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On French Interventions in the Financial Crisis

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ON FRENCH INTERVENTIONS IN THE FINANCIAL CRISIS

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INTRODUCTION

One of the main challenges in drafting this paper was compiling materials on "a moving target." Nobody knows yet if the crisis is over, nor whether the actions implemented to cope with the crisis will be sufficient. France is still considering more interventions; for example, issuing an exceptional government bond.

There is no "single" European answer to the crisis, although all E.U. governments have agreed on a consensus.[1] Despite the coordination of the plan by the Eurozone governments, each Member State has implemented differing individual plans. Of course, there has been some intervention from the E.U. Commission in respect to competition law, and, in particular, rules for State aid. It appears more and more clear that a discussion on structural reform will happen on the E.U. level.[2]

This paper first analyzes where France stands today in the global picture, and then underlines how French interventions are trying to hold this crisis in check. Finally, it makes a few predictions for reform.

I. WHERE DOES FRANCE STAND IN THE GLOBAL PICTURE?

Where does France stand in the global picture? The causes of the crisis are mentioned first, followed by a discussion of the impact of the crisis on the French economy as compared to other economies.

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1. *See* Press Release, Summit of the Euro Area Countries: Declaration of a Concerted Action Plan of the Euro Area Countries (Oct. 12, 2008)*; see also* C. Chatignoux, *Les Leaders du G20 Sous Pression pour Apporter une Réponse Commune à la Crise*, LES ECHOS, Apr. 2, 2009, at 6.

2. Alain Banluet, *Sarkozy et Merkel Font Front Commun Avant le G20*, LE FIGARO, Sept. 1, 2009.

A. Causes of the Crisis

It is unnecessary to repeat in great detail the causes of the crisis, but it can be linked to three factors.[3] First, global imbalance due to worldwide excess liquidity. This results from a major trade surplus and large public savings in emerging countries like China.[4] A second cause is microeconomic failure. Usually, when stocks are high, yield-to-maturity rates for bonds are low. In order to maintain profitability, banks have had to increase the volume of their activity by easing lending conditions and by using securitization vehicles.[5] The use of securitization is a third cause. It consists of transforming traditionally illiquid bank loans into securities traded on the market through an *ad hoc* legal entity.[6] What is the impact of this crisis on the French economy?

B. Impacts in France

Last May, the cover page of "The Economist," the liberal English magazine, led readers to think that it was going to say *mea culpa*.[7] French President Nicolas Sarkozy was on the top podium smiling down on a somewhat depressed German Chancellor Angela Merkel, and, the poor English Prime Minister Gordon Brown stood buried in gloom and doom.

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3. *See* John Cassidy, *Anatomy of a Meltdown*, THE NEW YORKER, Dec. 1, 2008, at 49; PATRICK ARTUS, ET AL., COUNSEIL D'ANALYSE ÉCONOMIQUE, LA CRISE DES SUBPRIMES 11–60 (2008), *available at* http://www.cae.gouv.fr/IMG/pdf/078.pdf; *see also* BANQUE DE FRANCE, LA CRISE FINANCIERE 9–10 (Feb. 2009), *available at* http://www.banque-france.fr/fr/publications/telechar/doc_debat/numero_2/integral.pdf.

4. Indeed, the productivity stock impacted growth, which in turn boosted earnings forecasts and led to an increase in investment and, therefore, lending. Under normal circumstances, an increase in inflation limits increase in lending, which in turn prompts a rise in interest rates. In the case of the subprime crisis, there was excess liquidity worldwide, which prevented inflation; global inflation continued to fall, and any volatility vanished. The drop in inflation led to a drop in long-term rates, fueling an abundant and bargain credit supply.

5. When markets were down, investors turned to bonds. Because of the macroeconomic imbalances, yield-to-maturity rates were very low. To keep up with profitability, banks increased the volume of their activity by easing lending conditions. That should have led to an increase in banks' equity to preserve the debt/equity ratio, but banks preferred to avoid this constraint by using securitization vehicles.

6. For example, the bank that issued the loans sold them to a special purpose vehicle that financed the acquisitions by issuing shares on the markets. The investors then purchased the shares that payed the revenue linked to the loans (interest and repayment of the principal). Securitization allows banks to transfer their credit risk to the market. In theory it is good to spread the risk. The problem is that a bank that no longer bears risks often becomes less strict in screening and monitoring.

7. *A New Pecking Order*, THE ECONOMIST, May 9, 2009, at 13.

The highly regulated French economic model appears to be weathering the crisis better than the old liberal English model. President Sarkozy recently outlined his vision of a "Brave New World," in which France would lead the way with the most rigorous regulations on record.[8]

Based on this observation, is *laissez-faire* an obsolete system? Just because France has resisted the crisis better than other countries does not mean that it will resist forever. Nothing is free in this world; there will certainly be a price to pay for greater social security and job protection. France may be slow to adjust and less innovative, leading, in the long run, to sluggish growth.

Looking at the litigation side, although people filed complaints in France because of the crisis, they are not equivalent in either number or subject matter to those filed in U.S. courts. The explanation for this is the attractiveness of U.S. securities class actions and the possibility of jurisdiction in U.S. courts over class actions initiated by French investors against French corporations.[9]

Nevertheless, France was severely impacted by the crisis, and the French government has reacted. Let us examine these interventions.

II. STATED INTERVENTIONS IN FRANCE

The French State first intervened directly through the French Bank Relief Act.[10] The second set of interventions was more structural and indirect, such as reforming executive compensation rules. These types of interventions will be discussed. A number of *ad hoc* measures such as

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8. *French Regulatory Vision*, FIN. TIMES, Aug. 27, 2009, at 1.

9. *See* In re Vivendi Universal, S.A. Securities Litigation, 2009 WL 855799, at *1 (S.D.N.Y. 2009); *see also* Pierre Servan-Schreiber & Olivier Boulon, *Le Contentieux Boursier né de la Crise Financière en France et aux Etats-Unis*, REVUE TRIMESTRIELLE DE DROIT FINANCIER 7 (2009). *But see* Morrison v. Nat'l Austl. Bank, 2010 U.S. LEXIS 5257 (June 24, 2010).

10. *See* Didier Martin, Olivier Saba, & Forrest Alogna, *European Responses to the Financial Crisis*, JCP/LA SEMAINE JURIDIQUE (2009); *see also* MAYER BROWN LLP, SUMMARY OF GOVERNMENT INTERVENTIONS IN FINANCIAL MARKETS – FRANCE (2009), *available at* http://www.mayerbrown.com/publications/article.asp?id=7847&nid=6; *see also* PASCAL BINES & SIDNE KOENIGSBERG, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, 2009 INSIGHTS: NAVIGATING TUMULTUOUS TIMES 26 (2009), *available at http://www.skadden.com/content/sitefiles/Skadden_0D39513A6E12353AA89BFD6B84527ADF.pdf*; ROBERT PAROLAI ET AL., CLIFFORD CHANCE LLP, FRENCH ACTION PLAN TO RESTORE CONFIDENCE IN THE BANKING SYSTEM (2008); LATHAM & WATKINS LLP, EUROPEAN GOVERNMENTS ACT TO STABILIZE MARKETS (2008); Symposium, Aspects Juridiques de la Crise Financière*, JCP E* (2009); Symposium, L'actualité du Droit Financier sur Fond de Crise, REVUE TRIMESTRIELLE DE DROIT FINANCIER (2009).

parts of the French rescue plan, for instance *Dexia*,[11] or the French automobile manufacturers *Renault* and *Peugeot-Citroën*, will not be discussed.[12]

A. French Bank Relief Act

The most direct intervention to rein in the crisis is the French Bank Relief Act ("the Act") adopted October 15, 2008.[13] The main features of the Act are the creation of two special purpose vehicles ("SPVs"): a Refinancing Company[14] and a Recapitalization Company.[15] The Act establishes a State guarantee for any debt securities issued by these two companies. In other words, State aid to banks consists of guarantees granted to these two companies, and is not granted directly to the banks for their own underwriting.

This is a major difference between France and the U.S. In France, the Act provides financing through the Refinancing Company, which can raise money partly due to the confidence inspired by a State guarantee. On the contrary, the U.S. plan provides credit to the bank itself to obtain financing. One advantage of the French SPV is that it allows banks to raise funds at rates lower than those available to private institutions that qualify for a State guarantee.[16] The French plan is easy because a single vehicle issues bonds.

Therefore, the French Bank Relief Act enables the State to become a major player in rescue efforts.[17] Thus, the State has become both a "lender of last resort" and a "buyer of last resort."

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11. This refers to the action plan to save *Dexia* Group so it could continue to finance local French authority. Other French initiatives include the battle against tax havens and the prohibition of short selling. *See* PAROLAI ET AL., *supra* note 10.

12. Matthew Saltmarsh, *France Announces $8.5 Billion Plan to Help Struggling Auto Industry*, N.Y. TIMES, Feb. 9, 2009, at B3.

13. Law No. 2008-1061 of Oct. 16, 2008, French Bank Relief Act, Journal Officiel de la Republique Francais [J.O.] [Official Gazette of France], Oct. 17, 2008, p. 1; *see also Opinion of the European Central Bank* CON/2008/56 (Oct. 21, 2008). This paper limits itself to discussion of the financial industry. It does not discuss other direct interventions, such as aid to households to limit the increase in payment defaults, or the Strategic Investment Fund to support the development of small and medium-size businesses and increase protection for the capital of strategic companies.

14. Société française de refinancement de l'économie or SFRE.

15. Société de prise de participation de l'Etat or SPPE.

16. VIOLAINE LE GALL, L'AGEFI, LA SFEF BOUCLE UNE DEUXIÈME EMISSION DE SIX MILLIARDS D'EUROS À DEUX ANS (Dec. 2, 2008).

17. *See* MAYER BROWN LLP, *supra* note 10, at 2–3; *see also* BINES & KOENIGSBERG, *supra* note 10, at 26; PAROLAI *supra* note 10; LATHAM & WATKINS LLP, *supra* note 10.

1. State as a Lender of Last Resort

The French State has agreed to play the role of a lender of last resort in order to maintain liquidity and to support inter-bank financing. The state accomplishes this via State/governmental guarantees, and through the Refinancing Company. The State guarantees the Refinancing Company's obligations. The Refinancing Company then loans out funds it raises to institutions. The consideration provided for the loan is the posting of collateral interest at a mark-up rate, in addition to the rates required by the international credit market.

France allows a broad category of financial institutions to take advantage of the State guarantee, whereas the U.S. restricts eligibility to banks and related institutions.[18] An "opt out" is possible in the U.S., whereas in France the scheme allows the financial institution to decide whether loans or bonds are preferred. By providing an opt-in/opt-out scheme, both the American and French plans preserve a quasi-contractual characteristic.

On October 24, 2008, seven French banks requested loans from the Refinancing Company for a total of 5 billion euros. The Refinancing Company borrowed funds from the financial institution of the French Government, the *Caisse des Dépôts et Consignation*. Thereafter, the Refinancing Company issued several public bonds, the proceeds of which were used to advance loans to credit institutions. It is estimated that the Refinancing Company will issue bonds totaling 80 billion euros in 2009, out of the total budget of 265 billion euros.

2. State as a Buyer of Last Resort

The second component of the French Bank Relief Act is recapitalization. For a total of 40 billion euros, recapitalization provides financial institutions with a sufficient cushion to continue to finance the "*real*" economy. The level of banks' regulatory capital directly affects the number of loans allowed. Through this recapitalization scheme, banks' debt/equity ratio should increase by an average of 1%.

It is the second SPV, the Recapitalization Company, which houses two types of instruments issued by the banks: deeply subordinated notes[19]

18. *See* WILLIAM D. TORCHIANA, UNE REPONSE A LA CRISE FINANCIERE : L'ACCES DES SOCIETES ETRANGERES AUX PLANS DE SOUTIEN ETATIQUES, JCP (2009).

19. In French: *titres super subordonnés.* A deeply subordinated note, which is also known as a "Perpetual" or "Perp," is a bond with no maturity date. Therefore, it may be treated as equity rather than debt.

and preferred shares.[20] In the U.S., investments made under the new Capital Assistance Program[21] are placed in a trust.[22] Although France has recently adopted a trust-like structure—the *fiducie*—it is, in fact, the Recapitalization Company that receives investments. In December 2008, the Recapitalization Company had already distributed the first tranche of 10.5 billion euros to six French banks. Technically, all these banks issued deeply subordinated instruments – not preferred shares. The Recapitalization Company subscribed to these deeply subordinated instruments.

During the summer of 2009, the Recapitalization Company distributed a second recapitalization tranche to *BNP Paribas* and *Société Générale* in the form of preferred shares, rather than deeply subordinated notes.[23] No voting rights attached to these preferred shares because the aim was to inject capital, not to gain control. *BNP Paribas* issued 5.1 billion euros of preferred shares, enabling it to repay the 2.55 billion euros of deeply subordinated notes subscribed by the Recapitalization Company.

There are at least two mechanisms that drive credit institutions back to private investors. The first is the very high interest rate of about 8.2 % charged by the Recapitalization Company for deeply subordinated notes.[24] The dividend for the preferred shares is even higher. The second mechanism that encourages prompt repayment is that the principal must be paid back at a premium that increases over time. For instance, the principal amount which has to be paid back would be over 10 % if one is waiting more than six years to repay his or her loan.[25] All of these are direct interventions by the French State, but there are other less direct and more structural interventions that aim to better regulate the financial industry.

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20. Both the deeply subordinated notes and the preferred shares are qualified as Tier 1 capital (France's regulatory cap on the proportion of Tier 1 capital that may be represented by hybrid instruments has been raised from 25% to 35%). However, their regulatory treatment is not identical: whereas only 35% of the Tier 1 capital may include deeply subordinated notes, preferred shares are eligible for up to 50%. *See The Next Wave Should be Shares*, INT'L FIN. L. REV. (2009).

21. *See* Minimization of Long-Term Costs and Maximization of Benefits for Taxpayers, 12 U.S.C.A. §5223 (2008). To greatly simplify, money is given in exchange for preferred stock that pays a 9% dividend.

22. For this component of the plan, other European States also created an SPV (e.g., Germany and the U.K.).

23. This was due to the different regulatory treatment of preferred shares and deeply subordinated notes. *See supra* note 20 and accompanying text.

24. This was to ensure that the initial capital injection of 10.5 billion euro would generate 850 million euro by the end of 2009.

25. A call may be exercised by banks at par during the first year, at 101% during the second year, and the premium reaches 111% after the sixth year.

B. Structural Interventions

Structural interventions are at the national level, though more and more often they are adopted at the E.U. level.[26] Three pieces of French legislation will be mentioned: first, the law modernizing the securitization legal framework; second, the law enhancing hedge funds competitiveness; and third, a stricter regulation of executive compensation. They are presented below in chronological order.

1. Securitization

Securitization is one cause of the crisis. However, "*it is not because the water is not clean that you have to throw out the bathtub too* . . . " This is why it is not surprising that France has decided to modernize the legal framework of mutual debt funds, to make securitization more attractive.[27] In the past, mutual debt funds were not attractive because their lack of legal and tax personality was an issue when transferring foreign receivables. One of the major features of the June 2008 ordinance is a new category of securitization vehicles with legal personality that allow securitization of insurance risk and extend the asset class of receivables that can be securitized.[28]

2. Hedge Funds

Some authors describe hedge funds as an accelerator of the crisis.[29] Here, the general view in France is not to eliminate hedge funds, but to regulate them better.[30] French law has therefore introduced *gate* possibilities as well as *side pocketing* for hedge funds in an ordinance dated October 23, 2008. The idea is to cope with the liquidity crisis on a microeconomic level.

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26. *See infra* Part IV.

27. Philip Boys, *New Legal Framework for Securitization,* INT'L LAW OFFICES, (Sept. 9, 2008), *available at* http://www.internationallawoffice.com/Newsletters/detail.aspx?g=a9415593-42c6-4286-bea3-eb2d592c6a0c.

28. It now includes the assignment of future receivables arising under lease agreements and lease purchase agreements.

29. Claire Gatinois, *Pétrole: Les Fonds Spéculatifs Attisent la Flambée des Cours*, LE MONDE (Nov. 23, 2007); *see also* J. Attali, *Le Vortex du Monde*, L'EXPRESS (Dec. 29, 2007), http://blogs.lexpress.fr/attali/2007/12/le-vortex-du-monde.php; M. Rocard, *La Crise Mondiale est Pour Demain,* LE NOUVEL OBSERVATEUR (Dec. 13, 2007), http://hebdo.nouvelobs.com/sommaire/les-debats/075556/la-crise-mondiale-est-pour-demain.html.

30. *See generally* Georges Cavalier, *La Réglementation des Fonds Spéculatifs (The Regulation of Hedge Funds, and State Funds)*, REVUE DE DROIT INTERNATIONAL ET DE DROIT COMPARÉ (2010).

As a reminder, mutual fund shares (including hedge funds) are redeemable from investors at any time; whenever an investor wants to exit the fund, it is possible. A *gate* provision restricts the amount of withdrawals an investor can make from the fund. It aims to insure the liquidity of hedge funds. *Gates* allow management companies to cap the amount of capital withdrawn from a fund at each scheduled redemption date. In other words, *gates* control the liquidity of the fund by spreading redemptions over time. It keeps the fund from having to sell off assets at fire-sale prices, which is disadvantageous to investors.

One can find a similar concept in *side pocketing*. This type of account separates illiquid assets from other liquid investments. The October 2008 ordinance also made this possible.

3. Executive Compensation

Executive compensation is probably the hottest topic in France today. Corporate governance is increasingly capturing attention. An Act passed in 2007 increased scrutiny of "*golden parachutes*" by prohibiting the award of deferred compensation to resigning corporate officers in listed companies, unless the compensation was conditional on the achievement of performance objectives.[31] It is a way to ensure that "*golden parachutes*" are not a "*reward for failure*."

In the same vein, on October 6, 2008, the French Business Confederation[32] presented a new Code of Corporate Governance (the "Code") which proposed stricter regulations.[33] It focuses on several objectives, including: (i) putting an end to "*golden parachutes*" and "*golden hellos,*" and (ii) creating new rules for granting stock options and preferential shares.

In the context of the crisis, it is now required that the beneficiaries of the French Bank Relief Act comply with the new Code, but the Code is "soft law" and hardly sufficient. Therefore, responding to public outcry, the French government issued a Decree in March 2009 banning stock options and limiting bonuses for bankers who lay off workers after ac-

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31. *See* AMF REPORT ON CORPORATE GOVERNANCE AND CONTROL, AUTORITE DES MARCHES FINANCIERS (Jan 28, 2008); *see also* Lukasz Stankiewicz, *Tax Reform in France: Sarkozy's Tax Package of August 2007*, BULLETIN FOR INTERNATIONAL TAXATION (2008).

32. The *Mouvement des Entreprises de France* (MEDEF) is the leading network of business people in France.

33. *See* Catherine Malecki, Régulation *Financière: Les Codes D'entreprise Feront-ils Grise Mine?,* RECUEIL DALLOZ (2009).

cepting government aid.[34] A number of French executives, including senior management at *Société Générale*, have recently abandoned bonuses.

III. FUTURE IMPLICATIONS

Even for the French, it is hard to make predictions in our "Brave New World." Prophecy has always been harder than history; however, hereafter is a guess about what will happen next.

One may predict that a strong international voice will be part of any lasting solution. This is already true for credit rating agencies, with efforts at the E.U. level to regulate them.[35] For instance, the ratings methodology now has to be public. This might also become true for executive compensation, where the European Commission has made recommendations on remuneration policy in the financial services sector. Even more recently, President Sarkozy and Chancellor Merkel, pledged their willingness to fight unjustified remuneration for traders.[36] Prime Minister Brown joined that pledge a few days later, followed by confirmation from the G20 Finance Ministers. Solutions cannot be made unilaterally because the market for traders is international, and institutions are competing for a limited pool of profitable talent.

Additionally, one may predict that pragmatism and efficiency will guide solutions in the current competitive environment. After all, is it so difficult to accept that there is not just one model of economic development, and that models evolve over time? The liberal model is probably best for the United States. However, if one tries this system in France, the result may be a new French Revolution. The French population is not likely to accept large income disparities with low social output. Moreover, even after the crisis is over, applying the French system in the United States will likely provoke another Boston Tea Party.[37]

Every nation and economy has to find a niche that best fits its talents and culture. It is not always easy to compare apples to oranges. Pragmatism and efficiency do not always aligned to one single ideology. Howev-

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34. Decree No. 2009-348 of March 30, 2009, Journal Officiel de la Republique Francaise [J.O.] [Official Gazette of France] (as modified by decree dated Apr. 23, 2009).

35. The E.U. approved a regulation of credit rating agencies; the same movement can be observed in Japan and Australia.

36. Norma Cohen, Jean Eaglesham & Brooke Masters, *Europe's Leaders Call for "Binding Rules" to Rein in Bankers' Bonuses,* FIN. TIMES, Sept. 4, 2009, at 1.

37. *See generally* Zachary Roth, *Tea Party Group: Obama is Both Goebbles and Mengele*, TPMMUCKRAKER, (Sept. 4, 2009), *available at* http://tpmmuckraker.talkingpointsmemo.com/2009/09/tea_party_group_obama_is_both_goebbels_and_mengele.php.

er, pragmatism and efficiency will always be a cornerstone of an effective market.

Lastly, a new role should be assigned to lawyers in the financial and commercial arena.[38] Law is not economy. Historically, lawyers were priests. Legal systems are moral systems, they are like religions and can be all-powerful – as well as have their own heretics! Some institutions gave money away for free. Everybody thought the *château* on the hill was worth 100, but it was a fairy tale; it was worth only 50. With laws, lawyers may be able to ground human optimism and dispel the belief that you can get rich quick doing nothing!

38. *See* Philip R. Wood, *Predictions for the Future of Financial Law and Lawyers*, 9 BUS. L. INT'L 234 (2008); *see also* Yann Paclot, *Crise Financière, Crise du Droit*, LA TRIBUNE, Jan. 14, 2009, at 8.