were simulated. The projected stressed cash flows were used, among others, to assess the price at which, in a particularly severe economic environment, the pool could be sold or refinanced. It is of note that the SCF could also borrow money from other institutions, as it is a société financière.

Maturity Mismatches

Upon enforcement of the collateral security, the issuer may need to raise funds to meet payments due under the covered bonds. Indeed, the amortisation profile of the assets typically will not match those of the bullet covered bonds, as is generally the case for European covered bonds. At the closing date, the WA residual maturity of outstanding OFs will be five years, shorter than the corresponding figure for the cover pool (nine years, assuming 0% prepayments).

Funds could be raised against the assets by selling parts of the cover pool. The ability to find a buyer within the specified timeframe will depend on a number of factors, including: (i) buyer appetite given the economic environment, which may not be favourable if SG has suffered significant downgrades, has defaulted, or incurred losses in its public entities lending business; and (ii) the size of the portfolio that needs to be realised.

In calculating the potential purchase price for loan sales, Fitch has assumed that any purchaser will discount 'AAA' levels of losses in the portfolio. Fitch has further assumed that a purchaser would perform a discount analysis using a rate at a certain margin over Euribor that equates to its cost of funding the purchase. Given the lack of a precedent, there is no guarantee that portfolios could be realised in any prevailing economic environment.

Hedging

At the start of the programme, the issuer will not be exposed to any interest rate or currency risk, since SG SCF will enter into swaps in order to match the payments from SG under the secured loan with the payments due under the privileged liabilities. However, upon enforcement of the collateral security, the issuer's assets will consist of those public loans and substitute assets that form part of the underlying cover pool. At this time, the issuer may be exposed to interest rate risk arising from the disparity in indexation between the assets and the covered bonds. Similarly, foreign exchange risk may arise as a consequence of mismatches in the relevant currencies of denomination (although currently, all cover assets and covered bonds are denominated in euros).

To address these risks, the transaction documents require a series of swaps to be entered into by the issuer, at the cost of SG, by the time SG is downgraded below ‘F1+’. Notably, provisions are in place to ensure the cover assets are swapped into floating rate, to avoid market value losses if fixed rate loans have to be sold in an adverse interest rate scenario. Failure by SG to enter into those swaps within 30 days of its downgrade below ‘F1+’ will constitute an event of default under the secured loan. Also, mirror swaps will be put in place between SG and the SCF to ensure that SG will retain the benefit of the swaps before the collateral proceeds are directed to the SCF.

The asset swaps (but not the mirror swaps) will benefit from the privilege under and will rank pari passu with the OFs. They will be agreed with one-sided collateral agreement whereby the cover pool does not post collateral. Collateral posted will not be part of the OC calculation.

If at any time a swap counterparty is downgraded below ‘A/F1’ for the interest rate or currency swaps, language will be in place whereby the relevant obligations will either be guaranteed by a third party with the requisite rating, transferred to a counterparty with a rating commensurate with Fitch’s criteria or collateralised to prevent a downgrade of the covered bonds in accordance with the Fitch hedging criteria (see report "Counterparty Risk in Structured Finance Transactions: Hedge Criteria”, *dated 1 August 2007*).

Margin under the Swaps

The interest and currency mismatches between the collateral assets and the secured loan are hedged by SG according to the current practice of the group. However, at the time SG is downgraded below ‘F1+’, when the SCF will have to hedge the mismatches between the collateral assets and the covered bonds, SG will ensure that a minimum excess spread between the assets and OFs will be left for the SCF.

Overcollateralisation

The coverage ratio of privileged liabilities by cover assets must be published twice a year. The specific controller must check that the coverage ratio is above 100% at all times. The specific controller ensures the compliance with this rule for each quarterly issuance programme.

Before enforcement of the collateral assets, the only source of credit enhancement available to OF investors will be the equity, which is currently invested with SG. Following enforcement, both the equity and the OC resulting from the minimum coverage ratio will constitute credit enhancement. In practice, SG commits to a minimum OC of 5% at all times for public-sector collateral (see Appendix 2). The minimum OC will be adjusted when new asset types are added to the cover pool. The coverage ratio will be monitored in SG’s systems on a monthly basis.

Conclusion

SG SCF’s IDR of ‘AA-’ forms the floor for the rating of SG SCF covered bonds on a probability of default basis. A D-Factor of 10.9% enables this rating to reach ‘AAA’ on a probability of default basis (see *Appendix 3*). In addition, Fitch’s stressed asset and cash flow analysis shows that the minimum OC of 5% sustains timely payment of OFs in a ‘AAA’ scenario.

Due to the dynamic nature of the cover pool and the covered bonds, Fitch will periodically review the key characteristics of the cover assets and perform its cash flow analysis to assess whether the OC provides a level of protection against identified risks commensurate with the rating of the OFs issued by SG SCF. Cover pool and OFs information will be displayed on Fitch SMART covered bonds surveillance tool (available on www.fitchresearch.com), and updated on a regular basis.

Appendix 1

Main Characteristics of French Covered Bonds (Obligations Foncières)

Main Characteristics of French Covered Bonds (Obligations Foncières)

Code Monétaire et Financier (Articles L515-13 to L515-33 and R515-2 to R515-14) and regulations from the banking authority.

Issuers	The issuer can only be a société de crédit foncier (SCF). This is a credit institution with the status of a finance company, ie it is not allowed to take deposits like a fully fledged bank. The exclusive purpose of an SCF is to grant or acquire real estate loans, loans to public entities and securities, and to finance these assets either with privileged bonds known as obligations foncières (or other resources, whose contracts mention the privilege), or non-privileged resources. SCFs are forbidden to hold equity interests in other companies.
Supervision	SCFs are under the supervision and control of the French Banking Authority, the Commission Bancaire. The SCF must send to the Commission Bancaire an annual report relating the performance of its assets and its interest rate exposure. This must be published in the Bulletins des Annonces Légales Obligatoires (BALO) within 45 days after the SCF's accounts have been approved by the relevant body. The Commission Bancaire also sets criteria for the calculation of the coverage ratio and checks its value twice a year. It gives its agreement for the appointment of a specific controller and can dismiss him.
Real estate collateral	Eligible loans can be: • Secured by a first-ranking mortgage or equivalent security interest. Loans can be either for residential or commercial purposes. • Residential loans guaranteed by a credit institution or an insurance company that is not part of the SCF's group. The guarantor must be a credit institution or an insurance company with minimum share capital of EUR12 million. The total amount of all guaranteed loans must not exceed 35% of the SCF's total assets (this was increased from 20% in 2007). The underlying assets must be located within the European Union ("EU") or the European Economic Area ("EEA") or countries benefiting from the highest rating grade by an agency approved by the Commission Bancaire. Their value is determined conservatively. Since 2007, Mortgage Promissory Notes (Billets Hypothécaires) can also be included for up to 10% of the pool, as long as the underlying loans comply with the above rules.
Loan-to-value limits for Real estate	The residential loans can be financed by privileged debt only up to a Loan-To-Value (LTV) limit of 80%. This rule also applies to loans backing securitisation tranches that are on the SCF's balance sheet. In that case, a look through analysis must be done when the tranche is issued or when it is purchased by the SCF. The above LTV limit can be increased to 100% if the loan carries a guarantee from the Fonds de Garantie à l'Accession Sociale à la Propriété (FGAS), or if the portion exceeding the required minimum ratio is covered by a guarantee from a credit institution (as defined in the preceding section) or a public entity.
Real estate valuation	• Must be a clear and transparent professional evaluation. It can be based on the transaction's total cost if the cost is less than EUR360,000 and the value less than EUR450,000. The valuation must be updated regularly, according to the type of asset. • The appraiser must be independent of the origination services of the original mortgage lender. • The appraisal method must be published once a year, together with comments from the specific controller.
Public sector collateral	Public sector collateral can be: • Exposures to states, regional and local authorities, or public entities within the EEA, the EU or countries benefiting from the highest rating grade by an agency approved by the Commission Bancaire. • Exposures to development banks or international organisations benefiting from the highest rating grade. • Exposures to regional and local authorities or public entities benefiting from the second highest rating grade by an agency approved by the Commission Bancaire. These assets cannot exceed 20% of the total OFs outstanding. Debt deriving from leasing contracts, which a French public entity has entered into as a lessee, is also eligible.
Eligible securities	Senior units issued by Fonds Communs de Créances (FCC) or similar asset-backed securities under the laws of EEA or EU countries are eligible among the assets of an SCF, provided that at least 90% of the collateral consists of loans similar to those described above. They must benefit from the highest rating grade assigned by an agency approved by the Commission Bancaire.
Replacement collateral	These are either assets that qualify for sale and repurchase operations with the ECB, or consist of loans to or debt issued by credit institutions with a maturity of less than one year. These assets cannot exceed 15% of the total OFs outstanding. Excess cash must be invested in replacement assets.

Main Characteristics of French Covered Bonds (Obligations Foncières)

Code Monétaire et Financier (Articles L515-13 to L515-32), implementing decrees and regulations from the banking authority

Register	The issuer must maintain an up-to-date register of all the loans that are on its balance sheet, together with the associated guarantees.
Privilege	• The obligations foncières enjoy a preferential claim over all the assets of the SCF, including any hedging instruments. In addition, any expenses due on the operations will rank pari passu with the Obligations Foncières. In the event of the insolvency of an SCF (règlement amiable, redressement judiciaire or liquidation judiciaire): • The obligations foncières (interest and principal) are redeemed at their due date (no acceleration of payments). No other creditors can claim nor will they receive payments (including interest payments) until debt owed to the holders of obligations foncières has been fully paid.
Swaps	SCFs can enter into hedging contracts that also benefit from the privilege if the hedge covers either the assets or the obligations foncières. If they hedge non-privileged resources, they do not have the benefit of the statutory privilege.
Insolvency	The legal winding-up (redressement judiciaire or liquidation judiciaire) of the shareholders of an SCF will not trigger the SCF's own liquidation. In the event of the legal wind-up of the servicer (redressement judiciaire or liquidation judiciaire) under contract to the SCF, the contract can be immediately revoked.
Overcollateralisation	The ratio of assets to privileged liabilities must at all times be greater than 1.The ratio must be published twice a year (30 June and 31 December). The denominator of the ratio is the total amount of privileged resources (including the sums due to preferential hedging instruments). The numerator of the ratio is the sum of the assets weighted as listed below: • Real-estate guaranteed loans: o 100% if the guarantor's rating is at least 'AA-(AA minus)' by one of the three recognised rating agencies; o 50% if the guarantor is rated between 'A-(A minus)' and 'A+'; o 0% in all other cases. • Senior notes of securitisations: o 100% if the notes are rated at least 'AA-(AA minus)'; o 50% if the notes are rated between 'A-(A minus)' and 'A+'; o 0% in all other cases. • The ratings considered above are the ratings that were outstanding at the time the asset enters into the SCF. • Liquid and risk-free assets: 100% (changed in 2007 from 95%). • Repossessed real estate: 50%. • Any other eligible assets (including mortgage loans and loans to public sector entities): 100%.
ALM and servicing	Loans servicing and ALM must be contracted out to a credit institution acting on behalf of and for the account of the SCF, which will also represent it in legal proceedings. Debtors must be informed of a change of servicer by post.
Assignment of loans	The assignment of loans to an SCF takes place by means of a bordereau signed by the parties, and the transfer (including any security relating to the loans) takes effect and becomes enforceable against third parties at the signing date of the bordereau.
Specific controller	A specific controller must be appointed by the SCF's management, with agreement of the Commission Bancaire. He is responsible for an SCF's compliance with legal requirements. He will verify that: • The coverage ratio is compliant with the law. In that respect, he checks the quarterly issuance programme of the SCF and approves any new issuance of more than EUR 500m. • He must comment on the appraisal method used by the SCF. This is done annually. The appraisal and the comments are published. • He must check that the duration mismatches are not excessive. He checks the eligibility of the assets in the pool. The specific controller must send an annual report to the Commission Bancaire and to the board of directors of the SCF. He is liable for any mistake he may make in the performance of his duties.

Source: Fitch

Appendix 2

Minimum Coverage Ratio

The value of the assets shall be at least equal to the financial exposure.

On each calculation date, the calculation agent will determine the financial exposure, which is defined as the aggregated amount of the secured advances granted to SG, multiplied by a factor that will be equal to 105% as long as SG is still 'F1'. In case SG is downgraded below 'F1' the coverage ratio will be increased with the view to maintain the ratings on the OFs. The amount of OFs issued will always match the value of the secured advances

On each calculation date, the value of the underlying assets will also be determined, according to the following rules as defined in SG SCF's internal management rules:

- 100% of the public sector loans (directly granted to or guaranteed by a public entity);
- the percentage corresponding to the share fully guaranteed by Coface, the French export credit agency. (No loan guaranteed by Coface is included in the pool at inception of the programme); and
- a percentage to be defined from time-to-time for all other receivables.

Appendix 3

Summary of Fitch Covered Bonds Rating Criteria

Fitch Ratings began applying its new rating methodology for covered bonds in February 2007. The ratings are based on probabilities of default and recovery expectations.

Fitch introduced a new concept, the discontinuity factor (D-Factor), as a measure of the likelihood that the covered bonds would suffer a default as a direct result of the default of their ultimate debtor. D-Factors range from 0% (standing for a perfect continuity of payments) to 100% (default probability of the covered bonds is equated to that of the issuer). The D-Factor is a weighted score of the following system- and issuer-specific elements: segregation of the cover pool (50%); solutions to overcome liquidity gaps upon an issuer default (30%); feasibility of the transition to an alternative cover pool management (15%); role of the supervisory authority (5%).

The combination of the issuer default rating and the D-Factor translates into a maximum rating that the covered bonds can achieve on a probability of default basis, provided overcollateralisation between the cover assets and the covered bonds can sustain the corresponding stress scenario. This is tested in Fitch's cash flow model, which compares the stressed assets and liability profiles in a wind-down scenario. Stresses includes credit losses on the assets, the cost of bridging maturity mismatches by disposing of the assets or investing excess cash, adverse variation of interest and currency rates, and expenses of a third-party manager.

Discontinuity Factor Matrix

The assigned rating will also incorporate the effect of stressed recoveries from the cover pool in the event that the covered bonds default. Depending on the assumed recovery percentage, an uplift of up to two notches at investment grade level can be assigned.

Maximum Achievable Rating Based on the Covered Bonds' Probability of Default

Issuer Default Rating	D-Factors 100%	50%	35%	20%	15%	10.9%	10%	5%	0%
AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA	AA	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA
AA-	AA-	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AAA
A+	A+	AA-	AA	AA+	AA+	AAA	AAA	AAA	AAA
A	A	AA-	AA	AA+	AA+	AAA	AAA	AAA	AAA
A-	A-	A+	AA-	AA	AA+	AA+	AA+	AAA	AAA
BBB+	BBB+	A+	AA-	AA	AA	AA+	AA+	AAA	AAA
BBB	BBB	A-	A	AA-	AA-	AA	AA	AA+	AAA
BBB-	BBB-	BBB	BBB+	A	A+	AA-	AA-	AA	AAA
BB+	BB+	BBB-	BBB	BBB+	A-	A	A	AA-	AAA
BB	BB	BBB-	BBB-	BBB	BBB+	A-	A-	AA-	AAA
BB-	BB-	BB+	BBB-	BBB	BBB	BBB+	BBB+	A	AAA
B+	B+	BB	BB+	BBB-	BBB	BBB	BBB	A-	AAA
B	B	BB-	BB	BBB-	BBB-	BBB	BBB	BBB+	AAA
B-	B-	BB-	BB	BB+	BBB-	BBB-	BBB-	BBB+	AAA
CCC+/CCC	CCC	B+	BB-	BB	BB+	BBB-	BBB-	BBB	AAA

Source: Fitch

Benefit for Recoveries

Recovery range	Maximum notching	
	Investment grade	Non-investment grade
91-100	+2	+3
71-90	+1	+2
51-70	+1	+1
31-50	-	-
11-30	-1	-1
0-10	-1/-2	-2/-3

Source: Fitch

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