A critical analysis of the new French Bank Resolution Mechanism

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DROIT ET CROISSANCE

Table of Contents

Introduction – The Legislative, Political and Economic context - Europe

5 June 2012 : the European Commission adopted a thorough 160 page **legislative proposal** for bank recovery and resolution to avoid financial instability and minimize costs for taxpayers (the "**EU RRD**")

- **Recovery and Resolution Plans** – living wills - to be prepared both at group level and for the individual institutions within the group
- Power to **change legal or operational structures**
- **Early intervention** powers
- Appointment of **special manager**

28 June 2013 : the European Council adopted a **new legislative proposal** which is now 318 page long!

Introduction – The Legislative, Political and Economic context - Europe

- **Harmonized resolution tools and powers**
  - **sale of business** of all or part of the failing bank to another bank
  - **the bridge bank** to separate good and bad (liquidated) bank
  - **the asset separation tool –** to be used in conjunction with other tools
  - **the bail-in tool** - shareholders are wiped out or diluted, and creditors would have their claims reduced or converted to shares
- **Cooperation between national authorities** with the participation of the European Banking Authority (EBA)
- **Creation of a resolution fund** financed by contributions from banks proportionate to their liabilities and risk profiles. The funds will have to build up sufficient capacity to reach 1% of covered deposits in 10 years

Introduction – The Legislative, Political and Economic context – France

Why the urge to enact a new bank resolution mechanisms before the EU?

❖ **Economic Context**

DEXIA

- Bad assets were put into an asset management vehicle to clean the balance sheet of the bank. This tool was used solely as a state aid measure as there was no restructuring through a bridge bank, sale of business or write down

- As of July 2013, French and Belgian taxpayers have lost more than €13 billion in Dexia's demise

- The Dexia case illustrates the flaws of the various bank resolution mechanisms in Europe: Neither France or Belgium had any resolution tool to force Dexia's creditors to absorb losses.

Introduction – The Legislative, Political and Economic context – France

❖ Economic Context

BANKING UNION

- The European Central Bank (ECB) will gain supervisory authority over most of Europe's banking system in the second half of 2014. This needs to be preceded by a rigorous balance sheet assessment that is likely to trigger significant bank restructuring, for which preparation has barely started

- This may be why the French government was under pressure to modernize its banking resolution framework in advance of the adoption of the EU RRD

Introduction – The Legislative, Political and Economic context - France

- **Political Context :** French President Hollande

April 2012 (Presidential Campaign) President Hollande targets the "**world of finance**" as his real enemy

> strong *political* pressure on French public authorities to provide a new framework for banks

- **Legislative Context :** First response of the French government to the EU proposal

October/ November 2012 – The initial draft of the new Bank Resolution Mechanism **(15 pages)** was circulated to a limited number of people inside banks for comments

> lack of *transparency* of the consultation process

The limited number of pages in the French proposal is a sign that France has not departed from its **traditional approach towards regulations**: tendency to adopt broad principles ("civil law approach") rather than explicit and detailed regulations > risk of uncertainty

Introduction – The Legislative, Political and Economic context - France

This initial draft provided for a mechanism largely inspired by the European proposal but:

- the scope of the bail in provision did **not** include the senior unsecured creditors.
- the bail in provision failed to provide any **rational basis for the valuation of the bank`s assets** which is a prerequisite for the orderly absorption of the losses by shareholders and creditors
- this failure to identify a **valuation process** also applies to **the losses** to be allocated between the shareholders and the creditors of the institution
- the « **no creditor worse off principle** » was (and remains) ineffective

French Bankruptcy Law – Main Provisions

A proper analysis of the French bank resolution mechanism resolution requires an understanding of the underlying bankruptcy law and its shortcomings

- Under French law a petition for bankruptcy proceedings is not viewed as a recognition event that reduces future possibilities to the present value of the entity
- There is no obligation, existing under US law, to reorganize the capital structure of the entity on the basis of its projected cash flows
- The automatic stay of all debts arising upon filing for bankruptcy proceedings is not used to evaluate the situation of the entity before a complete reallocation of the stakeholders' rights over the debtor's assets
- No cram down of stakeholders is possible

French Bankruptcy Law – Main Problems

- Violation of the order of priority is common as all stakeholders are always entitled to approve the reorganization plan
- Secured creditors are treated in the same way as unsecured creditors
- Violation of contractual subordination agreements
- Power of the court to automatically postpone debt maturity by up to 10 years with no increase in interest rate
- Shareholders and creditors can refuse debt/equity swaps hindering their ability to deleverage the company prior to a liquidity crisis
- Does not align the interests of “in the money” creditors with the interest of preserving the value of the business
- Creditors negotiate high interest costs which entail additional financial distress costs

French Law - Resolution Mechanism – Adopted July 26, 2013 – Overview

- Regulator intervention legitimized by threat to undefined "*stability of the financial system*" (Art L 612-1 *Code Monétaire et Financier*)
- The law violates EU directives on company law and on takeovers providing safeguards for the protection of shareholders and creditors of credit institutions
- The law may violate both the French Constitution and the European Charter of Fundamental Rights as lawmakers for the bill failed to submit the draft bill to the French Constitutional Court
- There is a real risk that the law will be ruled unconstitutional if investors challenge it after being forced to absorb losses of a failing credit institution. In this respect, no lesson was drawn from the Cypriot crisis.
- A decree was adopted on October 30, 2013 but many questions remain unanswered

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

Four main critiques:

- Questionable valuation mechanism
- Questionable scope : Systemic and non Systemic
- Ineffective “no creditor worse off principle”
- No Consolidation Principle

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

Questionable valuation mechanism

- The European framework incorporates a valuation based on the principle of 'market value' to assess the real value of the assets and liabilities of the institution that is about to fail
- This ensures that the losses are recognized at the moment when the institution enters into resolution
- Under the proposed EU regime, the valuation shall be done by an independent expert, unless there are reasons of urgency, in which case the resolution authorities would proceed with a provisional valuation that will, afterwards, be complemented by a definitive valuation with the involvement of an independent expert

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

Questionable valuation mechanism

- The resolution authorities have been granted the necessary powers to modify their resolution actions in accordance with possible discrepancies, if any, between the provisional and the definitive valuation

- The law refers to the valuation process as follows :

  « These *fair* and *realistic* values shall be the outcome of *objective* valuation methods and *industry practice* regarding the sale of assets, and shall account for the *market value* of the shares, the *value* of the assets, the *current profits*, the existence of *subsidiaries* as well as *future business prospects*."

- Broad discretion of the resolution authority to determine through moderation the value of the failing credit institution can be questioned. This board power may be contrary to ECDH jurisprudence defining appropriate safeguards for expropriation

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

Questionable Scope : Systemic and non Systemic

- There is no reference to the definition of **systemic risk** (included in the *Key Attributes of Effective Resolution Regimes for Financial Institutions* published by the *Financial Stability Board* in October 2011) to determine the scope of covered Banks

- Non systemic banks however should be **out of scope** and liquidated in an orderly manner according to standard Bankruptcy law since their survival is **not in the public interest**

- As discussed above, current French bankruptcy law is **inadequate** to properly liquidate a business let alone a bank

- Is this the reason why the French government wants to include smaller banks in the scope of its new Resolution mechanism?

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

Questionable Scope : Systemic and non Systemic

- Reference is made to the **size** of the Banks's **balance sheet** to define the Bank's "*impact on financial stability*" used as a proxy for its systemic character

- The **size** of the balance sheet however is in fact **less relevant** than the **type of debt** held by the Bank and in particular its holdings in **two** types of very short term debt including:

  - **commercial paper** (which accounted for ¼ of the balance sheet of Bearn Sterns)

  - **derivative products** due to the controversial legal protection which allows these contracts to be terminated in spite of the initiation of bankruptcy proceedings ("automatic safe harbor")

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

Ineffective no creditors worse off principle

- Under the FSB's "**no creditors worse off**" principle, creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime ("no creditor worse off than in liquidation" safeguard)

- Under French law however, the lack of any standard for the valuation of the Bank's assets in the context of liquidation proceedings creates a **problem** to determine the **relevant basis** for the applicable compensation

- This issue was pointed out by Rules for Growth in the draft stage of the law which originally made explicit reference to the French Commercial Code (which contains the provisions of the corporate insolvency laws) and was later removed to make reference to a broader concept of "liquidation value" which is, however, **not defined** under French law

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

No Consolidation Principle

- Under the FSB's Key Attributes, any financial institution that could be systemically significant or critical if it fails should be subject to a resolution regime

- The regime should be clear and transparent as to the financial institutions within its scope

- The regime **should extend** to:

  - holding companies of a firm
  - non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate; and
  - branches of foreign firms

  Under the Dodd Frank Act ("DFA") principle of "*single point of entry resolution*", the resolution tools apply only to the holding company whereas its subsidiaries may be allowed to continue to operate

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

No Consolidation Principle

- Under the Dodd Frank Act ("DFA") principle of "*single point of entry resolution*", the resolution tools apply only to the holding company whereas its subsidiaries may be allowed to continue to operate

- Under the DFA, the definition of financial institution is very broad and include insurance companies as well as hedge funds

French Law - Resolution Mechanism – Adopted July 26, 2013 - Critique

No Consolidation Principle

- French law does not address non regulated operational entities
- This jeopardizes the whole resolution process
- From a broader perspective, this a sign of the difficulties of French legislators to address **corporate bankruptcies** at the group level. This is true for banks as well as any other business.
- French law does not provide for the controversial concept established by US case law to account for "**substantial consolidation**" of assets and liabilities in bankruptcy proceedings for the sake of efficiency under limited circumstances

European Law - Resolution Mechanism – Proposal 28 June, 2013 - Critique

Too many legal privileges / safeguard provisions

- France and the UK have offered to exclude some or all of the **unsecured liabilities** from the scope of the bail in, (the "**safeguard provision**") where

  - it is not possible to bail in such liabilities within a reasonable timeframe,
  - such liabilities are strictly necessary to achieve the continuity of critical functions and core business lines,
  - the application of the bail-in tool would cause a destruction in value such that losses borne by other creditors would be higher than if these unsecured liabilities were not excluded from the bail-in

- Members States want to be able to provide a certain level of protection for individual investors as well as micro, small and medium enterprises holding eligible deposits above the EU threshold of guaranteed deposits: the "Cypriot precedent"

European Law - Resolution Mechanism – Proposal 28 June, 2013 - Critique

Too many legal privileges / safeguard provisions

- The draft directive contains provisions encouraging banking institutions not to structure their liabilities in a manner that impedes the effectiveness of the bail-in
  - Will this be sufficient?

- The new legal privileges (granting a higher priority ranking to some debt) create a high risk of unwanted consequences :
  - Increased cost of unsecured senior credit tranches which will not be granted a higher priority ranking
  - Incentive for credit institutions to structure their unsecured senior liabilities by way of (i) covered bonds because covered bond are statutorily exempted from normal insolvency proceedings in Europe and (ii) short term bonds > this will have counterproductive effect because short term bonds increase the systematic risk and may jeopardize any resolution attempt of credit institutions
  - Acceleration of the trend towards a conflicted "*originate to distribute* "model
  - Encourage credit institutions to split their commercial from their investment banking business

Recommendations for the IMF

❖ **At the French Level** :

Encourage the French government to offer a new draft that will not refer to or be based upon the current, inefficient French bankruptcy law

❖ **At the EU Level** :

Encourage EU law to avoid specific treatments which create market distortions and have serious counter productive consequences

Thank You

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The Institute Rules for Growth / Droit & Croissance "D&C" (www.droitetcroissance.fr) is a non-partisan think tank with an ambitious project: to transform our legal environement into a real engine for growth

Rules for Growth aims at 1°) enabling businesses to more easily adapt to the brutal cycles of growth and recession and 2°) promoting corporate finance thanks to new financing methods, which run in parallel to traditional bank loans or public funds

Building on a strong foundation in economic theory and law to carry out a cost/benefit analysis of our legal system, the innovative aspect of Rules for Growth lies in establishing a valuable link between researchers in law and economics, market players in law and finance, as well as legislators, regulators and judges

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