CLIFFORD CHANCE

Briefing note

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Financing real economy: incentivising insurers to invest in Debt Funds

A decree of 2 August 2013 makes investment rules for French insurance companies more flexible in order to facilitate direct and indirect loans to the "real" economy. This highly anticipated reform, expected however to be replaced by Solvency II rules around 2016-2017, opens up new opportunities for the French insurance sector to invest in debt funds but with some limitations.

Since the creation of the first French private equity investment vehicle named FCPR in 1983, the allocation of investments by French institutional investors into French private equity has slowly but continuously increased. The combination of the 2008 credit crunch and the strict regulations applicable so far to French insurance companies, have had a significant adverse impact on the financing of medium-sized enterprises (SMEs) and mid-caps in France which has dramatically dropped.

The French government has thus decided to adapt the current accounting and prudential framework applying to insurers in order to make initiatives such as the Novo Funds, whose launch was officially announced last July by the French Ministry of Economy, possible.

Previous unfavourable regulatory framework

Although in theory insurance companies are granted derogation from the banking monopoly, in practice to date they have not succeeded in their attempts to finance the real economy because of a strict regulatory framework combined with an equally strict interpretation from the French insurance supervisor (*Autorité de contrôle prudentiel et de résolution* ACPR), notably concerning the liquidity of listed bonds issued by securitisation vehicles.

The decree n° 2013-717 of 2 August 2013 (the " **Decree**"), which amends the investment rules contained in the French insurance code (the "**Insurance Code**") expands the range of assets with which insurance companies can cover their technical provisions, to include three new categories for investment, made either directly or through unlisted debt funds, in loans granted to non-listed companies or public authorities.

New unlisted funds include:

- So-called "*Fonds de prêts à l'économie"* or loan-to-real economy funds ("**FPEs**"); and
- Public Sector and Real Estate funds ("**PSRE Funds**").

In addition, unlisted securitisation funds created in the form of French FCTs or STs have now become eligible for regulated investments by insurance companies.

Finally, insurers will also be able to directly invest in those loans to the real economy (the same as those in which FPEs may invest), subject to the prior approval of an investment program from the ACPR. This Client Briefing will focus on debt funds.

New debt funds aimed to finance "real economy" (FPEs)

FPEs are funds that may take the form of either (i) securitisation organisms (*i.e.* mutual debt funds ("**FCTs**") or securitisation companies ("**STs**")); or (ii) specialised professional investment funds ("**FIPSs**") which are a type of alternative investment fund similar to British limited partnerships in terms of flexibility. Both may be structured as umbrella funds with segregated compartments and must be managed by a French management company licensed by the French financial market supervisor (the AMF).

The assets of such FPEs must exclusively consist of debt instruments (loans or bonds including potentially convertible or redeemable bonds or bonds with warrants attached), which must be issued by:

- regional authorities or public sector entities; or
- private legal entities whose main business activities are of commercial, industrial, agricultural or real estate nature,

in both cases established or having their registered office in the EU.

Note that financial sector entities as well as collective investment schemes (CIS) are excluded from the scope of assets eligible to FPEs. This means that, in the context of infrastructure/PPP or asset financing transactions, debt instruments of special purpose entities whose main purpose is to finance or refinance the projects or the assets do not constitute eligible assets of an FPE. Likewise, debt instruments of French REITs or other real estate investment vehicles, such as SIICs and OPCIs, are excluded. However, such restriction should not be a problem in the context of commercial real estate finance deals, as the facility is usually extended to a special purpose company having a regular corporate status (*i.e*. it is not *per se* a CIS), such as SCIs or SAs or SASs, and owning the asset. However, it will be necessary to demonstrate that such company carries out a genuine commercial activity (*e.g*. renting the asset, etc.).

Finally, because they do not run a commercial or industrial activity in their own right, loans to or bonds issued by pure holding companies (such as NewCos or HoldCos used in buyout transactions) are not, on the face of such provision, eligible either. In practice, this means that FPEs will not be eligible to participate in structured buyout investments but would only be eligible to participate in direct investments, as venture or growth capital debt funds usually do.

Additionally when the FPE takes the form of a securitisation organism, it may not acquire assets with a maturity falling after that of the units or bonds issued by it to its investors. Further, its ramp up or investment period cannot exceed 3 years from its creation. In exchange for such requirements, such funds, which are meant to meet insurers' long term investment needs, should benefit from a more favorable accounting treatment than that enjoyed by other FPEs, which are subject to the provisions of article R. 332-20 of the Insurance Code.

An FPE may issue bonds, units or shares, provided that they are denominated in Euro. Other currencies are excluded and an FPE may not enter into any hedging arrangements other than in relation to interest rate or basis hedges. Additionally, in anticipation of future requirements which will be imposed by the forthcoming Solvency II directive on insurers investing in securitisation positions (*i.e.* repackaged loans), the credit risk resulting from the insurer's investment in the FPE may not be economically tranched although a very residual portion of the FPE's interests (to be determined further by Ministerial Order) may be represented by a distinct class of shares, bonds or units, in order to allow managers of FPEs to also invest in the FPE. Finally, a FPE may not be leveraged.

The FPE's management company shall produce and send to the insurers investing in the fund an annual report on the management thereof and on the monitoring of the credit exposures comprised in the asset portfolio (including on a line by line basis).

Insurers may invest up to 5% of their regulated liabilities in FPEs. This is meant to represent a Euro 90 billion investment capacity for the French insurance industry.

Public Sector and Real Estate funds (PSRE Funds)

Insurers may now, indirectly through funds, invest in those mortgage loans (meeting certain criteria) and loans to public sector entities or regional authorities that they were allowed to extend or purchase directly from their balance sheet.

For such purpose, a new type of eligible debt fund is created, in the form of a French securitisation organism only. This new organism shares certain features with FPEs, namely:

- it may issue bonds, notes shares or units denominated in Euro (only);
- it may only purchase interest rate and basis hedges (in particular, it may not enter into currency hedges);
- its liabilities must not be tranched; and
- its management company must produce an annual management report, which includes information on the monitoring of the credit exposures comprised in the asset portfolio (including on a line by line basis).

Insurers may invest up to 10% of their regulated liabilities in PSRE Funds.

Private Debt Funds

It is worth noting that, following the Decree, investments in FCTs and STs issuing unlisted securities have become eligible for regulated investments by insurers. No specific conditions (*e.g*. similar to FPEs or PSRE Funds) are imposed by the Insurance Code, which makes it a very flexible structure that may be used as a fall-back solution for funds which do not meet the FPE and PSRE Fund criteria.

However, such investments fall into the so-called "garbage" ratio (i.e. 10% within the 65% bucket).

Listed Debt Funds

Listed debt funds (i.e. funds whose securities are listed on a EEA regulated market or an OECD securities market operating on an ongoing basis) organised in the form of a securitisation organism (i.e. an FCT or a ST) remain eligible to cover technical provisions of insurers, provided that they enjoy a proven liquidity as rigorously assessed by the ACPR. In addition, when the securities issued by such funds are admitted for trading on an EEA regulated market within the meaning of MiFID, the fund must issue a prospectus meeting the extensive requirements of the Prospectus Directive (which prove to be particularly burdensome for asset backed securities issued by the fund during the ramp up period).

In practice, this means that this kind of fund will be very rarely used (if not at all).

Summary of eligible debt funds

	Loan-to-Real Economy Funds ("FPEs")	Public Sector and Real Estate Debt Funds ("PSRE Funds")	Private Debt Funds	Listed Debt Funds
Eligibility bucket (art. R. 332-2 of the Insurance Code)	• §2 *Quater* • §7 *Quinquies*	§12 *Bis*	§6(b)	§2(b)
Legal form of the fund	• French securitisation vehicles, *i.e.* securitisation mutual funds (FCTs) and securitisation companies (STs) • French Specialised Professional Investment Funds (FIPSs)	FCTs and *STs*	FCTs and STs	• FCTs and STs • Foreign securitisation entities having a similar purpose
Eligible assets in which the fund may invest	Loans to, or debt securities issued by: • public sector entities (PSEs) or regional authorities • Commercial, industrial, agricultural or real estate companies Financial sector companies and collective investment funds (CIS) are excluded	• Loans to (or guaranteed by) States, PSEs or regional authorities • Loans to individuals or corporates secured by a 1st ranking mortgage on real estate assets or ships, with a LTV ratio not higher than 65%	No limitation	No limitation
Eligible countries of investment	European Union	OECD	No limitation	No limitation
Eligible securities issued by the fund	• Notes, units or shares issued by FCTs and STs • Fund units issued by SPIFs	Notes, units or shares	Notes, commercial paper notes, units or shares	Notes, units or shares
Issuance currency	Euro	Euro	No restriction	No restriction
Hedging	Only interest rate and basis hedges are allowed	Only interest rate and basis hedges are allowed	No restriction	No restriction

	Loan-to-Real Economy Funds ("FPEs")	Public Sector and Real Estate Debt Funds ("PSRE Funds")	Private Debt Funds	Listed Debt Funds
Investment diversification ratio	5%	10%	10% within the 65% ratio for all assets which are considered to be risky or are unlisted (also known as the "garbage" ratio)	No limit
Counterparty diversification ratio	1%	1%	1%	5%
Accounting treatment	• FCTs and STs: similar to art. R. 332-19 of the Insurance Code • FIPSs: art. R. 332-20 of the Insurance Code	Art. R. 332-20 of the Insurance Code	Art. R. 332-20 of the Insurance Code	Art. R. 332-19 of the Insurance Code, provided the securities issued by the fund are bonds or notes, are not index-linked and enjoy sufficient liquidity pursuant to the ACPR's doctrine
NAV calculation requirements	• Calculated by the management company on a quarterly basis • Certified annually by an Independent Expert	No specific requirement (but may be subject to AIFMD NAV requirements)	No specific requirement (but may be subject to AIFMD NAV requirements)	No specific requirement (but may be subject to AIFMD NAV requirements)
Tranching	Not allowed (but may issue subordinated units in a nominal amount to be specified by Ministerial Order)	Not allowed (but may issue subordinated units in a nominal amount to be specified by Ministerial Order)	No requirement (but tranching may affect Solvency II SCR calculation because the fund may fall under restrictions applying to "repackaged loans")	No requirement (but tranching may affect Solvency II SCR calculation because the fund may fall under restrictions applying to "repackaged loans"
Leverage and borrowing	Not allowed	Not allowed	Yes (no specific requirement, but Solvency II impact if leverage entails tranching)	Yes (no specific requirement, but Solvency II impact if leverage entails tranching)
Investor information	Specific annual management report on the monitoring of the underlying asset's credit risks	Specific annual management report on the monitoring of the underlying asset's credit risks	No specific requirement	No specific requirement

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