France
Full Rating Report

Dexia Municipal Agency (DMA)

Obligations Foncières

Ratings

Covered Bonds	AAA

Key Data

	March 11
Cover assets (EURbn)	78.0
Covered bonds (EURbn)	62.2
Available overcollateralisation (OC, %)	23.4
Maximum committed OC (%)	5.0
Residual weighted average asset maturity (years)	8.7
Residual weighted average liability maturity (years)	6.3
D-factor (%)	17.9

Analysts

Solena Gloaguen
+44 20 3530 1126
solena.gloaguen@fitchratings.com

Vito Natale
+44 20 3530 1304
vito.natale@fitchratings.com

Related Research

Applicable Criteria

- *Covered Bonds Rating Criteria* (August 2010)
- *Covered Bond Counterparty Criteria* (March 2011)

Other Research

- *Assessment of Liquidity Risks in Covered Bonds* (August 2010)
- *Assessment of Liquidity Risks in Covered Bonds - Public-Sector Spread Assumptions Addendum* (December 2010)
- *Dexia Credit Local* (September 2009)
- *Dexia* (October 2010)

Rating Rationale

- The 'AAA' rating on Dexia Municipal Agency's (DMA, rated 'A+'/Stable) Obligations Foncières (OF) is based on DMA's Long-Term Issuer Default Rating (IDR) of 'A+' and a Discontinuity Factor (D-Factor) of 17.9% assigned to the OF programme. This combination enables the OF's rating to reach 'AA+' on a probability-of-default (PD) basis and 'AAA' when taking into account recovery given default, as the overcollateralisation (OC) between the cover pool and the covered bonds is sufficient to sustain these levels of stresses.
- The D-Factor of 17.9% is driven by Fitch Ratings' view on: (i) the effective segregation of DMA's cover assets in the event of a default of its parent company, Dexia Credit Local (DCL; 'A+'/Stable/'F1+') under French law; (ii) the likelihood of DMA covering liquidity gaps — arising after a potential default of its parent — with the liquid assets available on its balance sheet; (iii) the feasibility of a transition to an alternative manager, allowed by the level of sophistication of DMA's IT systems even though potentially delayed by the high number of assets situated across many countries; and (iv) the specific regulation from the Autorité de Contrôle Prudentiel (ACP) as regards Sociétés de Crédit Foncier (SCFs); (v) the 25% intra-group swap exposure of DMA, which could be difficult to replace and could impact DMA's liquidity in case of material termination costs being due to DCL; coupled with the lack of replacement provisions in some of the swap agreements, whose effect could amplify the credit risk exposure of DMA towards its counterparties.
- The OC supporting the 'AAA' rating is 14.5%. Fitch compares this to the lowest OC of the past 12 months, which is 20.7%, whereas the current OC is 23.4%.

Highlights

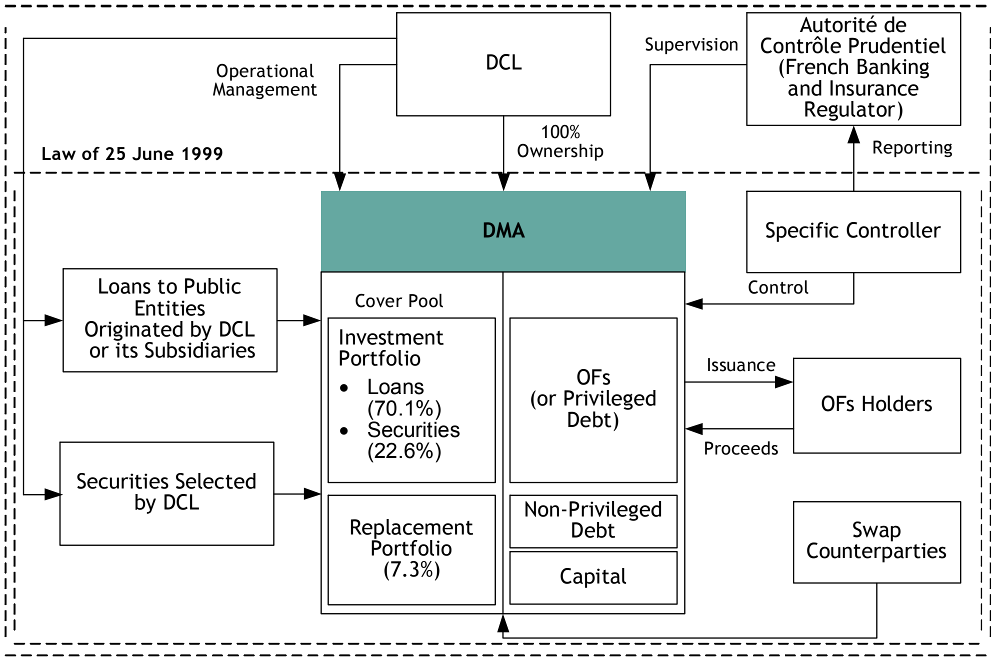
- The level of OC supporting a 'AAA' rating has increased since the last review. This is because, in a 'AAA' scenario, Fitch now applies an additional stress regarding the treatment of debtors located in non-'AAA' countries. In its analysis, Fitch has defaulted one non-'AAA' sovereign (9.7%) and assumed a significant increase in the default rate of exposures located in that country; the agency combines this with a low stressed recovery rate on these defaulted assets. Consequently, in a 'AAA' scenario, Fitch has calculated an expected credit loss of 10.6%.
- As of March 2011, DMA's assets consisted of 70.1% loans to public sector entities and 29.9% securities, with a total outstanding balance of EUR78.0bn. The geographic scope of DMA's assets has widened significantly with the increase in the proportion of Belgian assets since 2007. The main geographical exposures are now France (65.0% of debtors), Belgium (9.7%) and Italy (9.7%). The WA maturity of DMA's assets is 8.7 years, compared to 6.3 years for the OF. The assets and the OF are swapped into Eonia and are all swapped against euros.
- All else being equal, the covered bonds can remain rated 'AAA' as long as DMA's IDR is at least 'BBB+'.

Background

DMA is a wholly owned subsidiary of DCL, itself owned by Dexia ('A+'/Stable/'F1+'). It was set up in 1999 as an SCF. The SCF law prohibits a parent company's bankruptcy from being extended to the SCF and all OF holders and swap counterparties benefit from a privilege.

Figure 1

Diagram of Issuance by DMA



Source: Fitch

Overview

DCL is the French subsidiary of Dexia and specialises in public finance. The crisis in the financial markets severely affected DCL and in turn, Dexia, which was bailed out by the states of Belgium, France and Luxembourg. DCL has scaled down its former global activities and now focuses on the bank's core markets of France Belgium and Italy.

The bulk of DCL's activity relates to public finance, with most of its loans outstanding being granted to local authorities and other public sector bodies, such as hospitals and chambers of commerce.

DMA is licensed to issue OF, one form of French legislative covered bonds. Their issuance is governed by articles L515-13 to 515-33 of the Code Monétaire et Financier (the French Monetary Code), implemented on 25 June 1999 (and subsequently amended) and by the regulations of the ACP (see *Appendix 1*).

The Issuer

The sole purpose of DMA is to act as a refinancing vehicle for the public sector lending business of DCL by issuing OF under several issuance programmes: a A$5bn MTN, a EUR75bn EMTN and a USD10bn MTN. Given DMA's strong integration with, and strategic importance to, its sole parent, DCL, DMA's Long-Term IDR is the same as that of DCL. For the same reasons, DMA's Support Rating of '1' reflects Fitch's view that there is an extremely high probability that DMA would receive support from DCL, if necessary. Moreover, DCL has issued a public declaration of support for DMA and is committed to holding more than 95% of DMA's capital.

The SCF is constituted as a société anonyme (limited company) and is managed by a directoire (executive board) and a conseil de surveillance (supervisory board). DMA has no employees and subcontracts all operational tasks to DCL.

As of March 2011, DMA's outstanding OF represented 18.6% of DCL's total balance sheet.

Figure 2

Key Information

Issuer	Dexia municipal agency
Paying agent	Dexia BIL
Calculation agent	Dexia Bank
Asset monitor	FIDUS
Issuer's auditors	Mazars and Deloitte & Associés

Source: Fitch

> **Continuity Analysis**
> *D-Factor Components*
> - Asset segregation (45%)
> - Liquidity gaps (35%)
> - Alternative management (15%)
> - Covered bond oversight (5%)

Continuity Analysis

Covered bonds are assigned a D-Factor between 0% (no interruption of payment) and 100% (automatic interruption of payment), 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 DMA programme.

Asset Segregation (45%)

For its assessment of asset segregation, Fitch focuses on the legal framework that protects cover assets from the claims of unsecured creditors and ensures that covered bondholders have full priority access to such assets.

Under the French OF framework, the cover assets are segregated in a separate single-purpose legal entity — the SCF — rather than ring-fenced within the balance sheet of an institution with wider business objectives. As a result, Fitch's asset segregation analysis first addresses the validity of the transfer of assets from their originator to the SCF. Initially, assets were transferred by means of a bordereau. Since 2002, loan contracts originated by DCL mention that either DCL or DMA could act as a lender. As of today, 90% of the loans in the cover pool are directly originated in the name of DMA. For older contracts, the transfer via bordereau should not be challenged. Upon an insolvency of DCL, all borrowers will be notified of the transfer to DMA and this notification should not be challenged under the SCF law.

Bonds held by DMA are purchased at market price from DCL or on the market. The sale of the assets is conducted at a fair market value (subject to control by the auditors and the specific controller, see *Appendix 1*). According to the 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 be stopped until the privileged resources (mainly OF) 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, asset segregation within French OF law is very strong. Furthermore, Fitch has taken into account the five following points in the asset segregation's analysis.

Existence of Other Privileged Creditors

According to French SCF law, no other creditors will be paid until privileged creditors have been fully repaid. Preferential rights are given to counterparties of hedges for the assets or the privileged debt, which will therefore rank pari passu with OF-holders. The management contract of the SCF also benefits from this privilege. Costs related to the management and sale of cover assets 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 OC

Under the recent update of the OF law, the ratio of assets (subject to certain weighting) to liabilities must be at least 102% at all times. DMA commits itself to a minimum regulatory coverage ratio of 105%. The credit enhancement for the OF is constituted by equity, amounting to EUR1.3bn, by a non-privileged resource provided by DCL via a current account opened at DCL for the benefit of DMA (EUR10.0bn as of March 2011), and by a loan of EUR3.5bn. The current account agreement enables a permanent overdraft and medium-term drawings.

Commingling Risk

French debtors pay DMA and DCL via the local French treasury. Proceeds from this account are then swept daily to a unique bank account opened in the name of DCL.

This account is held with a bank outside the Dexia group and currently rated 'A+'/Stable/'F1+'. The majority of other debtors pay directly to this external account, except for payments from the intra-group securitisation tranches which are first directed to bank accounts held with some subsidiaries of DCL. All collections are then immediately redirected to DMA's bank account held at DCL and are used to reimburse the advances granted by DCL (except the OC level). The balance of this account is always negative as DMA makes drawings on it in order to finance the purchase of new assets. Drawings on this account are also a quick way to increase OC ahead of future issuances. As of March 2011, this current account had a debit balance of EUR10.0bn. Any cover pool collection is therefore immediately absorbed to pay down the overdraft. It is expected that as soon as DCL is not in a position to support DMA anymore, the cover pool collections will no longer be used to repay the overdraft on the current account maintained at DCL, as payments on the privileged debt will rank prior to a reimbursement of the drawings in case of insolvency of DCL.

As the majority of the collections are redirected to an account held by DCL, payments to DMA may be commingled with payments to DCL. DMA is currently reviewing the payment processes in order to mitigate this commingling risk; and in the short-term, the vast majority of the payments to DMA will be segregated from DCL. In addition, under the expected management rule, should the rating of the external account bank be downgraded below 'A' or 'F1' or on 'A'/'F1'/RWN, DMA will endeavour to find another account bank.

Set-Off Risk

Since DCL and DMA do not take deposits for public sector entities, the risk of borrowers instigating potential rights of set-off does not apply to DMA.

Claw-Back Risk

Claw-back could occur if the transfer of assets from DCL to DMA were to fall during the period preceding the default of DCL. As a mitigant, 90% of loans to public sector entities are originated in the name of DMA. For the remaining part of DMA's cover assets, the assignment of loans to DMA takes place by means of a bordereau signed by DCL and DMA, 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. Consequently, Fitch believes that claw-back risk is remote under the SCF Law.

Liquidity Gaps (35%)

As with most covered bonds, the maturity of the cover assets does not match the hard bullet maturities of the OF. 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.

DMA has set up internal rules in order to limit the liquidity gaps arising from a mismatch between the OF redemptions and the amortisation of its assets. First, DMA commits itself to limiting the duration gap between assets and privileged liabilities to less than three years. As at March 2011, the duration of the assets was 6.85 years, whereas that of the liabilities was 5.60 years. DMA also ensures that at any time, its cash requirements over a period of 180 days are covered by: replacement assets; assets eligible for credit operations with the Banque de France; or by refinancing agreements signed with credit institutions with the best short-term credit quality.

A further mitigant is the fact that DMA is able to repo assets with the ECB via an account in its own name at the Banque de France. Consequently, it has rapid access to additional liquidity. In total, as at March 2011, around 65% of DMA's assets are eligible for such repo transaction. In addition, DMA had around EUR3bn of highly liquid assets. Consequently, should there be a need to sell assets or use them for repo transactions, DMA's assets give comfort that this could be done relatively swiftly.

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 DMA made it too difficult for the new manager to retrieve the necessary information about the cover pool, the OF and the privileged swaps.

An SCF must subcontract all its operational tasks to a third-party credit institution, and it is the responsibility of the SCF's board 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. It only specifies that, in case the institution managing the SCF becomes bankrupt, the management contract can be revoked immediately (unlike in the general 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 in the duties of the incumbent management of any regulated financial institution. However, in the case of SCF, there is no certainty that this would occur in time to prevent a default under the OF. The role of the specific controller is not designed to fulfil any management function. Nevertheless, the fact that the assets securing 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 the alternative manager.

DCL has agreed to carry out all operational and administrative tasks on behalf of DMA in exchange of a fee, and a new manager will have to be found and appointed by the SCF's board should DCL default. The likely scenario in this case would be that the IT systems of DCL would be used and the same employees would still work for DMA 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. 80% of the IT systems used by DCL to manage the covered bonds and cover assets are standard in the market. The IT system is organised around an internally developed system called "Edouard", which is used to support the covered bond programme. This system is directly linked to other DCL systems, including the front-to-back office tool "Openlik" and "SAB", both of which are widely available.

Loans eligible for OF funding are flagged on a daily basis via SAB, which allows access to the principal characteristics of the loans. Swaps are clearly identified through the Openlik system. In addition, all DMA's operations are registered under a special entity code and are clearly separated from DCL.

Fitch is comfortable that the systems can clearly differentiate DMA's cover pool and privileged liabilities, including swaps, from the assets and liabilities of DCL. Cash flows, future payments from the cover assets as well as those due on the privileged debt can be extracted. However, in case of a default of the parent company, the alternative manager would have to handle a large number of assets situated across many countries and would also have to keep track of several hundred current individual publicly and privately placed OF as well as numerous swap contracts. This complexity, which could potentially slow down the handover process, has been reflected in Fitch's assessment of this component of the D-Factor.

Covered Bonds Oversight (5%)

The ACP exercises specific supervision on OF issuers, on top of the usual banking supervision to which credit institutions in France are already subject (see *Appendix 1*). In addition, a specific controller — selected from a list of certified auditors and approved by the ACP — is responsible for ensuring the SCF complies with the rules established by the law and the decrees regarding asset and liability management; the eligibility of the assets; the valuation of the underlying assets; and risk monitoring. The specific controller reports annually to the ACP and is in charge of the calculation of the regulatory OC ratios, which are published twice a year. Specific controllers are liable for any errors made in the performance of their duties but do not represent investors.

Fitch views positively the French regulator's willingness to proactively monitor and enhance the safety of OF for the benefit of OF investors. Although the level of controls under the French OF legislation is less stringent than under other legislative frameworks, Fitch is of opinion that the importance of covered bonds for French banks is likely to trigger an intervention from the regulator as the use of covered bonds for the overall funding of domestic banks has become more important in the last five years. The D-Factor therefore positively reflect the supervision of the French regulator and the increased size of the French covered bond market.

Adjustment for Swap Arrangements

DMA enters into different swap agreements to hedge against interest rate and currency risks. All the assets and liabilities are swapped into a three-month Euribor euro-denominated rate and are then swapped into EONIA to eliminate basis risks.

It is DMA's policy to only enter into swap agreements with financial institutions rated at least 'F1+'. Should a counterparty be downgraded below 'F1+', the swap documentation provides for it to post collateral weekly for counterparties rated at least 'A–', and daily for those rated below 'A–'. Collateralisation takes place on a unilateral basis, if the market value of the swap is in favour of DMA. As at March 2011, the total amount of cash-collateral received by DMA is EUR0.8bn. As only the mark-to-market of the swap is posted, without volatility cushion, the OC supporting the assigned rating may increase going forward.

DMA has entered into swap agreements with 28 counterparties. Replacement language is in place in 8 agreements; when in place, the documentation states that a counterparty downgraded below 'F1' has to be replaced. Fitch understands that DMA intends to use the regular update procedure to bring the rest of the documentation in line with Fitch's criteria. In the meanwhile, the programme's D-Factor has been modified, albeit to a limited extent.

As a standalone specialised issuer, DMA is in a better position to manage its swap exposure in a wind-down situation post an assumed insolvency of its parent company than is the case of covered bonds issued under an integrated template. On the other side, 25% of the notional of the swap agreements is with DCL and consequently, the credit risk of the OF remains more closely linked to that of DCL than if only external counterparties were used. Currently, DMA owns sufficient liquid assets to mitigate potential termination payments to privileged derivative counterparties ranking pari passu with payments owed to covered bond investors; however, there is no dynamically adjusted protection against this risk. Therefore, Fitch has adjusted the D-factor to reflect high potential termination costs arising in case of a default of DCL. Fitch will further adjust the D-factor should potential termination cost become increasingly constraining and should the ratings of the issuer and the counterparty be below A or F1. The agency may even cap the PD rating of the OF at the counterparty rating if material termination payments are likely to arise in the case of a non-mitigated default of a counterparty.

Overall D-Factor

Overall, DMA's OF have been assigned a D-Factor of 17.9%. Combined with DMA's IDR of 'A+', this D-Factor leads to a maximum achievable rating for the OF on a PD basis of 'AA+' and a rating of 'AAA' when factoring in recoveries given default. All else being equal, the OF's rating could be maintained at 'AAA' provided that DMA's IDR remains at least 'BBB+'.

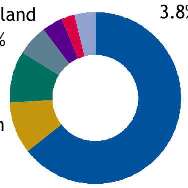
Cover Pool

As of March 2011, the nominal value of the DMA's cover pool was EUR78.0bn. This was comprised of loans to public sector entities (EUR54.6bn) and securities (EUR23.4bn).

Figure 3

DMA Cover Pool's Geographical Breakdown

As at March 2011



Source: Fitch

Portfolio Description

DMA's assets exclusively consist of public-sector exposures, either to public-sector entities (including states, regional and local authorities and public-sector bodies such as hospitals) or exposures fully guaranteed by such entities. Although French law allows for a mixed cover pool of mortgage loans and receivables against public-sector entities, DMA's licence as an SCF limits its activities to the refinancing of public-sector assets only. DMA's assets can be split into the following three main categories:

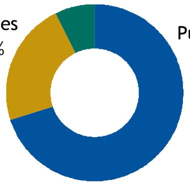
- **Loans:** (EUR54.6bn, 70.1% of the total portfolio) granted to public-sector entities or fully-guaranteed by such entities, mainly located in France (91.0%), and in Switzerland (7.4%).
- **Securities:** (EUR17.5bn, 22.6%) issued by public-sector entities or asset-backed securities (ABS) backed by public-sector assets, mainly Italian (43.1%) and Belgian (40.4%).

Among those securities, EUR3.7bn are issued by Dexia Crediop per la Cartolarizzazione (DCC: 'Asf'/Rating Watch Negative), an Italian securitisation vehicle set up by Dexia Crediop S.p.A. (rated 'A'/Rating Watch Negative/'F1') to ease the transfer of assets to DMA. DCC assets consist of securities issued by Italian public sector entities originally acquired by Dexia Crediop. DCC's debt benefit from a guarantee from Dexia Crediop, but no credit is given to such guarantee in a post sponsor default analysis.

Figure 4

DMA's Assets by Type

As at March 2011



Source: Fitch

Similarly, since June 2007, DMA has bought securities issued by Dexia Secured Funding Belgium (DSFB, a Belgian securitisation vehicle set up by Dexia Bank Belgium (rated 'A+'/Stable/'F1+')) — through its compartments DSFB I ('A+sf'/Stable), DSFB II ('A+sf'/ Stable) and DSFB IV ('AAsf'/ Stable) — to facilitate the transfer of Belgian public-sector assets to DMA. DSFB's assets consist of loans to Belgian public local authorities. As of March 2010, these securities amounted to EUR7.3bn.

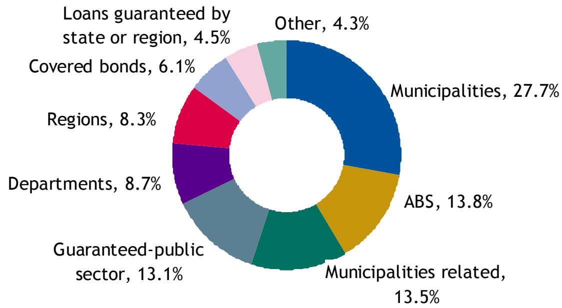
- **Replacement Assets:** (EUR5.8bn, 7.3%) are securities classified as such by DMA which comply with the corresponding requirements defined in the law. They comprise of the following Dexia Group covered bonds: EUR3.0bn of cédulas territoriales — Spanish public sector covered bonds — issued by Dexia Sabadell; EUR1.85bn of Lettres de Gage Publiques — Luxembourg public sector covered bonds— issued by Dexia LdG Banque; three certificates of deposit issued by DCL, with a maturity of less than 100 days (EUR0.6bn) and one secured loan granted by DMA to DCL and backed by JPY-denominated public sector assets (EUR0.35bn).

In geographic terms, the cover pool is exposed to 17 different countries. The majority of the pool is located in France (65.0%), Belgium (9.7%), Italy (9.7%) and Switzerland (5.2%) as shown in *Figure 4*.

Figure 5

DMA Cover Pool's Breakdown

As at March 2011



Other includes: Bonds guaranteed by State or region 1.7%, States 1.4% & DCL 1.2%
Source: Fitch

Over the last three years, DMA's exposure to Belgium and Italy has increased, especially through the acquisition of the securitisation tranches issued by DSFB and DCC.

Static Credit Analysis

In a 'AAA' scenario, Fitch has performed a two-tier analysis of DMA's cover pool by first looking at the aggregated exposure by country and then at the individual borrower exposures. In the first step, the country exposure analysis focused on the portfolio exposure to non-'AAA' countries, which represents 25% of the portfolio. Fitch has stress-tested the default of one non-'AAA' sovereign and a significant increase in the default rate of the exposures located in that country, combined with a low stressed recovery rate on these defaulted assets to simulate the potential impact that sovereign default could have on the public-sector entities located within that country.

In the second step, the agency analysed the credit risk of the assets in the remaining cover pool — comprising debtors located in 'AAA' and non-'AAA' countries not assumed to default — using its stochastic capital model. This assesses the defaults and recoveries of the loans and securities within the cover pool via Monte Carlo simulation techniques. The main inputs for this model consist of the public (or otherwise assumed) ratings for the loans and securities, together with their maturity profiles. A look-through approach has been conducted for exposures to public-sector assets repackaged via the securitisation vehicles DSFB and DCC.

In addition, Fitch assumed that some of the replacement assets, which mainly consist of covered bonds issued by entities of the Dexia group, would default. Owing to the special characteristics of Spanish law, the cédulas territoriales issued by Dexia Sabadell were assumed to default in a situation where DCL is assumed to default; their recovery rate was assumed to be quite high, based on mandatory OC of at least 43% for the Spanish cedulas territoriales. In contrast, Luxembourg legislation allows the Lettres de Gage issued by Dexia LdG Banque to withstand a default of the DCL group. Fitch has also assumed 100% default and a low recovery rate on the exposure to DCL via the certificate of deposit. For the secured loan granted by DMA to DCL and backed by JPY-denominated public sector assets, Fitch has used a look-through approach.

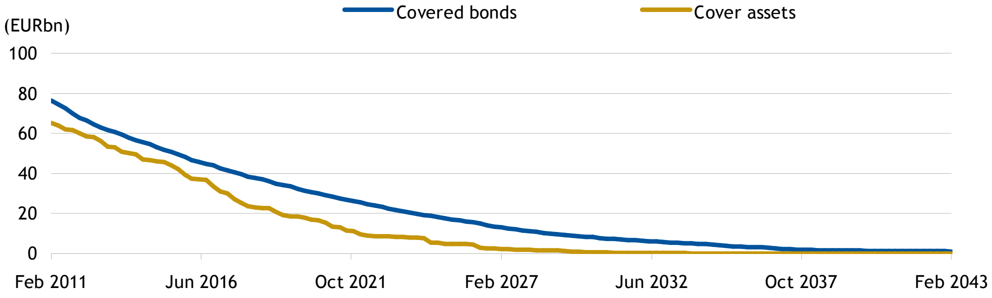
Overall, in a 'AAA' scenario, the agency has calculated an expected credit loss of 10.6% for the entire cover pool.

Cash Flow Analysis

Figure 6

Amortisation Profile

As of March 2011



Source: Fitch

On an ongoing basis, DMA issues OF secured by its cover assets. Fitch's cash flow analysis is conducted in a wind-down scenario where, following a DCL event of default, no new assets would enter the cover pool to replace those that have matured or are non-performing; further issuances of OF would be suspended.

Expected credit losses in a 'AA+' and 'AAA' scenario, calculated according to the above-described methodology, were used as inputs in Fitch's covered bond cash flow model to assess whether, under certain stress situations, the cover pool — with the benefit of the privileged derivative contracts in place — is able to service interest and principal payments on its privileged obligations when due. Separately, recoveries from the cover pool in case of a covered bond default were given credit according to Fitch's Recovery Rating methodology (please see Fitch's covered bond rating criteria).

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 DCL 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, part of the cover pool could be sold or refinanced. In its cash flow analysis, Fitch has also taken into account that DMA could use its own assets or its own OF for repo transactions with the ECB in the weeks following a default of DCL.

Maturity Mismatches

The amortisation profile of the assets will typically not match those of the bullet covered bonds, as is generally the case for European covered bonds. DMA intends to maintain the duration gap between assets and liabilities below three years. As a result, temporary surpluses or shortfalls in funds could arise in an amortisation scenario. In both cases, this would place a strain on available resources.

In the first case, Fitch assumes that any cash not needed to repay liabilities will be invested at sub-Euribor rates. In the second case, Fitch has assumed that cash needed to repay liabilities will be borrowed at above-Euribor rates, or that some assets will be sold or used as collateral in repo transactions. Fitch notes that there is no guarantee that a buyer would be found. Also, cover assets could be sold at a significant discount in a stressed market environment. In its assumptions, Fitch has also assumed that in the short term, DMA may be able to enter repo transactions with the ECB backed by the cover assets or by its own OF and in its own name; this has been tested and may ease its refinancing needs following an issuer default.

Interest Rate and Currency Hedging

DMA enters into different swap agreements to hedge against interest rate and currency risks. All the assets and liabilities are swapped into a euro-denominated floating rate (three-month Euribor) and are then swapped into EONIA to eliminate basis risks.

On a pre-swap basis, around 93% of DMA's assets are denominated in euros and 60.5% bear a floating rate. On the liabilities side, around 79% of outstanding OF are denominated in euros and 78.5% are issued at a fixed rate.

Overcollateralisation

The coverage ratio of cover assets to privileged liabilities must be reported to the ACP twice a year. The specific controller must check that the regulatory coverage ratio is above 102% at all times. The specific controller ensures compliance with this rule for each issuance.

DMA publicly commits to a minimum regulatory OC of 5% at all times. As of March 2011, the nominal collateralisation level stood at 123.4% and the regulatory coverage ratio stood at 120.4%. This is lower because of certain haircuts applied under the regulation.

Recovery Analysis

Under the French SCF framework, the OF remain payable as originally scheduled in the event of a missed payment on one of them. As a result, Fitch assumes recoveries on defaulted OF will be distributed sequentially to outstanding OF.

This time subordination of recoveries given default justifies a departure from Fitch's practice of granting up to one notch above the rating of the covered bonds on a PD basis (assuming it is in the investment-grade range) if stressed recoveries reach at least 51% of the liabilities. Instead, the agency only grants this uplift if stressed cash flows enable a 100% recovery in the targeted rating scenario.

The OC supporting DMA's OF' 'AAA' rating stands at 14.5%. As long as DMA's IDR is at least 'BBB+', Fitch will compare this level to the minimum nominal OC observed over the last 12 months, which as of March 2011, stood at 23.4%. The OC supporting a given rating will be influenced, among other things, by the profile of the cover assets versus the covered bonds, and therefore can change over time.

Conclusion

DMA's IDR of 'A+' forms the floor for the rating of its covered bonds on a probability of default basis. A D-Factor of 17.9% enables this rating to reach 'AA+' on a probability of default basis (see *Appendix 2*) and 'AAA' on a recovery basis (because the OC is sufficient to sustain these levels of stress).

Due to the dynamic nature of the cover pool and the covered bonds, Fitch periodically reviews the key characteristics of the cover assets and performs its cash flow analysis to assess whether the OC provides a level of protection against identified risks commensurate with the rating of the OF issued by DMA. Cover pool and OF information are displayed on Fitch's covered bonds surveillance platform (available at www.fitchresearch.com) and updated on a regular basis.

Appendix 1

Figure 7

Main Characteristics of Obligations Foncières

Code Monétaire et Financier (Articles L515-13 to L515-33 and R515-2 to R515-14) amended by the decree n°2011-205 dated 23 February 2011 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, the contracts of which 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 Autorité de Contrôle Prudential (ACP). The SCF must send to the ACP 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 ACP 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 them.
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; and • 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 EUR12m. 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 ACP. 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 an 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 conducted 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 ACP; • exposures to development banks or international organisations benefiting from the highest rating grade; and exposures to regional and local authorities or public entities benefiting from the second highest rating grade by an agency approved by the ACP. 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.

Main Characteristics of Obligations Foncières (Cont.)

Code Monétaire et Financier (Articles L515-13 to L515-33 and R515-2 to R515-14) amended by the decree n° 2011-205 dated 23 February 2011 and regulations from the banking authority

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 ACP.
Replacement collateral	They can consist of deposits or loans to, or debt issued by, credit institutions rated at least 'AA-', or 'A-' if the exposure does not exceed 100 days. Replacement assets cannot exceed 15% of the total OF outstanding.
Privilege	• The OF 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 OF. In the event of the insolvency of an SCF (règlement amiable, redressement judiciaire or liquidation judiciaire): • the OF (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.
Liquidity	Requirement to cover principal and interest payments on the OF and sums due to swap counterparties for a period of 180 days, taking into account all cash flows expected on the cover assets and other eligible assets to be granted as collateral with the Banque de France, or by entering into refinancing agreements with credit institutions benefiting from the highest level of short-term credit quality, established by an external rating agency recognised by the ACP.
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 winding-up of the servicer (redressement judiciaire or liquidation judiciaire) under contract to the SCF, the contract can be immediately revoked.

Main Characteristics of Obligations Foncières (Cont.)

Code Monétaire et Financier (Articles L515-13 to L515-33 and R515-2 to R515-14) amended by the decree n°2011-205 dated 23 February 2011 and regulations from the banking authority

Overcollateralisation	The ratio of assets to privileged liabilities must at all times be greater than 102%. 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 (Insurance company is not part of the SCF's group) o 100% if the guarantor's rating is at least 'AA-' by one of the three recognised rating agencies; o 80% if the guarantor is rated between 'A-' and 'A+'; and o 0% in all other cases. • Real-estate guaranteed loans (Insurance company is part of the SCF's group): o 80% if the guarantor's rating is at least 'AA-' by one of the three recognised rating agencies; o 60% if the guarantor is rated between 'A-' and 'A+'; and o 0% in all other cases. • Senior notes of securitisations acquired before December 2011 and whose assets are part of the SCF's group: o 100% if the notes are rated at least 'AA-'; o 80% if the notes are rated between 'A-' and 'A+'; and o 0% in all other cases. • Senior notes of securitisations acquired before December 2011 and whose assets are not part of the SCF's group: o 100% if the notes are rated at least 'AA-'; o 50% if the notes are rated between 'A-' and 'A+'; and o 0% in all other cases. • The ratings considered above are the ratings that were outstanding at the time the asset entered 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	Loan 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; 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 ACP. The controller is responsible for the SCF's compliance with legal requirements. She/he will verify that the coverage ratio is compliant with the law. In that respect, the controller checks the quarterly issuance programme of the SCF and approves any new issuance of more than EUR500m. The controller must also comment on the appraisal method used by the SCF. This is done annually. The appraisal and the comments are published. The controller will also check that the duration mismatches are not excessive and the eligibility of the assets in the pool. The specific controller must send an annual report to the ACP and to the board of directors of the SCF. The controller is liable for any mistakes made in the performance of her/his duties.

Source: Fitch

Appendix 2

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

	D-Factors (%)								
Issuer Default Rating	100	50	35	20	17.9	15	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+	AA+	AAA	AAA	AAA
A	A	AA-	AA	AA+	AA+	AA+	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	A+	AA-	AA	AAA
BB+	BB+	BBB-	BBB	BBB+	BBB+	A-	A	AA-	AAA
BB	BB	BBB-	BBB-	BBB	BBB	BBB+	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+	BB+	BBB-	BBB-	BBB+	AAA
CCC+/CCC	CCC	B+	BB-	BB	BB	BB+	BBB-	BBB	AAA

Source: Fitch

Figure 8

Benefit for Recoveries

	Maximum notching	
Recovery range	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