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TASK 1.1: Assistance to the STFs regarding the true sale of energy-efficient refurbishment loans to institutional investors

Deliverable information

Title	Report on refinancing of building renovation loans of STFs
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Lead beneficiary	GNE Finance
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Report on refinancing of building renovation loans of STFs

Deliverable 1.1

Task 1.1 : Assistance to the STF regarding the true sale of energy-efficient refurbishment loans to institutional investors

To reach the goal of providing a refinancing solution to STF for building renovation loans, the objectives of the report are *i) analysing the business model and operational set-up of the "Public Energy Efficiency Service" (Service Public de l'Efficacité Energétique*, also called SPEE) of Hauts-de-France Region, operating under Hauts-de-France PASS Renovation trademark, and *ii) finding a financial structure to refinance SPEE's direct loans it provided to real-estate owners for energy efficient home refurbishments*. The result is based on the findings with SPEE only. However, to make this a financing platform for all STF, the recommendations provided to SPEE will also have to be taken into account by the other STF which would aim at participating in refinancing their loan portfolios in the capital markets.

Objective 1 : business model and operational set-up of the "Public Energy Efficiency Service" (Service Public de l'Efficacité Energétique)

Given the vaste volume of possible energy efficient real-estate refurbishment in the French regions, the financing of this potential pipeline can't only rely on funding provided by the European Investment Bank (EIB) and/or regional governments, since their available funds is well short of what is required annually to reach the global climate goals. This will require the help of institutional investors, be it via capital markets or via a private placement. However, to make an investment decision, institutional investors have to follow internal investment guidelines, justifying their investment decisions. Part of this analysis deals with an investment's underlying collateral data, involved parties' governance and soundness operationally and financially. In short, institutional investors need to understand and feel comfortable with SPEE's and STF's business model and its loan operations.

In order to approach institutional investors, GNE had to review SPEE's business model and its operations through a thorough due diligence process. As part of the operational review, it had to be verified that **the loan origination process and the ongoing loan administration comply at least with existing market standards**, since the investment proposal is based on buying SPEE's existing loan portfolio.

GNE created a detailed due diligence questionnaire, focusing on corporate management, regulatory issues, the loan origination and servicing business, data processing and systems, legal aspects, internal audit mechanisms plus asking for a static and historical loan file, providing detailed information about each borrower and its payment history. This was sent to ED/SPEE by July 2020. By November 2020, ED/SPEE provided answers to its business model plus loan operations. Part of the information needed to provide a detailed analysis of SPEE's loan portfolio was first made available by October 2020. Given the set-up of the loan database, whereby borrower information is stored and kept in different locations (also in paper form), not all information required was delivered. As such, not all information received during a project origination process by a borrower is stored electronically, resulting in not-complete charts. By April 2021, more information was made available, also for analyzing historical payment behaviour of the borrowers.

Based on the information provided through the due diligence questionnaire, the following findings were highlighted, which some were either not conform to or need to be checked against current market standards:

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- **Marketing strategy:**

There is no clear path on how to grow the size of the loan portfolio. However, in order to refinance the loans through institutional investors, there needs to be a prospect for investors that they buy not only one small loan portfolio, but that there are more investments foreseen in the short- to mid-term. At this stage, neither SPEE nor all the STF have a significant loan volume available for sale.
This point is to be connected with the evolution of the STF environment to be highlighted by the survey on the attractiveness of STF offers carried out in the framework of WP3, task 3.3 (See WP 3 section).

- **Loan origination process:**

✓ Borrower's credit risk analysis:

There needs a thorough process to analyze the individual borrowers credit risk. SPEE has a very detailed approach in gathering information and analyzing it. However, the data analysis revealed that **95 loans out of 750 don't have a borrower credit score assigned**, which institutional investors might not accept in a potential purchase[1].
The current credit scoring mechanism doesn't allow to calculate an average risk profile of the loan portfolio. In addition, **the credit score scale should be compared to market standards** applied by financial institutions or analyzed by rating agencies. This will give an investor a real sense of risk exposure he would actually purchase, since the lowest credit risk assigned by SPEE (for people with low- to middle-income) will not correspond to one assigned by a financial institution (high income).
Per market standards, **a borrower with low credit risk should pay less interest than one with a high risk**. In SPEE's origination process, this distinction is not made. All the borrowers get the same interest rate, irrespective of their credit risk. The interest rate charged by SPEE neither corresponds to current market rates, since the average rate of its portfolio is around 2%, whereas a capital market transaction issued by BNP Paribas has an average interest rate of around 4.5%.

✓ *Loan agreements:*

An external law firm should analyse existing loan and project agreements correspond to market standards and allow for the assignability to capital market transactions

✓ *Project information storage:*

All information from a borrower should be stored in one central location, including those provided on paper form. This would allow to generate automated loan portfolio reports as designed under Task 1.3. Most importantly, all the processes and information should be recorded in a manual, so all the steps for a loan origination are documented and no information gets lost.

- **Loan administration procedures**

SPEE is managing in house the loan administration and the cash flows are managed by the regional office of the Tax Administration. The current process doesn't correspond to market standards and is **not really well documented in a manual**. To make institutional investors feel comfortable, a service provider experienced in loan administration would need to be engaged, occurring additional costs. Given the low interest rate set by SPEE, this would reduce the excess cash flow generated by the loans (difference between the borrower's interest rate and the rate charged by the EIB), normally needed to cover operating costs and potential losses.

- **Asset & liability management**

Having a market conform data management tool, allowing to determine the expected payment behaviour of the borrowers, this will allow SPEE to better match its funding strategy with the duration of the loan portfolio, potentially lowering their funding costs once using the capital markets.
To make institutional investors buy a loan portfolio from SPEE, these topics will need to be addressed.

[1] These loans concern the first two renovation projects carried out by SPEE on condominiums. Since then, SPEE has changed its procedures: all individual loans are scored, regardless of their amount, and only shares of collective loans of less than €23k are not subject to individual scoring.

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For the static loan analysis, three files provided had to be reformatted to be able to provide the charts for Tasks 1.1 and 1.3. For the historical payment behaviour analysis, focusing on borrowers' prepayments and delinquencies, a GNE data specialist had to build a pipeline for the pre-processing and modelling of the dataset (which included detecting errors, redundancies, indexing the dataframe for easiness of manipulation and analysis), using Python, Panda's library and in-house functions developed by GNE. Once the historical time series of each contract were obtained, an infrastructure and algorithms were designed to evaluate the historical prepayment and delinquency performance of the loan portfolio since the beginning of SPEE's loan program. The results were used to determine potential portfolio valuations and for the design of the benchmark reporting Task 1.3.

Objective 2 : financial structure to refinance SPEE's direct loans

For the *second objective*, finding a refinancing tool for SPEE, the focus was put on the securitization market, where similar loans originated mainly by financial institutions are sold to institutional investors. The securitization market exists since around the 1990 in France. The regulations (with recent updates due to the financial crisis in the early 2000s) and the investors' understanding of such structured products are proven. As part of the report, the French legal framework was researched and described in the report. Given the special grant received by the ACPR (A*utorité de Contrôle Prudential et de Résolution*), SPEE is able to originate loans without a banking license. As such, a legal questionnaire was put together with questions to be asked to lawyers and accountants, in order to find out if the same conditions apply to SPEE and the other STF as for current originators for securitization transactions (i.e. loan assignment to special purpose vehicles), and if so, how the newly imposed 5% retention rule has to apply. The legal questionnaire was sent to ED in May 2021. Given the status of the entire project, ED decided to address the questionnaire at a later stage, to be determined (see below).

Without having approached law and accounting firms to analyse the legal framework for STF to sell loans via a true-sale securitization structure, the theoretical analysis couldn't be completed yet. Based on the information currently available, it can be assumed that STF could actually refinance their loan portfolio via a securitization structure. However, even if this financing structure is legally feasible, the current loan origination volume, state of the loan management system (from loan data storage, loan origination criteria, loan administration, etc.) and borrowers' interest rates wouldn't allow for an economically sound financing structure. This is based on the research conducted related to the French and Spanish securitization markets. The research showed that a consumer loan portfolio securitized by BNP Paribas in 2021 had an average interest rate of around 4.5%. Considering this as market standard for selling a loan portfolio at par, SPEE could only sell its loan portfolio below a par value, since the interest rate of its loan portfolio is around 2%. This would mean that the current portfolio of around EUR 15 million can only be sold for around EUR 13 million, resulting in a loss of EUR 2 million. The proceeds of such a sale would not cover the current funding provided by the EIB.

In addition to the current lending done through funds provided by the EIB, the actual trend is to provide loans to borrowers at a zero percent (0%) interest rate, taking advantage of the « Eco-PTZ » regulated loans framework (see Section related to WP3). However, this can only be supported by banks complying with this type of subsidy scheme offered by the government. As explained previously, this should be part of the overall funding strategy, but also this source of funds is limited and can not be refinance by institutional investors.

Without any further funding schemes provided by the EU or the French government (see more details under Task 1.2), GNE's view is that the only viable sources of funding the future growth of all STF' loan portfolios in the mid- to long-term are lying in the capital markets.

However, the prospect of improving the refinancing of Third-Party Financing Companies should take into account several recent developments:

- the rationalisation of SPEE means to manage its loan portfolio, as recommended by GNE to facilitate the production of data in the format expected by investors, should take a few months
- The adoption of the same management processes by the other third-party financing companies, in order to provide investors with volume prospects, requires the organisation of several workshops, which should be scheduled for early 2022, within the framework of the STF-ORFEE association.

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- Another factor is the willingness of third-party financing companies to distribute the eco-ptz, a regulated and specific loan, which would make them less likely to meet investors' expectations for loans that are simple to analyse and manage. Nevertheless, the distribution of the eco-PTZ is a key element of the attractiveness of the STF offer
- and finally, the evolution of the mutual banking sector with regard to Third-Party Financing Companies. Thus, the Third-Party Financing Companies observe that several mutualist groups offer to finance them directly, on advantageous terms, which leads them to relativise the competitive advantage that would be obtained through securitisation.

This is why ED recommended delaying the next steps to 2022, so as to take into account these structuring contextual elements to re-think the work to be done under task 1.1:

- to **design a clear growth strategy related to the loan origination volume** and define a **standardized loan origination process** (related to a borrower's credit risk analysis, legal project documentation and ongoing loan portfolio reporting) and servicing model for all the STF.
- Having achieved that the STF could start discussions with financial institutions to structure a financing platform which could be used by all STF at the same time.