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Fiducie: How to strengthen secured financing

France's trust structure has proved its potential for risk mitigation in the higher risk-return part of the credit spectrum, and its potential for more vanilla or investment-grade financing is becoming clear. Benjamin Raillard of Solutions Fiducie explains

Since its creation in 2007, *fiducie*, the equivalent of the trust in French law, has been the pre-eminent tool used to hedge credit and execution risks in transactions of higher complexity. These have included restructuring, sub-investment grade corporate financing, high-beta real estate and distressed merger and acquisition transactions.

Its distinctive characteristic is the transfer of the legal property of an asset to a bankruptcy-remote estate managed by the trustee or *fiduciaire*. This characteristic is well codified in French law (in the *Code Civil*, *Code monétaire et Financier* and *Code de Commerce*), in accounting rules (*Comité des Normes Comptables*) and in fiscal regulations (*Code Général des Impôts*). The result is an onshore scheme that is both robust and compliant on all fronts.

As I detailed in a September 2018 article in *Private Debt Investor*, the hedging properties of *fiducie* can be directly compared to those of a credit default swap. Similarities between the two tools – a running fee and conditional cashflow triggered by a credit event and equal to the difference between par and the recovery rate – explain the *fiducie*'s attractiveness in terms of credit risk management.

This is in sharp contrast with a *nantissement*, *gage* or *hypothèque*, which are security packages that do not involve the transfer of property at the onset of the transaction and have consequently left painful souvenirs to creditors faced with French insolvency proceedings. The *fiducie* is establishing itself as a key hedging tool in transactions that probably could not be considered without a serious dose of protection, thereby providing lenders with a guarantee that they will rank first on the proceeds of the assets' liquidation.

Financing growth

As the *fiducie* has proved its potential as a risk-mitigation technique in the higher risk-return part of the credit spectrum, its potential for more vanilla or investment-grade financings is becoming clearer. As illustrated by the activity of Solutions Fiducie, which acts as both a *fiduciaire* and a manager of private debt funds, there has been an undoubted transition away from financing companies to get them out of difficulties towards financing growth.

The oversupply of capital chasing too few assets has translated into a lower appreciation of risk by many market participants. This does not bode well for creditors seeking to participate in deals while imposing robust security packages. This environment has so far limited the use of the *fiducie* in the most high-grade part of the market, where competition from private equity funds and related leveraged finance is high.

Offsetting the latter headwind, competition among qualified *fiduciaires* is offering participants a wider choice of expertise while bringing down the costs linked to the set-up and management of *fiducies*. The value of a *fiducie* can be easily appraised using the same methodology as for a CDS: by computing the expected loss of the contingent leg, which a product of the cumulative default probabilities and the recovery rate.

By all accounts, the actual cost of putting a *fiducie* in place is a fraction of the former, and this is causing increasing numbers of creditors to adopt the structure as the cost of de-risking becomes a fraction of credit spreads.

One sub-segment of the market where such a trend can be witnessed is real estate financing. Replacing the cumbersome and fallible hypothèque with a transfer of property company shares into a *fiducie* translates into a security package that is more robust, far more flexible and sometimes cheaper.

This approach is now widely accepted, considered as a prerequisite by many specialised originators, and several prominent banking groups are gradually incorporating it as a standard tool.

Small and medium-sized enterprises faced with expanding working capital requirements caused by sustained growth are also good candidates for the *fiducie*. The scheme helps in providing secured lending on terms – relating to the amount, cost, covenants and maturity – that are consistent with operational constraints and with the time needed by these entrepreneurs to invest in, rationalise and develop their businesses.

Because lending is being made possible in cases where there are more assets than cashflows, even the credit analysis methodology can be reviewed. It becomes less a of solvability review – essentially focused on the probability of default – and more of a broader analysis of risks, constraints and value creation. This involves shifting some of the emphasis to a broader approach based on the loss given default, which incorporates a controlled recovery rate. As risk analysis has broadened, so has the universe of SMEs eligible for financing, with obvious benefits for value and job creation.

Project finance is another space where the *fiducie* is an obvious tool. The structure can strengthen the link between an asset and its cashflows on the one side and its assigned funding on the other. By transferring shares of special purpose vehicles, intra-group loans and existing and future receivables linked to the project, a *fiducie* can be used to contractually organise a waterfall of secured creditors – even those at a remote distance from the underlying assets.

Part of the mainstream

Lastly, the use of *fiducies* to secure numerous types of corporate transactions – such as acquisitions, carve-outs, earnouts, vendor loans, escrows, golden shares and employees' pensions – is becoming mainstream practice, and is well understood and employed by legal and financial advisors.

The ability to secure a party or an aspect of the transaction is certainly contributing to better, clearer and faster deals. Moreover, the ability to transfer into a *fiducie* less tangible assets – such as brands, patents, rights, cashflows and websites – means the structure lends itself to applications that are largely growth-oriented.

The *fiducie* is becoming widespread, supporting growth in its countless applications in corporate finance and the financing of the real economy. Its use as a prevalent risk-mitigation technique is improving as contracts and prices stabilise towards more established market practices.

Ultimately, its breakthrough will take place in instances of sharp risk repricing. Should the global environment seize up and trigger an environment of less liquidity, higher default rates and negative rating migration, the *fiducie* will become the only security package worth having when the tide goes out. ■

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