Mastering the financial crisis – The French approach

by

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France suffered from the financial crisis originating from the United States in 2007 like all other European countries. However, the French banking sector was significantly less impacted by the financial crisis than other European countries. This lead France to adopt a financial rescue plan including a recapitalisation and a refinancing scheme presenting technical and sometimes fundamental differences with other European countries. France also took a very hard view on managers' and traders' compensation. Measures adopted during the financial crisis on compensation as temporary counterparty imposed on banks and financial institutions might probably become partially or totally permanent.

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Introduction

France suffered from the financial crisis originating from the United States like all other European countries.

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The crisis started to gain public notice in June 2007 when two highly leveraged funds of Bear Stern[2] invested in subprime loans had to be liquidated. However, at this time, many observers still believed that the crisis was limited to a specific portion of the real estate market and would be contained to the United States. It did not prove so. In Europe, the German IKB bank, who had also heavily invested into subprime loans, had to be bailed out in August 2007.

Shares of other European banks started to decrease regularly and significantly in value for fear that their balance sheet would be exposed to the US subprime market. In March 2008, Bear Stern had to be purchased by JP Morgan Chase, acting with the support of the US Treasury and the Federal Reserve, in order to prevent a bank failure. On Monday September 15, Lehman Brothers Holdings Inc. (LBHI) filed for Chapter 11 protection in the Bankruptcy Court for the Southern District of New York after no more buyer could be found for the firm when the US Treasury refused to provide funding or guarantees for a rescue[3]. The decision to let Lehman fail took the market by surprise. This forced the US Government to adopt rescue measures. Few days later, on Friday, the announcement of the Troubled Assets Relief Program (TARP) by the US Treasury, which consisted in purchasing or insuring up to $700 Billion of « troubled assets », initiated a panic which sent the S&P 500 lower by 28 % until October 10, when a change to a TARP equity plan was announced[4]. In between, Congress adopted in emergency the *Economic Emergency Stabilization Act* on October 3, 2008 which gave power to the US Treasury to put TARP in practice[5]. The lack of transparency on the assets held by the banks increased the confidence crisis and threatened the financial stability of the banking system in many countries. Financial markets in European countries also collapsed and shares of banks were particularly hit.

In Europe, many banks were also affected by the panic which followed the Lehman collapse and had to request or to receive public support, since private markets were closed to them unless they would be willing to pay an uneconomic price. Due to the closure of public markets, States suddenly became the lender of first and last resort for many banks. Among the most affected banks in Europe, immediately after the Lehman bankruptcy, were

2 These funds were the « Bear Stearn High-Grade Structured Credit Strategies Fund » and the « Bear Stearn High-Grade Structured Credit Strategies Enhanced Leveraged Fund ». The losses from the funds amounted to $1.8 billion. The two managers of the funds were arrested and sued criminally in the US but where acquited by a jury in November 2009. A civil suit from the SEC for fraud is still pending (SEC v. Cioffi, 08-CV-2457, U.S. District Court for the Eastern District of New York, Brooklyn).

3 The Bankruptcy court appointed an examiner which issued a report in March 2010 on the causes of the Lehman collapse and the potential liabilities associated. This report is available at : http://lehmanreport.jenner.com/

4 The S&P 500 tumbled from 1255 to 899 between September 19 and October 10.

5 Public Law 110–343 (Pub. L. 110–343,122 Stat. 3765, enacted October 3, 2008).

Electronic copy available at: http://ssrn.com/abstract=2060812

banks in Iceland, Ireland, the United Kingdom, Belgium, Germany and Switzerland. This lead governments in these countries to adopt emergency measures to bail-out failing banks on an ad hoc basis and/or to adopt general schemes to offer capital and financing to financial institutions. For instance, in the United Kingdom, a plan which served as a model in Europe and in the US was announced on 8 October 2008 which included guarantees and recapitalization measures. It therefore differed from the TARP plan which considered direct purchase of mortgage backed securities but the US Treasury announced two days later its intention instead to recapitalize the banks. A similar plan was adopted in Germany with the Financial Market Stabilisation Fund Act (FMStG) which entered into force on 18 October 2008[6]. However, the situation was very different from country to country[7]. In some countries, the crisis affected mostly one or two large financial institutions whose balance sheet had grown disproportionate to the size of the country, making it harder and more risky for Governments to rescue them. This is the case for instance of Switzerland with UBS[8] and Belgium with Fortis and Dexia. Other countries were exposed to a large number of ailing banks, sometimes before the Lehman bankruptcy, like the United Kingdom (Northern Rock, RBS, HBOS….), Ireland and Germany (IKB, Sachsen LB, HRE…). France was also affected by the financial crisis although to a much lesser extent than many other European countries. Despite this favorable situation, the French government also took emergency measures and adopted a general scheme to provide capital and liquidity to major banks.

The French financial rescue measures were adopted quickly by a law during the same period as the American, British and German plans[9].

The main instrument was the law on Finance n°2008–1061 of October 16, 2008 which was adopted within one week and came into force on 18 October 2008. The law included a recapitalisation and a refinancing scheme[10]. A

6 BGBl I, No. 46, page 1982. On the German plan, see. Klaus J. Hopt, Christoph Kumpan and Felix Steffek, Preventing Bank Insolvencies in the Financial Crisis: The German Financial Markets Stabilisation Act, European Business Organization Law Review (2009).

7 For a presentation of the different plans, See. Ana Petrovic and Ralf Tutsch, National rescue measures in response to the current financial crisis, ECB Legal Working Paper Series, n°8, July 2009, available at: www.ecb.int/pub/pdf/scplps/ecblwp8.pdf

8 On the difficulties of UBS see. Myret Zaki, UBS. Les dessous d'un scandale., ed. Favre, Switzerland, 2008, 220 pp.

9 On the French rescue plan, see. G. A. Cavalier, French Interventions in the Financial Crisis, available at www.ssrn.com; R. Parolai, D. de Mouy, B. Fatier, F. Lacroix, C. Dragan, French Action Plan to Restore Confidence in the Banking System (Update), RTDF no 4/2008, p. 18.

10 Law on Finance for the financing of the Economy n°2008-1061 of October 16, 2008, JO 17 October 2008, p. 15905.

specific law on finance was necessary since a guarantee provided by the State must be approved by the Parliament through such legal instrument[11].This Act was followed by another law on Finance n°2009–431 of April 20, 2009[12]. There were also several more specific acts which related to the financial crisis. One was the law n°2009–715 of June 18, 2009 on the merger of *Groupe Caisses d'épargne* and *Groupe Banques Populaires*[13]. Another one was the law n°2009–1955 of 9 October 2009 on access to credit for small and medium size enterprises and to improve the functioning of financial markets[14].

Two decrees were of great importance. The first one was the decree n° 2009–348 of March 30, 2009 on managers' compensation of banks aided by the State and the second one was the decree n° 2009–445 of April 20, 2009 on the Social and economic development fund, which mostly amended the first one.

Although they present some similarities, financial rescue measures and legal problems raised during the course of these actions have been different in the Member States. Therefore, it is interesting to look, as an example, at the French approach to mastering the financial crisis. France is also interesting since it held the European Union Council presidency between July and December 2008, and was therefore very influential at the EU level at a time when the crisis was the most severe and individual and general schemes were adopted in many European countries.

Before presenting the financial rescue measures adopted by France (II) and the regulations and obligations imposed on banks (III), it is necessary to present the European framework and the comparatively favorable French situation (I).

I. The European framework and the French situation

The European institutions played an important role in fighting the financial crisis. Some countries even called for an European financial bailout plan but it was finally refused. Therefore, financial rescues plans have been adopted at the level of States and not at the EU level. This solution was logical because plans implied using national taxpayer money for saving national banks. However, all European institutions played a role in mastering the financial crisis (A). France financial rescue measures benefited but were also subject to this

11 Art. 34 of the Loi Organique sur les lois de finance.

12 Law on Finance n°2009-431 of April 20, 2009, JO 22 April 2009, p. 6872.

13 Law n°2009-715 of June 18, 2009 relative à l'organe central des caisses d'épargne et des banques populaires, 19 June 2009, p. 9971.

14 Law n°2009-1955 of 9 October 2009 on access to credit for small and medium size enterprises and to improve the functionning of financial markets, JO 20 October 2009, p. 1740.

European framework, especially in the area of competition rules. However, the situation of French banks was relatively favourable (B).

A. The European framework

All European institutions played a role in mastering the financial crisis. The first ones are the European Central Bank (ECB) and the European Investment Bank (EIB) which provided financing (1°). The other ones are the ECOFIN and the Eurogroup which provided guidelines for national rescue plans (2°). The last one was the European Commission which had to approve all State aids to financial institutions (3°).

1°) The ECB and the EIB

In order to help financial institutions, the ECB reduced its interest rate on the main refinancing operations of banks from 4,25 % to 3,75 % on 8 October 2008 in coordination with the Bank of England and the Federal Reserve. The rate has been reduced regularly since and has stayed at 1 % since May 2009. This helped banks to borrow money from the ECB at a very low cost. On 23 October 2008, the ECB also extended significantly the eligibility criteria for collateral in order to substitute itself to the interbank market which normally allowed banks to refinance themselves for short term loans. However, this left open the problem of longer term refinancing (one year and more) which was then dealt with by the States. On May 7 2009, the ECB decided to purchase euro-denominated covered bonds (*Obligations foncières, Pfandbriefe*) issued in the euro area, for an amount of EUR 60 billion from July 2009 to June 2010. The ECB also provided input on the recommendations issued by the Commission as to the level of compensation to be requested from banks and as to the valuation of certain securitised assets on the balance sheets of financial institutions[15].

The European Investment Bank (EIB) was asked by the Ecofin Council to provide € 30 billion for financing small and medium business enterprises.

15 'The pricing of recapitalisations' – Confidential ECB-Eurosystem document, 20 November 2008.

2°) The ECOFIN and the Eurogroup

The ECOFIN Council of 7 October 2008 led to a statement, whose inspiration was in line with the French plan. According to that, Governments should be in a position to force a change of management and have the power to intervene in compensation[16]. Few days later, on 12 October 2008, a meeting of the Eurogroup led to the "Paris Declaration" which stated that Governments of the Euro Area were ready to take proper action in a concerted and coordinated manner to improve market functioning over longer term maturities and notably by facilitating the funding of banks through government guarantees of bank debt and recapitalisation[17]. It also provided a Guideline for national rescue plans. The declaration also called for « flexibility » in the implementation of accounting rules which was a call, successful, to the International Accounting Standards Board (IASB) to soften the interpretation of « mark-to-market » rules in order to align them with the interpretation adopted in the United States by the Financial Accounting Standards Board (FASB)[18].

3°) The Commission

The role of the EU Commission was essential mostly because all financial aids from States to financial institutions had to be approved as being State aids. Several States, including France for the Dexia plan[19], argued that these were not State aids since the level of interest was close to the one that would have been paid to private investors under « normal conditions ». But, the Commission argued that remuneration must be assessed not with regard to

16 The text of the Conclusion is available at : http://www.eu2008.fr/PFUE/lang/en/accueil/PFUE-10_2008/PFUE-07.10.2008/ECOFIN_results.html

17 The text of the declaration is available at : http://www.eu2008.fr/PFUE/lang/en/accueil/PFUE-10_2008/PFUE-12.10.2008/sommet_pays_zone_euro_declaration_-plan_action_concertee.html

18 On 13 October 2008, the IASB adopted amendments to IAS 39 Financial Instruments: Recognition and Measurement and of IFRS 7 Financial Instruments: Disclosures.On 31 October, the IASB published a document setting out guidance on important measurement issues affecting the valuation of financial instruments when an active market does not exist. The IASB's guidance makes clear inter alia that transaction prices and broker or pricing service quotes might be inputs when measuring fair value, but may not be determinate if an active market does not exist. These new interpretation were then adopted by the EU. Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, OJ L 320, 29 .11.2008, p. 1.

19 Decision of 19 November 2008 in Case No NN 50/08 (now transferred to Case No C 9/09) Dexia – FR, p. 6.

any 'normal' functioning of the market but by taking into consideration the circumstances which existed at the time of the operation. At the time no private investors would have lent money to Dexia or similarly situated banks. Therefore, all financial measures adopted by Member States were State aids which had to be notified ex-ante and approved by the Commission[20].

The Commission played a positive role because it adopted a flexible interpretation of the EC Treaty. State aids to individual companies in difficulties are normally assessed under article 107(3)(c) of the Treaty on the Functioning of the European Union (TFEU)[21] which deals with « aid to facilitate the development of certain economic activities ... » and the Community Guidelines on State aid for rescuing and restructuring firms in difficulty[22]. Before the Lehman bankruptcy, the Commission used this article for rescue plan of individual institutions such as Northern Rock in 2007[23] or West LB in 2008[24]. However, this article did not fit with the situation since the crisis had widened and threatened several institutions, some of them not being insolvent. In addition, some institutions needed immediately "restructuring aid" which under the Guidelines were only available after six months. The very legitimacy of State aid control in this situation was raised and the Commission was put under political pressure from several Member States, mainly France and Germany, to soften its approach.

Therefore, instead of using article 107(3)(c), the Commission accepted to use article 107(3)(b) of the Treaty which allows State aids « to remedy a serious disturbance in the economy of a Member State ». This article had only been used once before, in 1987, for Greece[25]. The Commission had refused to allow France to invoke this provision in 1995 when it bailed out the Crédit Lyonnais because the plan concerned only one bank and not the banking sector as a whole and there was no systemic crisis[26]. But the possibility to invoke this article in case of « systemic crisis » had been accepted. In its October 13, 2008 Communication on "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis"[27], the Commission created a specific framework for bank rescue plans.

20 Art. 107 Treaty on the Functionning of the European Union (TFEU).

21 Article 87(3)(c) of the EC Treaty before the entry into force of the Lisbon Treaty

22 OJ C 244, 1.10.2004, p. 2.

23 Commission Decision of 5 December 2007, NN 70/07 UK, rescue aid to Northern Rock.

24 Commission Decision of 30 April 2008, NN 25/2008 West LB riskshied.

25 Commission Decision of 7 October 1987 concerning Law 1386/1983 by which the Greek Government grants aid to Greek industry, JOCE n° L 076 of 22/03/1988 p. 18.

26 Décision 85/547/CE of the Commission of 26 July 1995, portant approbation conditionnée de l'aide accordée par la France à la banque Crédit Lyonnais, JOCE n° L 308 du 21/12/1995 p. 0092-0119.

27 OJ C 270, 25.10.2008, p. 8.

The failure of a large bank in Member States was accepted by the Commission as being able to fulfill the condition of a « serious disturbance ». In addition to accepting ad hoc measures for specific banks, the Commission also accepted to validate general rescue scheme. A last point in the Communication was that the Commission made a major distinction between financially sound institutions, which needed less substantial restructuring but could receive financial aid whereas this was not admitted by the Guidelines, and financial institutions characterised by endogenous problems which would be subject to far reaching restructuring. This was important for France since French banks were considered to be financially sound. A second communication of January 15, 2009 dealt with « The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition »[28]. The Commission accepted that the then current market price for loans to banks of 15 % would not be used to assess the price of recapitalisation aid. Another major point was that state aids should be designed in a way that provides incentives for banks to redeem the State as soon as market circumstances would permit. A third Communication of 25 February 2009 dealt with the evaluation and treatment of impaired or toxic assets[29]. A fourth Communication dealt with the "return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules"[30].

Finally, because of the urgency of the situation of some banks and the need to have a quick answer, sometimes during the weekend, the EU Commissioner in charge of Competition policy was given the right to approve individual and collective State aids instead of the whole Commission. Therefore, many authorisation were granted by the Commission between September and November 2008, generally as fast as one week.

The French rescue plan was subject to these rules. However, the situation of French financial institutions was more favorable than in some other European countries.

B. The French situation

The French banking sector has been significantly less impacted by the financial crisis than other European countries. French banks had globally a limited exposure to US subprime loans. According to the French Central Bank, as of mid-2009 asset writedowns linked to toxic assets represented 16 % of Tier 1 for French banks compared to 33 % in Germany and in the United

28 OJ C 10, 15.01.2009, p. 2.
29 OJ C 72, 26.03.2009, p. 1.
30 OJ C 195, 19.08.2009, p. 9.

Kingdom[31]. This is in addition to the fact that French banks had apparently marked down by mid 2009 more their toxic assets, by 60 %, than UK or German banks, with 20 %[32]. This does not mean that all French banks escaped the financial crisis. There were two major casualties, Dexia which is technically a Belgian bank, and Natixis. The reasons for this favorable situation are not easy to determine (1°) but it had a major influence on the French financial rescue plan (2°).

1°) Possible reasons for France favorable situation

There might have been several reasons to this favorable situation: a more conservative business model, a a more conservative behaviour, a better regulation and, possibly, "luck".

A first reason is that the French banking sector business model was rather conservative. French banking sector is highly concentrated with seven major groups representing most of the market. These groups are *BNP Paribas*, *Société Générale*, *Crédit Agricole* (which includes the *Crédit Lyonnais*), *Crédit Mutuel*, *Groupe Banques Populaires* and *Groupe Caisses d'Epargne.* All of these groups are universal banks which means that, contrary to the US investment banks, they had stable funding through deposits. Although some of them also had large investment bank activities (*Société Générale*; *Banques Populaires* and *Caisses d'Epargne* through their subsidiary Natixis), the existence of a large deposit base made them less vulnerable to a bank run. In addition, most of their profits originated from the retail part and the asset management part with only a limited part originating from investment bank activities. Only *Société Générale* had a large part of its profits, close to 30 % in 2005 and 2006, coming from its investment bank activities[33].

French banks managers and consumers were also more conservative. First, French banks had high capital ratio and some of them raised capital before the emergency measures were adopted. The six most important French banking groups had raised 17,95 billions euros before the emergency measures were adopted. Second, French banks were more conservative as to subprimes. For instance, *BNP Paribas* was not materially exposed to subprime loans. *Crédit Agricole*, through its investment bank subsidiary Calyon, was issuing Collaterized Debt Obligations (CDO) but only kept a few portion of the

31 See. Cour des comptes, Rapport public, Les concours publics aux établissements de crédit : premiers constats, premières Recommandations, June 2009, p. 86. The report is available at : http://www.ccomptes.fr/fr/CC/Publications-RPT.html. A second report was published in May 20.

32 See. Ibid.

33 See. Société Générale 2010 Registration Document, p. 16.

highest grades CDOs on its balance sheet and stopped this securitisation activity in February 2007[34]. One of the reasons for being more conservative might be that some of these banks where mutualist banks with strong controls from the regional banks. For instance, *Crédit Agricole* is owned by regional banks who tend to be conservative. French consumers also tend, for cultural reasons, to be more conservative than in some other countries and are reluctant to enter into debt. This reduced also the risk that the level of debt of French consumers would form a bubble.

A third reason is that French legislation and regulation was more conservative than in other countries, although this started to change shortly before the crisis occurred.

As to capital ratio, the banking regulator, the Banking Commission (*Commission bancaire*), replaced since 2010 by the Prudential Control Authority (*Autorité de Contrôle Prudentiel* or ACP)[35], was more conservative than other European regulators. European banks are subject to the Basel Committee on Banking Supervision regulation on Capital ratio (Cooke ratio), which was implemented in Europe by the 1989 Capital Adequacy directive[36]. According to the Basel I capital ratio, introduced into French law in 1991[37], banks need to have a 8 % ratio of capital against weighted assets. The capital is divided, according to the quality of the capital, into Tier 1 Capital, Tier 2 Capital, which cannot represent more than 50 % of the Tier 1 capital, and Tier 3 capital. Tier 1 capital is the highest quality capital (original own funds) and is composed of ordinary shares, reserves and preferred shares which satisfy certain criteria. It is itself divided into Core Tier 1, which can be taken into account without any limitation, and non-core Tier 1 (innovative and non innovative hybrid capital) which is capped and cannot be more than a certain percentage of the Core Tier 1. In 1998 the Basel committee capped innovative

34 Rapport d'information déposé en application de l'article 145 du Règlement par la Commission des finances, de l'Economie générale et du plan relatif à la crise financière internationale et présenté par MM Didier Migaud, Président et Gilles Carrez, rapporteur général, Assemblée Nationale, n° 1235, Enregistré à la Présidence de l'Assemblée nationale le 5 novembre 2008. p. 246. The report is available at http://www.assemblee-nationale.fr/13/rap-info/i1235.asp.

35 Ordinance no 2010-76 of 21 January 2010 portant fusion des autorités d'agrément et de contrôle de la banque et de l'assurance, OJ of 22 january 2010 p 1392. On the reform See. Th. Bonneau, Commentaire de l'ordonnance n°2010-76 du 21 janvier 2010 portant fusion des autorités d'agrément et de contrôle de la banque et de l'assurance, JCP éd. E. 11 february 2010, 1140. See also, P.-H Conac, The reform of the French financial supervision structure : « Twin-Peaks » revolution on the menu. Liber Amicorum Klaus Hopt, De Gruyter, 2010.

36 Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions, OJ L 386 , 30. 12. 1989 p.14..

37 Regulation CRBF n° 91-05 of 15 February 1991 regarding solvency ratio.

hybrid capital at 15 % of Tier 1[38]. In 2004, the French Banking Commission imposed that hybrid capital (innovative and non innovative) be limited to 25 % of Core Tier 1. This level was more conservative than the one in the United Kingdom where hybrid capital could represent 50 % of Core Tier 1 capital[39]. Therefore, French banks entered the financial crisis with a better quality capital and a Tier 1 ratio above the 4 % level required by regulators. The Basel I ratio was replaced in 2004 by the Basel II ratio (Mc Donough ratio), which notably allows for using internal models to determine the risk of certain assets, but did not modify the 8 % solvency ratio. The Basel II ratio was implemented in Europe by the Capital Requirement Directive (CRD) of 14 June 2006[40]and, at the outset of the crisis, in France by two 2007 ministerial order[41].

Another favorable point is that subprimes could not have been easily developed in France since there are many legal protections for borrowers, some of them which are court made. In addition, contrary to the situation in the US were usury laws were repealed in the 1980 s[42], usury laws apply to mortgage loans to consumers and prevent banks from applying very high interest rates in order to cover the increased risk on these loans[43]. This made it more difficult for risky loans to be provided by banks, contrary to the United States where there was no meaningful subprime borrower protection. The only way to make borrowers more creditworthy in France was to increase the duration of the loans, which actually did happen shortly before the crisis. Loans were first extended to 30 years and then after a legal reform, in 2007 to 40 and 50 years[44]. However, this was the time when the financial crisis started

38 Sidney Press release : Instruments eligible for inclusion in Tier 1 capital (27 October 1998), available at http://www.bis.org/press/p981027.htm

39 FSA handbook – General Prudential sourcebook, available at http://fsahandbook.info

40 Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), OJ L. 177, 30.06.2006, p. 201.

41 Ministerial order of 20 february 2007 relatif aux exigences de fonds propres applicables aux établissements de crédit et aux entreprises d'investissement, JO 1st March 2007, p. 3796. Ministerial order of 20 February 2007 modifiant les règlements du Comité de la réglementation bancaire no 90-02, no 90-15, no 91-05, no 92-12, no 93-05 et no 95-02 et les règlements du Comité de la réglementation bancaire et financière no 96-15, no 97-02, no 97-04, no 98-04, no 99-06, no 99-07, no 99-15, no 99-16, no 2000-03 et no 2002-13, en application de l'arrêté du 20 février 2007 relatif aux exigences de fonds propres applicables aux établissements de crédit et aux entreprises d'investissement, JO 1st March 2007, p. 3880.

42 Depositary Institutions Deregulatory and Monetary Control Act (DIDMCA) of 1980.

43 Art. L. 313–3 Consumer code.

44 An Ordinance of 2006 authorised mortgages up to 50 years instead of 35 years before. Art. 2434. Civil code. Ordinance n° 2006–346 of 23 march 2006 relative aux sûretés, JO n°71 of 24 march 2006 p. 4475.

which prevented this type of loan to develop. In 2006, the French government also introduced a US inspired mortgage equity withdrawal (*hypothèque rechargeable*), which allows the owner of a home to use the reimbursed part of his mortgage for consumption[45]. This mechanism, helped by rising home prices, had significantly spurred growth in the US after 2001. However, this reform only entered into force in France in January 2007, at a time when the financial crisis was about to start. These factors prevented a real estate bubble from forming in France, contrary to the situation in the United States.

Finally, French banks might have been simply lucky. The Kerviel fraud was discovered in February 2008. It first forced the *Société Générale* to increase its capital by 5,5 billion euros in order to cover the loss of 4,9 billion euros incurred after unwinding 50 billion euros of unauthorised positions. However, the fraud also forced *Société Générale* to reduce its investment bank activities at an early stage in the financial crisis[46]. The fraud quickly lead the Ministry of the Economy to adopt guidelines in order to better monitor market risks. Other French banks activities were put under scrutiny by the Banking Commission and were subject to more on site inspection[47]. In a sense, the Kerviel fraud, put French banks investment bank activities under increased regulatory scrutiny which might have had a chilling effect on risk taking.

2°) Specificities of the French rescue measures in comparison with other Member States

Since the French banking system was less affected than in other countries, the French financial measures present some specificities in comparison with other countries.

There was no creation of a «public bad bank» for acquisition of toxic assets such as in Germany or Ireland (National Asset Management Agency or NAMA). This solution had been used in France in the case of the failure of the *Crédit Lyonnais* in 1995. However, it was not used this time because the situation of French banks was not so severe as to require such tool. However,

45 Art. 2422 Civil code. Ordinance n° 2006–346 of 23 march 2006 relative aux sûretés, JO n°71 of 24 march 2006 p. 4475.

46 On the Kerviel fraud, various reports were requested or produced by the Société Générale management. See. Société Générale, Inspection Générale, Mission Green, Rapport de synthèse, 20 february 2008 ; Société Générale, Inspection Générale, Mission Green, Rapport de synthèse, 20 May 2008 ; Report of the board of directors to the general shareholders' meeting, 22 May 2008 ; PricewaterhouseCoopers, Synthèse du diagnostic de PwC et analyse du plan d'action, 23 May 2008. See also, Sanction decision of the Banking commission, Société Générale, July 2008.

47 Banking Commission annual report 2008, p. 103.

there were two exceptions. The first one was Dexia, where a portfolio of toxic assets guaranteed by several States was put into a run-off mode. A second exception was Natixis, with a 33 billion euros bad bank, but organized by the controlling shareholders themselves, after recapitalisation by the State.

Similarly, there was no nationalisation or quasi nationalisation of banks, such as in the United Kingdom, Ireland, Iceland, Germany and Austria. The recapitalisation of Dexia amounts to a partial nationalisation but was an isolated event. France also ruled out a direct State guarantee on bank loans since it was not necessary, would have been risky and it did not fit with the objective to increase lending to the economy.

Finally, there was no unlimited guarantee on deposits as in Ireland or in the United Kingdom. The reason is that the situation was considered not so difficult as in the countries which adopted the measure and there was no bank run. On the contrary, such an announcement could have had the contrary effect to create the impression that there was a problem[48]. Therefore, the 30 September 2008 decision by Ireland to provide for an unlimited guarantee of deposits, which was quickly followed by Greece, Austria, Denmark and Germany, was not copied in France. However, on 25 September 2008 in Toulon, the French president declared during a public speech that in case a bank would file for bankruptcy, no depositor would lose money. This amounted to an implicit guarantee on all deposits. The French guarantee was of 70,000 euros. A revision of the EU deposit guarantee scheme took place in March 2009 and raised the minimum guarantee from 20,000 euros to 50,000 euros, and 100,000 euros by 31 December 2010[49].

Given this relatively favorable situation, French financial rescue measures presented some differences with other countries.

II. Financial rescue measures

Like other European countries, France adopted a plan to finance the banking sector (A). However, the French Government also had to adopt or encourage specific measures for some banks (B).

48 Rapport d'information déposé en application de l'article 145 du Règlement par la Commission des finances, de l'Economie générale et du plan relatif à la crise financière, op. cit.

49 Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, OJ L 68, 13.3.2009, p. 3.

A. Financing the banking sector

Like in many other countries, the French scheme for banks, organised by the law of 16 October 2008 on finance took the form of a recapitalisation scheme (1°) and a refinancing scheme (2°).

1°) Recapitalization of the banking sector

The recapitalisation scheme was made in two periods through a state-owned investment company, the *Société de prise de participation de l'État* (SPPE).

The goal of the scheme was not to save ailing banks but was a precautionary measure designed to increase the capital ratios of French banks in order to allow them to extend credit[50].

The SPPE is a simplified joint stock corporation (*Société par actions simplifiée*) with the French State as its sole shareholder. In order to finance itself, the SPPE issued bonds guaranteed by the French State on a case by case decision to be taken by the Ministry for the Economy. The bonds issued are short term bonds because banks have a strong incentive to reimburse quickly the capital injection. In addition, the yield on the 10 years note was around 4 % against 2 % for short term notes (commercial paper) which created an incentive to finance the SPPE with short term bonds. The amount issued was included in the debt according to Maastricht standards.

The first capital injection in French financial institutions did not take the form of ordinary shares but of deeply subordinated debt securities (non-innovative hybrid instruments). There were several reasons for this decision. The main reason is that French banks were not insolvent or close to bankruptcy, except Dexia, or in a comparable situation to the one existing in some other countries. Their solvency ratio, including Dexia, was above the regulatory requirements[51]. Therefore a capital injection in the form of ordinary shares was not required. On the contrary, it would have sent to the financial markets the message that the situation was worse than previously disclosed[52]. Another

50 The decision to announce details of the plan was accelerated by the decision of the Dutch authorities on October 19, 2008 to provide 10 billion euros to ING, which created an expectation on the markets for similar capital injections in other countries.

51 As of 30 June 2008, the Tier 1 solvency ratio were 8,3 % for Crédit Agricole, 7,6 % for BNP Paribas, 8,2 % for Société Générale, 9,7 % for Crédit Mutuel, 8,3 % for Caisse d'épargne and 9,6 % for Banque Populaire. See. Cour des comptes, Rapport public, Les concours publics aux établissements de crédit : premiers constats, premières Recommandations, June 2009, p. 56.

52 Hearing C. Lagarde, 5 nov. 2008, Rapport d'information déposé en application de l'article 145 du Règlement par la Commission des finances, de l'Economie générale et du

reason is that the cost of issuing ordinary shares would have been more costly for banks than issuing hybrid instruments. The Government chose not to issue preferred shares either because, following negotiations with the Commission, interest on preference shares was set at a higher rate (10 %) than on hybrid securities[53]. This was logical since the more the instrument was close to equity, indicating a distressed situation, the more the cost should be. Preference shares are also less used in France by banks which issue rather TSS. Therefore, the French financial rescue plan differed from the German, British and Greek plans which included capital injections in the form of preferred or ordinary shares.

The first tranche of deeply subordinated debt securities (*Titres super subordonnés à durée indéterminée* or TSS), a financial instrument created in 2003[54], was issued on 11 december 2008, after the French plan was approved by the EU Commission on 8 December 2008, to the six most important French banking groups[55]. The TSS can be classified as non-core Tier 1 capital, after agreement from the Banking Commission, if three conditions are satisfied. They must be perpetual (or have a duration of 99 years), and can only be reimbursed in limited circumstances if they are replaced with capital of the same quality, unless the supervisor determines that there is adequate capital. The issuer can cancel the payment of the dividend in times of stress and the cancelled payment will be not accrued. Finally, they must have the capacity to absorb losses during liquidation and as a going concern by reducing their nominal value. In summary, they must be equivalent to equity.

This lead to an increase of each bank Tier 1 ratio by 0,5 % (50 basis points) from around 8 % to around 8,5 %. Eligible institutions were financial institutions (*organismes financiers*) which include credit institutions and other types of regulated entities such as portfolio management companies. The banks who took the funds were *BNP Paribas* (2,55 billion euros), *Société Générale* (1,7 billion euros), *Crédit Agricole* (3 billion euros), *Crédit Mutuel* (1,2 billion euros), *Groupe Caisses d'épargne* (1,1 billion euros), and *Groupe Banques Populaires* (0,95 billion euros). Like in other countries like Germany (Deutsche bank) or Italy (Banca Intesa), some banks such as *Société Générale,*

plan relatif à la crise financière internationale et présenté par MM Didier Migaud, Président et Gilles Carrez, rapporteur général, Assemblée Nationale, n° 1235, Enregistré à la Présidence de l'Assemblée nationale le 5 novembre 2008. p. 288. The report is available at http://www.assemblee-nationale.fr/13/rap-info/i1235.asp.

53 Art. L.228-11 Commercial code. On the regime of preferred shares, see P-H Conac, The New French Preferred Shares: Moving towards a More Liberal Approach, ECFR 4/2005, p. 488.

54 Article L. 228-97 Commercial code. Law n°2003-706, 1 août 2003, loi de sécurité financière (LSF), art. 61, p. 1947, JO 2 August 2003, p. 13220.

55 State aid N 613/2008 – Republic of France. Capital-injection scheme for banks. Brussels, 8.12.2008.

stated publicly that they were reluctant to accept the capital injection. However, in France they all finally accepted. It cannot be ruled out that there was some political pressure on the reluctant banks to accept to participate in the scheme. By forcing all major French banks to participate into the scheme, the Government prevented the market from identifying a weaker one and creating a panic like what had happened before to Fortis and *Dexia* in Europe, or Bear Stearn and Lehman in the US.

The issues could be subscribed quickly since there was no need for an extraordinary shareholders' meeting of the banks since under French company law, these instruments are treated as debt, which under French company law can be issued by the board of directors of the company without shareholders authorisation.

At the same time, in November 2008, the French Banking Commission softened its approach and allowed hybrid capital to represent 35 % of the Tier 1 ratio in order to allow the banks to take full benefit of the financial rescue plan[56]. This allowed the banks to take full benefit of the SPPE plan since some of them had already reached the 25 % threshold established in 2004. The Directive of 16 September 2009, which modified the 2006/48 capital adequacy directive has also introduced a 35 % threshold and includes the possibility, which corresponds also to the approach adopted in France, to raise the ratio of hybrid capital in time of crisis[57].

The interest rate on the TSS was set up around 8,2 % which was equivalent to the interest rate on the 5 years State bonds (*BTAN*), which was around 4 % at the time, five times the CDS of the bank, which lead to around 2 %, plus a 2 % additional interest. This amount was similar to what banks where paying at the beginning of 2008, before the financial crisis. The remuneration would be fixed rate during five years and would become variable after March 11, 2014[58]. Repurchase of the TSS could be requested at any moment by the issuer, with the agreement of the Banking commission and the purchaser. Following the EU Commission guidelines which requested a strong incentive to reimburse the State, so that State aid remain temporary, the interest increased every year (step-up). The nominal amount to be redeemed would increase by 1 % if reimbursement took place between 1 and 2 years of issuance, 3 % between 2

56 See, Cour des comptes, Rapport public, Les concours publics aux établissements de crédit : premiers constats, premières Recommandations, June 2009, p. 19 available at : http://www.ccomptes.fr/fr/CC/Publications-RPT.html

57 Art. 66§4 of the 2006/48 CRD directive as amended. Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, OJ L 302, p. 97.

58 The variable rate would be EURIBOR + 250bps + 5 x CDS (senior five years).

and 3 years, 5 % between 3 and 4 years, 7 % between 4 and 5 years, 9 % between 5 and 6 years and 11 % beyond. Such interest rates provided a strong incentive to pay back the TSS in the short term.

Since the financial crisis did not abate, the State announced on 21 January 2009 a second recapitalisation designed to increase French banks Tier 1 ratio by another 0,5 %. The EU Commission had authorised a 21 billion euros scheme, so that a second recapitalisation round was possible[59]. However a second authorisation was necessary since preference shares were considered[60]. Since most banks had already reached the maximum 35 % of Tier 1 threshold, it was decided that banks would be offered either hybrid capital, on the same terms as those approved in the decision of 8 December 2008, and preference shares, which, under certain conditions can be classified as Core Tier 1 capital. By allowing preference shares, not only would the capital injection increase the Core Tier 1 ratio but it would also allow mechanically more TSS to be included in the Tier 1 ratio since the amount of Core Tier 1 capital would increase. A 2008 modification of the legal regime of preferred shares made this operation possible for banking regulators. Before the 2008 Act of modernisation of the Economy (LME Act)[61], listed preferred shares could be reimbursed at the request of a shareholder in case of the market was illiquid. Therefore, the Banking commission had then refused to include such assets into the Core Tier 1 category. This provision was abrogated by the LME Act which allowed the Banking commission to decide in February 2009 that preferred shares could be included in the Core Tier 1 ratio. The program was of an amount of 11 billion euros. Eligible banks also had the possibility to convert previously issued TSS into preferred shares in order to increase in their Core Tier 1 capital.

Preferred shares issued under the plan were non voting shares not convertible into ordinary shares. Negotiations with the Commission led to the establishment of a higher remuneration for preference shares, compared to the TSS, reflecting their higher degree of risk. In addition, the cost was also higher for the banks since the payments on the preferred shares were not tax deductible. However, payment to the State was only allowed if a dividend was paid to the shareholders. In order for the preferred shares to be accepted as Core Tier 1, only the issuer could decide to reimburse the shares. Like with the TSS, the

59 The EU Commission also accepted (28 January 2009) to increase the autorisation by € 500 M in order to take into account the merger of the Caisses d'Epargne and the Banques Populaires available at : http://ec.europa.eu/community_law/state_aids/comp-2009/n249-09.pdf

60 State aid N 29/2009 – French Republic Amendment to the capital-injection scheme for banks, Brussels, 28.1.2009.

61 Art. 31, abrogating article L. 228-20 of the Commercial code, of the Law no 2008-776 of 4 August 2008 of modernisation of the economy, JO 5 August 2008, p. 12471.

preferred shares included step-up provisions in order to create an incentive for repayment. The maximum repurchase price was regularly increased but capped at 20 % after the first 5 years and 60 % after 13 years. The limitation of capital gains for the State was the counterparty of the increased interest on preferred shares.

The French State did not request to be represented on the board of directors of the banks, except in the case of Dexia and of the new BPCE group resulting from the merger *of Groupe Caisses d'épargne* and the *Groupe Banques Populaires.* The presence of representatives of the State at the level of BPCE was probably caused by the fact that the previous cooperation between the two companies had been contentious, and that Natixis was a subsidiary of the new group. Apart from the BPCE, the main reason is that preferred shares issued by the banks did not give voting rights. However, no legal provision prohibits holders of non voting preferred shares to be elected to the board of director or to the supervisory board. In addition, since the 2008 LME Act, it is not even necessary any longer for a director or a member of a supervisory board to be a shareholder, preferred or non preferred, except if provided for the contrary by the articles of association[62].

The option was open until 30 August 2009 because under French company law, banks need a special authorisation from the extraordinary general shareholders' meeting to increase capital for the benefit of one identified person. Therefore, the board of directors alone could not issue the preferred shares to the SPPE. Not all French banks subscribed to this second tranche. The subscribers were *Société Générale* (1,7 billion euros) with preferred shares, *BNP Paribas* with preferred shares (5,1 billion euros), *Caisses d'épargne* (1,1 billion euros) and *Banque Populaire* (0,95 billion euros). *Crédit agricole* and *Crédit mutuel* did not subscribe to the second tranche.

Because they were costly and temporary, most French banks, like in the US and the UK reimbursed the TSS and the preferred shares very quickly. This took place between October and November 2009, especially through share increases in order to pay back the TSS and the preferred shares. As of December 2009, €13,5 billion had been paid back to the French State, and all French banks, except the new BPCE group had reimbursed the French State.

A second aspect of the French financial rescue scheme, in line with other countries, was the refinancing of the banks.

62 Art. L. 225-25 (board of directors) and L. 225-72 (supervisory board) Commercial code. See B. Saintourens, Les réformes du droit des sociétés par la loi du 4 août 2008 de modernisation de l'économie, Revue des sociétés, Dalloz 2008, p. 477.

2°) Refinancing of the banking sector

Like other countries, the French Government did not want just to improve the solvency of French banks but also to make their assets more liquid so that they could have funds to lend to businesses. Therefore, the State needed to substitute itself to private markets. This was done through the creation of a company, the Company for the financing of the French economy (*Société de Financement de l'Économie Française* or SFEF). This approach was unique in Europe because many other States (Germany, UK, Belgium) chose to guarantee directly debt issuances of their banks. The reason might be that, apart from Dexia and Natixis, there were not officially specific ailing banks.

The decision to create a special entity was due to clarity reasons, in order to distinguish State debt from debt issued for the benefit of the banking sector. It was also a way to underline that the SFEF was a non-recurring debtor, contrary for instance to the German *Kreditanstalt für Wiederaufbau* (Kfw), which was considered to have a positive effect on possible lenders. The SFEF is a joint-stock company (*Société anonyme*) held by the six major banks and HSBC France (66 %) with a blocking minority for the French State (34 %)[63]. Michel Camdessus, former International Monetary Fund (IMF) chairman, was appointed as chair. The French State was granted two representatives on the board of directors and there is a veto right for the Ministry for Economy on any decision of the board of directors which could affect the interests of the French State.

The decision to create a special entity majoritarily-owned by the private sector was also due to a willingness to avoid the inclusion of the large amount of debt issued by the SFEF into the French public debt. Despite the fact that the company was majority owned by the private sector, Eurostat considered at first that the SFEF was a public institution and therefore that the debt was to be accounted as State debt according to the Maastricht standards. However, in July 2009, after apparently strong pressure from France and in order to provide a level playing field with European States which had provided direct guarantees to banks and whose guarantees were not included in their debt, Eurostat excluded the amount of debt issued by the SFEF from the French national debt. This lowered the French debt by around 4 %.

The SFEF was not given credit institution (*établissement de crédit*) status in order to avoid the application of the Basel solvency ratio which would have implied for its shareholders bringing around 750 million euros of capital. Therefore, the capital could be limited to 50 million euros. Although not legally a bank, the SFEF was granted an exception to the banking monopoly and is subject to the supervision of the Banking Commission. Therefore, the

63 Art. L. 225–96 Commercial code.

Chairman of the French Central Bank, who is also the chairman of the Banking commission, attends the meeting of the board. The SFEF was also granted the right to issue immediately bonds, whereas under the Commercial Code, joint-stock companies have normally to wait 2 years[64].

Under the Law for finance of 16 October 2008, the SFEF was allowed to issue bonds which would be guaranteed by the French State, up to 265 billion euros[65], including 55 billion euros for companies of the Dexia group and bonds issued by the SPPE. Contrary to the SPPE, the guarantee of the State was charged to the SFEF which transferred the cost to the borrowing banks. This amount was close to 17 % of the France Gross National Product, and was comparable to plans adopted in the UK and Germany. The State guarantee on debt issued by the SFEF, making it AAA rated, was given on a case by case by the Ministry of the Economy and provides the highest level of security since the guarantee is autonomous, on first request, unconditional and irrevocable. The 265 billion euros level was very high in oder to reassure the markets but was not meant to be really raised. The SFEF had only issued 50 billion euros in April 2009 and stopped issuing bonds at the end of September 2009. Despite this guarantee, the SFEF bonds had to be priced at 0,5 % more than bonds issued directly by the French State, because it was still a private issuer.

The refinancing scheme for credit institutions in France was initially approved by the Commission on 30 October 2008[66]. Its extension was authorised on 12 May 2009[67]. The two constraints from the EU Commission were that the guarantee should be paid by the banks at market price and that the plan should be temporary with issuances until the end of 2009 and bonds having no more than a 5 years maturity. Regarding the price of the guarantee, the ECB recommendation of October 20, 2008 requested an interest rate of 0,5 % above the cost of refinancing for the State, which could be reduced to 0,2 % in case of posting of collateral by the banks. The loans from the SFEF required collateral so that the cost of the operation to the eligible banks could be reduced. The collateral accepted were more flexible than the ones accepted by the ECB but were still of high level. They included investment grade assets such as mortgage loans, real estate loans guaranteed by a bond issued by a highly rated financial institution, loans to municipalities and local authorities, consumer loans to French residents, loans to highly rated companies…

64 Art. L. 228-39 Commercial code.

65 The original amount provided for in the law for finance was 360 billion euros, but the Commission reduced it to 320 billion euros, by reducing the amount that the SPPE could raise from 40 to 21 billion euros.

66 Sate aid No N 548/08 France – Financial support measures to the banking industry in France.

67 State Aid No N 251/09 France – Financial support measures to the banking industry in France

Quality of the collateral is monitored by the French central bank. The SFEF also benefits for its loans and for the collateral attached of close-out netting provision of the Collateral Directive[68]. This scheme was unique in Europe and reflected the better financial situation of most French financial institutions[69].

Eligible institutions were not just the seven banks who were shareholders of the SFEF but are all « credit institutions » licensed and supervised under the conditions defined by the French Monetary and Financial Code, and which comply at the time the request is made with capital adequacy requirements, and have signed an agreement with the State on corporate governance and extension of credit to certain individuals. Like with the SPPE, the SFEF mechanism was only open to financial institutions who satisfied the Basel sovency ratio. The scheme was open to subsidiaries of foreign groups. The facility was used by six of the major bank shareholders, except HSBC France, and consumer oriented financial institutions, especially financial arms of automobile builders[70]. The beneficiary banks represented 80 % of the outstanding loans to the economy.

The SFEF stopped its activities in October 2009 since French banks could refinance themselves on the market. As a whole, the SFEF issued debt for an amount of 77 billion euros. In addition to this general financial rescue scheme, specific rescue measures were also adopted.

B. Specific rescue measures

The French State had to take specific measures for two banks in a difficult situation (1°), but this situation did not go so far as a nationalisation of the banks (2°).

1°) Banks concerned by specific measures

The banks concerned by specific measures were Dexia group (a) and Natixis (b). In addition, in case Dexia or another bank would needed funds in an emergency situation, the 16 October 2008 Act allowed the Ministry for the

68 Art L. 431-7 Monetary and Financial Code.

69 See, Cour des comptes, Rapport public, Les concours publics aux établissements de crédit : premiers constats, premières Recommandations, June 2009, p. 73.

70 These institutions are SA Finance (PSA-Peugeot-Citroën), General Electric, le Crédit immobilier, Laser Cofinoga, RCI banque (groupe Renault), S2Pass (groupe Carrefour) et VFS Finance (groupe Volvo). See, Cour des comptes, Rapport public, Les concours publics aux établissements de crédit : premiers constats, premières Recommandations, June 2009, p. 32.

Economy to grant directly *ad hoc* guarantee to the financial instruments issued by « credit institutions » (only) before 31 December 2009 and for a maximum duration of 5 years. The guarantee was subject to the same requirement of collateral as for loans from the SFFE.

a) The case of Dexia

The Dexia group was created in 1996 by the merger of a Belgian retail bank (*Crédit communal de Belgique*), which also included a Luxembourg subsidiary (*Banque Internationale à Luxembourg* or BIL), and a French bank without a deposit base and specialising in loans to municipalities (*Crédit Local de France* or CLF). It was decided in 1999 that the holding company would be incorporated in Belgium. It was supervised by the Belgian financial regulator (*Commission bancaire, financière et des assurances* or CBFA) with a college including the French and Luxembourg supervisors. The CLF was a former subsidiary of a major State-owned financial institution the *Caisses des dépôts et consignations* (CDC) and had been listed on the Paris Stock Exchange in 1991. Therefore, Dexia included a large French shareholder base and a large French activity.

The financial difficulties of Dexia originated mainly from a US subsidiary, Financial Security Assurance (FSA), which had been bought by the French based *Dexia Crédit Local* in 2000. The activity of FSA was to provide insurance against default for bonds issued by american municipalities. Since Dexia had a AAA rating, this allowed american municipalities to reduce their borrowing cost by benefiting from the FSA rating. This was consistent with providing services to municipalities.

However, FSA also expanded its activities and guaranteed not only municipalities but also asset-backed securities (ABS) essentially in pooled corporate, consumer loans and residential mortgage-backed securities. As of 31 December 2006, Dexia had through FSA a net par exposure of 135 billion dollars to ABS[71] and 425 billion dollars as at 30 September 2008. Despite believing to be extremely conservative by insuring a majority of at least A rated assets, FSA was hit when the real estate market deteriorated in the United States. FSA also had to pay claims on its HELOC (Home Equity Lines of Credit) portfolio. However, Dexia was faced with significant liquidity risk since some contracts could be terminated in advance in particular case or if the credit rating of FSA fell below certain levels which would trigger in both cases requirements for collateral. Therefore, Dexia had to provide a line of financing of 5 billion dollars to FSA in 2008 in order to protect its credit rating. Despite this measures, shares of the company regularly decreased in value and problems became more acute when the market realised the danger posed by

71 Dexia annual report 2006, p. 64.

FSA. Another weakness was that *Dexia Crédit Local* was highly dependent on markets to refinance itself, making it very vulnerable to a loss of confidence.

The Fortis bail-out was followed a few days later by a Dexia bail-out. On Monday 29, 2008, the non-guaranteed interbank market was closed to Dexia which had to resort to the ECB's discount window for liquidity. Standard and Poor downgraded Dexia debt. The cost for insuring dexia debt through CDS increased. The share lost nearly 30 % of its value in one day. Finally, private and institutional depositors started to withdraw funds in Luxembourg and Belgium, starting a bank run. Management decided that they needed an equity injection in order to reassure the markets. On 30 September 2008, a plan was announced in order to recapitalise Dexia through a reserved capital increase of 6 billion euros. France decided to support Dexia since it is the most important lender to French local authorities. The CDC brought 2 billion euros in capital, including 0,29 billion euros through its subsidiary CNP, and the French State through the SPPE, 1 billion euros[72], since the CDC did not want to support all the cost of the capital increase. The Belgian State and regions provided 3 billion euros, and the Luxembourg Government provided 0,4 billion euros in convertible bonds directly to the Luxembourg subsidiary.

The capital increase could be decided quickly because, under Belgian company law, the board of directors can, if this is allowed by the articles of incorporation, increase the capital up to the authorised capital[73]. In addition, the pre-emptive rights of existing shareholders can be removed for issuance of shares decided by the board of directors within the authorized capital, if the statutes of the company provide so[74]. This possibility was provided for in the Dexia statutes. The price of the newly issued shares was 9,9 euros which was substantially above the then market price. This situation was due to the fact that under Belgian company law, in order to protect minority shareholders, the issue price for new shares without pre-emption rights in favor of one or more specific persons, must be, when the company is listed, at least equal to the average closing price of the company shares over the 30 calendar days preceding the day of the launch of the issue[75]. Since the share was quickly losing in value, the market price at the time of the capital increase was substantially lower than the average. As a result of the capital increase, France received a blocking minority, which is set at 25 % under Belgian company law[76].

72 The SPPE had been established before the Law of 16 October 2008 for finance.

73 Art. 603 Belgian company code. The authorised capital cannot be more than the amount of the existing capital.

74 Art. 605 Belgian company code.

75 Art. 598 Belgian company code.

76 Art. 558 Belgian company code.

In exchange for this recapitalisation, the French government demanded a change in the institution's direction. The Belgian CEO and the French Chairman of the board had to step down and were replaced by a former French civil servant and a Belgian politician. France also demanded successfully that the CEO would not receive his golden parachute. These conditions reflected the general position of France on recapitalisation. The French State also requested seats at the board of directors, which was normal since it became a large shareholder. Finally, the new management had to present a restructuration plan.

Despite these strong measures, confidence did not return and Dexia was still facing difficulties to refinance itself on the market and Dexia lost access to short- or long-term financing on the interbank or capital markets. Therefore, a second plan was adopted, one week later, on 9 October 2008. The French Belgian and Luxembourg government issued a joint and non several guarantee on debts issued up to 150 billion euros by Dexia, and Dexia subsidiaries. Eligible liabilities were bonds and debt securities issued by companies of the Dexia group to credit institutions and institutional counterparties raised between 9 October 2008 and 31 October 2009 and maturing before 31 October 2011. Therefore, the guarantee covered medium term financing. The guarantee was used to a maximum amount of 95,87 billion euros as to 27 May 2009 and still covered 45,73 billion euros guarantee as to 31 March 2010. The amount was reduced by the EU Commission to 100 billion euros in November 2009 and the duration of the scheme to June 2010. Those schemes were approved by the Commission under article 107(3)(b) since the failure of Dexia would have create a serious disturbance in the Belgian economy[77].

Finally, on 14 november 2008, a guarantee on 16,9 billion dollars of "toxic" assets held in a "Financial Products portfolio" of Financial Security Assurance (FSA) was provided by the French (38 %) and Belgian (62 %) States. The guarantee is an autonomous first demand, irrevocable and unconditional guarantee. FSA was sold in July 2009 to Assured Guarantee for a loss, following an agreement on 14 November 2008, but the "Financial Products portfolio" remained with Dexia and has been managed since in run-off mode. The guarantee was necessary in order to allow Dexia to sell FSA to a purchaser. Dexia had to pay for the guarantee following the ECB guidelines. Under the agreement Dexia covers losses up to 4,5 billion dollars on one part (the highest grade) of the portfolio ("excluded assets"). This was necessary since, according to the Impaired Assets Communication, there must be burden-sharing of the costs between the State and the bank. On the other part of the portfolio, States provide a guarantee and will be entitled to cash, for a

77 State aid NN 49/2008 – Belgium, NN 50/2008 – France, NN 45/2008 – Luxembourg Emergency aid to Dexia in the form of a guarantee for bonds and liquidity assistance, Brussels, 19 November 2008.

first tranche, and for the second tranche to ordinary shares of Dexia[78]. This mechanism had to be submitted for approval to a Dexia extraordinary shareholders' meeting since it implied an increase of capital through warrants and issuance of shares paid by a contribution in kind (necessary action against Dexia)[79].

Under the restructuring plan, approved by the Commission in March 2010[80], Dexia has to focus on its core banking activities and its traditional markets – Belgium, France and Luxembourg. Dexia is also obliged to make a sufficient own contribution to the restructuring costs by suspending, for two years, cash dividend payments on equities and interest payments on instruments constituting own funds.

The other case in which the French Government was involved, although more indirectly, was the case of Natixis.

b. The case of Natixis

The other large casualty in France of the banking crisis was Natixis, and indirectly its two controlling shareholders, the *Caisses d'épargne Group* and the *Banque Populaires Group.* Natixis was created in 2006 by the merger of an investment bank, IXIS Corporate & Investment Bank, and *Natexis Banques Populaires*, which was more a commercial bank. IXIS Corporate & Investment Bank had originally been created in 2000, as a fully-owned subsidiary of the CDC which was under pressure from the Commission to separate its private sector activities from public interest activities. In 2004, IXIS was then sold to the *Groupe Caisses d'épargne*, which entered in 2006 into a strategic alliance with *Groupe Banques Populaires.* Natixis was soon after subject to an IPO which attracted 2,8 millions shareholders at a price of 19,55 euros. Both groups kept 71,3 % of the capital of their joint subsidiary.

Natixis was a cause of problems for its parent companies for two reasons. First, IXIS Corporate & Investment Bank had established in 2001 a monoline insurer in the United States, Compagnie Ixis Financial Guaranty (CIFG), which first guaranteed municipal debt, but started in 2004, similarly to Dexia

78 States are entitled to cash up to 4,5 billion euros, and for the rest in ordinary shares. However losses on the « excluded assets » count towards the 4,5 billion euros amount of the first "tranche" for which the States benefit from a direct cash recourse against Dexia.

79 State aid C 9/2009 (ex NN 49/2008) – Belgium. C 9/2009 (ex NN 50/2008) – France C 9/2009 (ex NN 45/2008) – Luxembourg. Aid to Dexia in the form of guarantees for bonds and certain assets, liquidity assistance and a capital increase, Brussels, 13 March 2009.

80 State aid C 9/2009 (ex NN 49/2008) – Belgium, C 9/2009 (ex NN 50/2008) – France, C 9/2009 (ex NN 45/2008) – Luxembourg. Aid to Dexia in the form of guarantees for bonds and certain assets, liquidity assistance and a capital increase. Brussels, 13 March 2009.

owned FSA, to diversify into guarantee of structured products and subprime. When the financial crisis started in August 2007, CIFG found itself exposed up to a level of 90 billion dollars, after having increased its bets against 35 billion dollars one year sooner, and had to be sold in December 2007 in a fire sale for 2 euros to its two parent companies, which then injected 1,5 billion dollars into CIFG. In 2009, *Groupe Caisses d'épargne* and *Groupe Banques Populaires* had to pay another 1,4 billion euros and transfer 90 % of CIFG to holders of guarantees issued by CIFG. As a whole, CIFG costed 3,5 billion euros to its two controlling shareholders.

Second, as an investment bank, with a large presence in New York, Natixis, was a major actor in the subprime market. When the financial crisis started, instead of reducing its exposure, Natixis increased its bets. The New York activities, which had been so far highly profitable, were apparently not subject to a strict control and they were tensions between the two majority shareholders as to who would control the potential group to be formed. In addition, managers in Paris felt that the crisis was only temporary. However, the situation deteriorated and a 3,7 billion euros capital increase had to be announced in July 2008. However, the bank had to wait three months since it had to call an ad hoc extraordinary shareholders' meeting. It could proceed with its share increase only in September 2008 at a deep discount. In December 2008, of the 2,05 billlion euros received by *Groupe Caisses d'épargne* and *Groupe Banques Populaires* from the SPPE in the form of TSS issuance, 1,9 billion euros went directly to Natixis.

On October 2008, under request from the French Government, the two parent companies decided to merge. The merger became effective in June 2009 through an Act which was necessary since the provisions applicable to each group were located in the legislative part of the Monetary and Financial Code. On October 17, 2008, a trading loss from unauthorized position for an amount of 0,75 billion euros was disclosed and, after the Government requested sanctions, the chairman of *Groupe Caisses d'épargne* was forced to resign by his board. A new chairman for both groups, close to the French presidency, was appointed by both board in February 2009.

In May 2009, the French State injected through the SPPE 2 billion euros in TSS in the merged group and 3 billion euros in preferred shares. Like for the other banks, after 5 years, in 2014, the non-voting preferred shares will be convertible into ordinary shares through warrants, which is an incentive for the bank to pay back the shares since otherwise the French Government would have held 20 % of the capital. As with the other preferred shares and TSS subscribed by the SPPE, in order to create an incentive for repayment, the remuneration and the nominal amount to be repaid increase with time. Although not a shareholder, the State also received a veto right at the board level on strategic decisions through the requirement of a qualified majority

which cannot be reached without the vote of some of the State appointed directors.

Natixis did not receive State aids as such and therefore did not need an authorisation from the EU Commission. State aids were provided to *Groupe Caisses d'épargne* and *Groupe Banques Populaires* through the SPPE and the SFEF.

Contrary to the situation in Germany or the United Kingdom, France did not had to nationalise partly or fully its banks. Under French law, a full nationalisation of a bank facing difficulties or filing for bankruptcy would have faced several difficulties.

2°) Legal issues attached to nationalisation

The French government would have faced legal issue if it had attempted to acquire control of a systemic bank, facing the prospect of insolvency, through expropriation (a) or without expropriation (b).

a) Acquiring control through expropriation

First, shareholders are entitled in France, like in other European countries, to a protection of their property rights which means that the State has to show a « public interest » in order to be able to expropriate them.

Under the European Convention for the protection of Human Rights and Fundamental Freedoms of 4 November 1950, and more specifically Article 1 of the First Additional Protocol, property is protected. According to European Court for Human Rights (ECHR) case law, a share in a company is considered to be a property of the shareholder[81]. However, the issue of State interference in order to solve a bank difficulties was raised before the ECHR in a case where the participation of a shareholder in a failing bank was reduced from 45 % to 0,4 %[82]. In this case, the ECHR recognized that there was a balance between the shareholders' property rights and public interest objectives so that the reduction of the participation could be accepted. The Court also granted a wide margin of appreciation to the States as to the amount of compensation to be given to the shareholders and the method for valuing shares

Under French law, property is also protected by the Constitution and deprivation of property is only allowed when « public necessity, legally ascertained, obviously requires it, and just and prior indemnity has been

81 Sovtransavto Holdings v. Ukraine, n°48553/99, ECHR 2002-VII, 25 July 2002.

82 Olczak v. Poland, n°30417/96, ECHR 2002-X, 7 November 2002.

paid »[83]. Protection of property is also assured by the Civil code[84]. A decision of the French Constitutionnal Council (*Conseil constitutionnel*), issued in the context of the 1981 nationalisation, confirmed that property included shares[85]. There is no law in France allowing for a nationalisation of a systemic important bank such as the German Rescue Takeover Act (*Gesetz zur Rettung von Unternehmen zur Stabililisierung des Finanzmarktes*). Therefore, the issue of whether such a law would satisfy the « public necessity » requirement has not been tested in France. However, it is unlikely that the French constitutional court (*Conseil constitutionnel*) or the judicial courts, as to the First Additional Protocol, would not validate an expropriation scheme for systemically important banks.

b) Acquiring control without expropriation

In the absence of an *ad hoc* legislation, the French State would face practical difficulties to take full control of a bank or to change significantly its ownership, unless it is already under administrative or judicial administration, which might then be to late to restructure it, like the experience of Lehman Brothers shows when it filed for Chapter 11 protection in the US. There are three different possible situations. The bank can still be solvent, can be under provisional administration, or has filed for bankruptcy.

If the French State wants to take full control of a bank which is not placed under administrative or judicial administration, it does not have any specific squeeze-out right. Therefore, it must launch a takeover and reach a threshold of 95 % of the capital or the voting rights before being able to squeeze out minority shareholders[86]. However, there is no guarantee to succeed, especially if there is a reluctant majority or even minority shareholder. In addition, in the case of a non-listed bank, this method is not available.

In the case of an ailing bank, the Banking Commission can appoint a provisional administrator (*administration provisoire*)[87]. However, like in other EU countries, a special administrator cannot undertake a quick recapitalization of a credit institution without an extraordinary general shareholders' meeting (unless a prior authorisation). The reason is that the European Union Court of Justice ruled in 1996 that the Second Directive applies also to bank restructuring measures when the bank is a joint-stock

83 Article 17 of the Declaration on Human and Civic rights of 26 August 1789.

84 Art. 545 Civil code : « No one may be compelled to yield his ownership, unless for public purposes and for a fair and previous indemnity ».

85 Decision n°81-132 DC of January 1982 and n°82-139 DC of February 1982 of the French Constitutional Council.

86 Art. L. 433–4 Monetary and Financial Code.

87 Article L. 612–34 Monetary and Financial code.

company[88]. In this case, a temporary administrator appointed by the Bank of Greece had decided an increase of capital without shareholders approval and without respecting their pre-emption right. The ECJ precludes an administrative body such as the ACP in France from deciding alone a recapitalisation of a bank. However, if the State can gain a majority of the votes at the meeting, the French highest judiciary court, the *Cour de cassation*, has been rather liberal in allowing recapitalisation decided by shareholders through a capital increase even if it resulted in the former minority shareholders being wiped out[89].

Finally, in the case of a bank which has filed for bankruptcy, the 2001 Banks' Winding-up Directive does not deal with the question of the effect of reorganisation measures on shareholders and leaves this issue to Member States[90]. In France, restructuring measures fall within the competence of the judicial authorities, like for any commercial company and not of the Banking Commission. The Banking commission can intervene at several stages of the restructuring process but with no binding power. For instance, the judicial reorganisation and liquidation cannot be initiated until the Banking Commission opinion has been obtained[91].

III. Regulations imposed on banks

The objective of the French financial rescue plan was that banks extend loans in order to prevent a credit crunch. Therefore, the main counterparty to the French financial rescue plan was that banks increase financing of the real economy (A). The other counterparty was a limitation on managers and traders compensation (B). However, like in other European countries, the French reaction to the crisis also included several measures in these areas which were not the counterpart of the rescue plan.

88 ECJ, Panaganis Pafitis and Others v. Trapeza Kenkritis Ellados A.E. and Others, C-441/93, 1996, ECR-I-1347.

89 For an exemple, see. S. Sylvestre, De la légitimité d'un coup d'accordéon eu égard aux intérêts des actionnaires et de la personne morale, Bulletin Joly Sociétés, 01 juin 2005 n° 6, p. 701.

90 Directive of the European Parliament and of the Council on the Reorganisation and winding-up of Credit Institutions of 4 April 2001, OJ L 125/15, 05/05/2001.

91 Article L. 613-27 Monetary and Financial code.

A. Financing by the banks

France adopted several measures in order to help finance the economy (1°). The obligations accepted by the bank as part of the financial rescue scheme were subject to controlling mechanisms (2°).

1°) The measures adopted by the French State in order to help finance the economy

Some measures were the counterpart of the financial rescue plan (a) while others were not (b).

a. The measures which were the counterpart of the financial rescue plan

The law on finance of October 16, 2008 included a provision according to which credit institutions who had received financing from the SFEF should sign a convention regarding the financing of individuals (consumer loans and mortgage), companies and local authorities. The convention was not signed with the SFEF but directly with the French State. The convention included provisions according to which the State could sanction the credit institutions in case they would not have fulfilled their commitment. The obligation of credit institutions was to increase from 3 to 4 % (on an annual basis) their loans to business and individuals[92]. The increase in loans at the time of the Act was around 8 %. The 13 credit institutions who received funding from the SFEF represented 83,5 % of the loans to the economy. Therefore, the plan had a wide coverage. This commitment was not fully respected but the banks were not to blame for this. The reason is that the commitment had been accepted on the assumption of a an increase in the GDP of 1,3 % and inflation of 2 %. Instead, in 2009, the French GDP shrank by 2,25 % and inflation was only 0,1 %. The final increase in loans in 2009 was 2,7 %.

In addition, a separate convention between the SFEF, the State and five French banks (*BNP Paribas*, *Société Générale*, *Crédit Agricole Groupe Banques Populaires* and *Groupe Caisses d'Epargne*) was signed in April 2009 so that banks would provide funds for exportation up to 7 billion euros.

b. The measures who were not the counterpart of the financial rescue plan

The French government also adopted several economic rescue measures unrelated to the plan. A first plan including a 22 billion euros financing for

92 This increase was equivalent to around 75 billion euros as of october 2008.

small and medium enterprises (SMEs) was adopted on October 2, 2008[93]. The plan was due to the fact that the cost of financing for SMEs had increased in comparison with larger companies. The spread went up to 200 basis point in February 2009 instead of 50–100 basis point since mid-2006. A second Recovery Plan (*plan de relance*) was released on 4 December 2008 and included a € 26 billion euros financing. A third plan was specific for the car industry and included, for instance, an incitation to sell old cars (9 February 2009). These measures and others are not very different from those adopted in other EU countries in order to boost the economy.

Other general measures included a reorientation of available funds. For instance, the 4 August 2008 LME Act forced banks to use certain assets to provide loans to SMEs. Another Act of 19 October 2009, created a duty for life insurance companies to invest into SMEs[94]. In addition, in order to protect SMEs from credit withdrawal, the law also requested that banks give a 60 days notice in case of reduction or withdrawal of credit. Financial institutions are also requested to disclose and explain, upon request, the reason for the reduction or withdrawal of credit

After the Kerviel scandal in February 2008, there were also some fears in France of a foreign hostile takeover on *Société Générale.* Therefore, there was a political declaration that a foreign takeover on *Société Générale* would not be allowed. There were then debates about turning the CDC into a French Sovereign Wealth Fund in order to defend French listed companies against potential takeovers. This fear lead the Government to set up a strategic investment fund (*Fonds stratégique d'investissement* or FSI), which was created in December 2008 as a joint-stock company, owned by the CDC and the French State, managed by the CDC and monitored by the Parliament[95]. The reason for creating the fund was to protect listed and non listed companies experiencing difficulties from foreign « predators » and to help these companies grow by taking minority stakes.

93 One part of the funding, € 16,7 billion euros, was attributed to the banks, while another part, € 5 billion euros, went through OSEO, a French public body which finances and supports small and medium-sized enterprises.

94 Law n°2009-1255 of 19 Octobre 2009 to favor access to credit by SMEs and to improve the functionning of financial markets, JO 20 oct. 2009, p. 17410.

95 The FSI was granted 20 billion euros, but only 6 billion euros in new money and the rest by transfer of pre-existing assets. On the Fonds Stratégique d'Investissement, see. www.fonds-fsi.fr

2°) *Controlling mechanisms*

Several controlling mechanisms were put in place in order to control the implementation by credit institutions of their commitments. A parliamentary oversight was organised (a), but the most original measure was the creation of a Credit Mediator(b).

a. Parliamentary oversight

The Law on finance of October 16, 2008 included a provision according to which the Government should report quarterly to the Parliament on the implementation of the financial rescue plan. In addition, a committee composed of two members of Parliament, the chair of the Central Bank and two senior civil servants was created in December 2008 in order to supervise the implementation of the financial rescue plan[96].

b. The Credit Mediator

A Credit Mediator (*Médiateur du crédit*) was created in October 2008[97]. The goal of the mediator for credit is to prevent companies from going bankrupt in case they experience difficulties with regard either to renegotiating conditions for their commitments, or to refusals to provide loans or open cash lines. It was also a mean to make sure that banks would respect their obligation to increase the volume of loans to companies. On 27 July 2009, this system was reinforced through the signing of a convention between the State, the Credit Mediator, the French Central Bank and the credit institutions. This system has been very successful and a large majority of cases submitted to the mediator have led to an agreement among the parties.

The other major counterparty imposed and banks and regulation imposed on them concerned compensation.

B. Limiting compensation

A major aspect of the French financial rescue plan has been the limitation of bankers' compensation in exchange for the support. These types of measures were also adopted in the United States, in the United Kingdom and in Germany. Some of these measures were linked to the financial rescue and are

96 Decree n° 2008-1287 of 10 december 2008 relatif à la création d'un comité de suivi du dispositif de financement de l'économie française, JO 11 December 2008, p. 18844.

97 See. www.mediateurducredit.fr

temporary (1°). However, the French government also adopted measures which are permanent (2°).

1°) Temporary provisions

Some temporary provisions on compensation concerned senior management (a) while other were targeted at traders (b).

a. Temporary provisions on senior management compensation

Temporary provisions on compensation depend on the type of aid received but where generally severe. The conditions attached to the recapitalisation scheme were more stringent than for those attached to the refinancing scheme. Specific provisions were also adopted for State-owned companies.

Regarding credit institutions helped by the SFEF, the Law on finance of October 16, 2008 included a provision according to which credit institutions which had received financing from the SFEF should sign a convention with the State which would include « ethical obligations ». This provision was not very precise but implied that banks should abide by the AFEP-MEDEF Corporate governance code on executive compensation which had been released on 6 October 2008[98]. These principles apply to all companies whose shares are listed on a French regulated market and already included listed banks.

The AFEP-MEDEF code includes several important provisions. Firstly, a senior executive should not benefit from an employment contract, so that in case of dismissal for or without cause, he cannot be protected by labor law. Secondly, several principles applied to stock-options. Stock-options should be granted with a view to associate their beneficiaries in the long term and not be an instant supplementary compensation, be subject to precise performance conditions, must not be disproportionate in comparison to the fix compensation, must not be too much concentrated on the managers but also benefit employees, must not be hedged by their beneficiaries, and must not be granted when the price of the share is abnormally low. Third, any golden parachute should be limited to two years of remuneration (fix and variable) and should only be paid in case of forced departure and only if the manager has satisfied performance criteria. Finally, the attribution of supplementary defined benefits pensions (*retraites chapeaux*) to senior management should be

98 AFEP stands for Association Française des Entreprises Privées and is an association of French private sector companies. The AFEP acts as a pro- business lobbying group. MEDEF stands for Mouvement des Entreprises de France and is the oldest and most important French business confederation.

subject to conditions of seniority, and should be of a limited amount compared to the fix part of the compensation[99]. The Convention signed by banks receiving funds with the State included a provision regarding the respect of these provisions.

The enforcement of these principles soon appeared insufficient and some of them were turned into hard law. The immediate reason was that, on 20 March 2009, four top managers of the *Société Générale* were granted stock-options by the board of directors. This immediately triggered heavy criticism from the French Government. *Société Générale* had received public funds and support. The strike price was deemed « abnormally» low (24 euros), given the general drop in the price of banking shares, providing for a high probability of a very large gain if the price of the stock was to reach even its pre-Lehman failure level (60 euros). It was considered to be easy money at the cost of taxpayers. The managers « voluntarily » gave up their stock-options grants. A few days later, a decree of 30 march 2009 provided that credit institutions having received long term financing by the SPPE, which included Dexia, should have their conventions with the State modified in order to include several new provisions and prohibit grant of stock-options[100]. In addition, another scandal took place only one week later, when the CEO of a car supplier company (Valeo) had to resign due to a strategic divergence with the board of directors. He nevertheless received a very large golden parachute while at the same time the company was suffering losses and announcing large lay-offs. In the meantime, the Parliament, unwilling to be left behind, extended the scope of the decree of 30 march 2009 by a law of 20 April 2009[101]. Therefore, the same day as the publication of the law, another decree of 20 April 2009 included some additions and modifications mainly targeted at golden parachutes[102].

The two decrees apply retroactively to the conventions signed by the SPPE and financial institutions. It applies to senior management : chairman of the board of directors, CEO, senior executives (*directeurs généraux délégués*) chairman of the managing board and chairman of the supervisory board. First,

99 Supplementary defined benefits pensions (*retraites chapeaux*) can be granted to managers who have reached the retirement legal age (60 years) and who end their career in the company. The objective is to make-up for the difference between the legal amount of the pension and the last wage. The amount usually represent 50 to 60 % of the last salary. The cost of this benefit is paid fully by the company.

100 Decree n°2009-348 of 30 March 2009 relatif aux conditions de rémunération des dirigeants des entreprises aidées par l'Etat ou bénéficiant du soutien de l'Etat du fait de la crise économique et des responsables des entreprises publiques, JO 31 March 2009, p. 5622.

101 Law n°2009-431 of 20 April 2009 de finance rectificative pour 2009, JO 22 April 2009, p. 6872.

102 Decree n°2009-445 of 20 April 2009 portant modernisation du fonctionnement du Fonds de développement économique et social, JO 22 April 2009, p. 6897.

credit institutions are prohibited to grant stock options and free shares to their senior management. Therefore, the regime is much stricter than the one established by the AFEP-MEDEF code. Second, the variable and exceptional (bonus) elements of the compensation, other than stock options and free shares, can only be authorised by the board of directors or by the supervisory board for a maximum period of one year, and must be performance linked through pre-established quantitative and qualitative criteria which cannot be linked to the price of the share. The requirement that the criteria be pre-established is a way to prevent a board to modify ex-post the criteria in order to still give the manager a bonus if the original criteria have not been fulfilled. The authorisation of the board is made public, in order to create a pressure on the board to limit the amount of the variable compensation. Third, the decree prohibits the granting and the payment of variable (Decree 30 March 2009) and exceptional – including golden parachutes (Decree of April 20, 2009) compensation if the company decides large lay-offs. The French regime is therefore similar to the American *Economic Emergency Stabilization Act* of 3 October 2008 which prohibited the payment of golden parachute to managers of credit institutions who received TARP funds. Finally, the decree prohibits the attribution of supplementary defined benefits pensions (*retraites chapeaux*) to senior management, after the entry into force of the April 20, 2009 Law. This prohibition only applies to new grants and not to existing grants, which reduced significantly the reach of the regime. However, unlike the US[103] and Germany, France did not adopt a cash remuneration cap for credit institutions having received funds from the SPPE.

These provisions were applied to the car industry (*Renault, PSA, Iveco, Renault Trucks*), including car suppliers such as Valeo, which received help from the Economic and Social Development Fund (*Fonds de développement économique et social*). The prohibition applies only to companies who received a loan higher than € 25 millions.

The decree of 30 march 2009 also included specific rules for State owned companies (*entreprises publiques*) whose securities (which definition is not limited to shares but includes also bonds) are admitted to trading on a regulated market. These rules apply regardless of whether or not the companies benefited from the financial rescue plan. First, the CEO or the chairman of the managing board must give up his or her work contract at the latest when his or her position is renewed. Second, the variable elements of his or her compensation must be authorized by the board and the authorization is made public. The variable elements of the compensation cannot be linked to the stock price. Also, the level of the golden parachute must be limited to two years of remuneration, and can only be paid in case of forced departure, and only if the manager satisfies performance criteria. In addition, he cannot be

103 American Recovery and Reinvestment Act of 17 february 2009.

paid if the company is experiencing serious economic difficulties. The decree did not deal with stock-options in State owned companies. However, the government forced on 26 March 2009 the CEO and the vice-CEO of listed energy company GDF-Suez, partly owned by the State (35,7 %), to renounce to their stock-options despite the fact the company did not receive funds from the rescue plan. This meant that companies with a large State participation would be subject *de facto* to similar requirements. This was made also clear by the fact that the decree provides that the *Fonds stratégique d'investissement* must take into account in the companies where it has invested the compensation principles stated in the decree for State owned companies.

Actions taken by the French government on the issue of compensation were at first weak but were subsequently strengthened. However, the provisions of the 30 March 2009 decree are only temporary and applicable until 31 December 2010. In addition, since all banks except two, *Groupe Caisses d'épargne* and *Groupe Banques Populaires*, have reimbursed the SPPE, the Decree 30 March 2009 is no more applicable to the banking sector. Banks are now only subject to the AFEP-MEDEF code, through their participation to the SFEF, although for listed banks, there were already subject to this code.

b. Temporary provisions on traders' compensation

Specific provisions were also adopted for traders' remuneration. Credit institutions receiving funds from the SFEF had to agree to present to the banking commission, within six months of the signature of the convention, their policy on traders' remuneration[104]. In addition, like in the United States, a compensation « Czar », Michel Camdessus, was appointed in September 2009 in order to monitor, in an advisory capacity, the compensation of the 100 best paid employees in credit institutions having received funds from the SPPE[105]. This person is informed on the compensation policy and individual amount paid to the 100 best paid employees and controls its conformity with the Financial Stability Board (FSB) "Principles for sound compensation practices"[106]. He also has an advisory role to management of the bank. If his recommendations are not applied, he can inform the Banking Commission which can trigger a prudential control, and/or the board of director, and/or the shareholders.

In addition to these temporary provisions, the crisis lead to the adoption of permanent provisions on compensation.

104 See. Cour des comptes, Rapport public, Les concours publics aux établissements de crédit : premiers constats, premières Recommandations, June 2009, p. 40.

105 Ministerial Order of 10 september 2009, JO 11 September 2009, p. 14968.

106 The text is available at : www.financialstabilityboard.org/publications/r_0904b.pdf

2°) Permanent provisions

Some permanent provisions on compensation apply to all companies (a), whereas others only apply to credit institutions (b).

a. Permanent provisions on compensation for all companies

The MEDEF published in 2003 for the first time a special report on Directors and Officers Remuneration in listed companies[107]. Another recommendation targeted at compensation was published in january 2007. Generally, the AFEP and the MEDEF have issued recommendation when there was too much political pressure, in order to prevent a legislative intervention. The financial crisis did not lead the French Government to give up its traditional approach to self-regulation in the area of manager compensation, although some legal provisions were also adopted. Instead, the Government asked the AFEP and the MEDEF to strengthen significantly their recommendations on compensation.

This political pressure lead to the adoption of the Corporate governance code on executive compensation of 6 October 2008[108]. These recommendations were later made part of the Corporate Governance Code. The council of Ministries of October 7, 2008 requested that listed companies adopt those principles before the end of 2008 or a law would be passed. According to the French securities regulator, in January 2009, almost all major listed companies had accepted the code[109]. Reversing its long standing previous position, the MEDEF then decided to monitor the application of its Corporate governance code, including principles on compensation, by the largest listed companies (CAC 40 and SBF 120) and to publish an annual compliance report. The latest report published in December 2008 indicates that principles on Corporate Governance and compensation are generally well applied. In addition, at the request of the Government, a « wise men » committee chaired by the former CEO of AXA, Claude Bébéar, was established and can be requested by companies for advice in the application of the code.

In addition to these new soft law principles, the Parliament also adopted, or was considering adopting, measures on executive compensation. The reason is that there is a general feeling of a failure of self-regulation in the area of managers' compensation.

107 Chairman and Chief Executive Officer and Executive Directors compensation, Report of MEDEF, Committee on Business Ethics, May 2003, 6 pp.

108 AFEP-MEDEF, Recommendations concerning the compensation of executive directors of companies whose shares are admitted to trading on a regulated market, October 6, 2008.

109 AMF annual report 2009, p. 102.

On the tax side, shortly after the adoption of the October 2008 financial rescue plan, the Parliament, following an amendment from a member of the socialist party, adopted a provision to limit the tax deductibility of golden parachute, whereas before it was fully deductible[110]. The tax deductibility was fixed at six times the applicable annual « individual social security cap », which amounts to approximately 200,000 euros in 2008. Another law subjected the part of golden parachutes above 1 million euro to social contributions[111]. A later December 2009 Act doubled the tax cost for companies for supplementary defined benefits pensions (*retraites chapeaux*) and the Government will present a report by 15 september 2010 on the issue[112].

On the company law side, a law of 4 December 2008 required that stock-options and grant of free shares can only be granted to senior management if they are also granted to 90 % at least of the employees[113]. Several bills were also introduced in Parliament but have not been passed so far. However, they are interesting because they indicate the direction of future reforms.

A bill introduced by a minority party of the majority was introduced in May 2009 in the lower house (*Assemblée nationale*) and would have imposed a « Say on pay » covering all elements of compensation (fix and variable, deferred, exceptional) of senior management of listed companies[114]. « Say on pay » also exists in other European countries (Denmark, Sweden, Netherlands, Spain, Switzerland, United-Kingdom). A positive vote would not have prohibited the opposing shareholders from suing the company. The bill was sent to the floor for a vote but then sent back to a committee while waiting for the report of a parliamentary working group on the issue. The *Houillon* report, named by the chair of this group, was released soon after in July 2009[115]. The *Houillon* report proposed among other legislative measures, that compensation of senior management should comply with the « company

110 Art. 21, Law n°2008-1425 of 27 December 2008 for finance, JO 28 December 2008, p. 20224.

111 Art. 14, Law n° 2008-1330 of 17 December 2008 de financement de la sécurité sociale pour 2009, OJ of 18 Decembre 2008 p. 19291.

112 Law n°2009-1646 of 24 December 2009 de financement de la sécurité sociale pour 2010, OJ of 27 Decembre 2009 p. 22392.

113 Art. L. 225-186-1 and Art. L. 225-197-6 Commercial code. Art. 22, Law n° 2008-1258 of 3 decembre 2008 en faveur des revenus du travail, OJ of 4 decembre 2008, p. 18488.

114 See. Proposition de loi visant à démocratiser le mode de fixation des rémunérations des mandataires sociaux dans les sociétés anonymes, n°1761, Assemblée nationale, Enregistré à la Présidence de l'Assemblée nationale le 13 mai 2009.

115 See. Rapport d'information par la Commision des lois constitutionnelles, de la législation et de l'administration générale de la République, sur les rémunérations des dirigeants mandataires sociaux et des opérateurs de marchés, présenté par M. Philippe Houillon, n°1798, Assemblée Nationale, Enregistré à la Présidence de l'Assemblée nationale le 7 juillet 2009.

general interest », that a compensation committee should be created in large listed companies, imposed a prohibition for a senior executive to hold at the same time an employment contract (already provided by the AFEP-MEDEF code), a prohibition on supplementary defined benefits pensions (*retraites chapeaux*), and the application of the regime of conflicted transactions (Art. L. 225–38 Commercial code) to all exceptional remuneration (*golden parachutes, golden hello…*). A bill was introduced in October 2009 and passed in the upper court (*Sénat*) in November 2009 in order to cap the compensation paid to a person holding a position both in State-owned company and in the private sector[116]. Separately, another bill was introduced in *Assemblée Nationale* in September 2009 and passed in October 2009 which created for large listed companies an obligation to create a compensation committee[117]. The initial draft, introduced by the socialist opposition, dealt directly with the issue of compensation and favored caps on compensations in all listed companies[118].

These provisions are in line with a pre-existing trend in France since 2005 to move from self-regulation to hard law on compensation and to make it harder for listed companies to adopt excessive or unjustified compensation. As for stock-options, for instance, since a 2006 Act, the exercise of stock options (and not just the grant) by senior officers, directors and members of the supervisory board is strictly regulated. Stock-options cannot be exercised by their beneficiaries before the end of their term in office, or they have to keep until

116 Proposition de loi tendant à interdire ou à réglementer le cumul des fonctions et des rémunérations de dirigeant d’une entreprise du secteur public et d’une entreprise du secteur privé, Sénat, Enregistré à la Présidence du Sénat le 6 octobre 2009. The bill is currently scheduled for a vote in the lower House of Parliament.

117 See. Proposition de loi visant à créer un comité des rémunérations dans les sociétés anonymes excédant certains seuils de chiffre d’affaires et d’effectifs, Assemblée Nationale, Texte adopté n°335, 20 octobre 2009. The bill is currently pending in the Senate and there is no indication that it will be sent to the floor for a vote.

118 See. Proposition de loi visant à rendre plus justes et plus transparentes les politiques de rémunérations des dirigeants d’entreprises et des opérateurs de marché, Assemblée nationale, 2 septembre 2009. The initial draft would have capped the remuneration of senior management (CEO, chairman of the board of directors, chairman of the managing board and chairman of the supervisory board) of companies who benefited from the recapitalisation scheme to around 300 000 euros (Art. 1). For all listed companies, the compensation of senior management (CEO, chairman of the board of directors, chairman of the managing board and chairman of the supervisory board ; senior executives) would be capped by a decision of the board to a multiple of the lowest remuneration paid within the company and subject to a vote of the GSM (Art. 3). The amount of a golden parachute and supplementary defined benefits pensions (retraites chapeaux) paid to senior management (CEO, chairman of the board of directors, chairman of the managing board and chairman of the supervisory board) would be more severely capped (Art. 4 and 5). Finally, stock-options would only by allowed in companies not older than 5 years, that is start-ups (Art. 7).

the end of their term a certain part of the shares acquired through the option ("Balladur" amendment)[119]. The choice is to be made by the board of directors or by the supervisory board. The information relating to this choice has to be disclosed in the annual report. An identical rule applies to grants of free shares[120]. As to golden parachutes, a 2005 Act submitted those granted to the CEO, chairman of the board and executive officer of listed companies (directors are not concerned), by the company itself or by any controlled or controlling company, to ex-ante approval by the board of directors and ex-post approval to the general meeting of shareholders[121]. Each individual golden parachute is subject to a separate vote at the general meeting of shareholders level. A new vote is required each time that the position is renewed, which under French company law, will be at most every 5 years. Another 2007 Act, prohibited golden parachutes which payment are not subject to conditions of performance, appreciated with regards to the performance of the company of which he is CEO or executive officer[122]. Conditions of performance relate to strategic or commercial objectives, rentability… Finally, as to supplementary retirement benefits (*Retraites chapeau*), the 2005 CME had Act submitted supplementary retirement benefits granted to the CEO, chairman of the board and executive officer of listed companies (directors are not concerned), by the company itself or by any controlled or controlling company, to ex-ante approval by the board of directors and ex-post vote to the general meeting of shareholders[123].

Therefore the latest developments in the area of manager compensation triggered by the financial crisis seem to be only a part of a trend to limit compensation abuses. The temporary provision of the decrees of March and April 2009 only took this tendency one step further. Therefore, there is a reasonable degree of probability that some provisions of the temporary measures will be turned into hard law.

b. Credit institutions

As to credit institutions, the French Government was also very active but focused mainly on traders' remuneration. Like with the AFEP-MEDEF code, the Government also requested in December 2008 professionals to draft self-

119 Art. L. 225-177 and L. 225-179 Commercial code. Law n°2006-1770 of 30 December 2006 pour le développement de la participation et de l'actionnariat salarié et portant diverses dispositions d'ordre économique et social, OJ of 31 Decembre 2006 p. 20210.

120 Art. L. 225-197-1 Commercial code.

121 Art. L. 225-42-1 Commercial code. Law n° 2005-842 of July 26, 2005 pour la confiance et la modernisation de l'économie, OJ of 27 July 2005 p. 12160.

122 Art. L. 225-42-1 Commercial code. Law n° 2007-1223 du 21 août 2007 en faveur du travail, de l'emploi et du pouvoir d'achat, OJ of 22 August 2007 p. 13945.

123 Art. L. 225-42-1 Commercial code

regulatory principles. Therefore, the French Banking Federation (FBF), in close cooperation with the Government, drafted and issued in February 2009 principles on traders' remuneration (« Pauget » principles)[124]. This code provides that bonuses must be calculated on annual effective results and take into account several years. France was the first country to adopt such type of provision.

Banking regulation was modified in order to allow the banking regulator to check the adequation of the remuneration policy with the risk created by such policy[125]. The banking regulator can take sanctions in case these principles are not applied.

On August 25, 2009, the French Government also announced measures on traders' remuneration. However, so as not to prejudice the Paris financial centre, these measures were only implemented on 3 November 2009[126]. The reason was that France waited for the G-20 Pittsburg meeting of Head of States to endorse the FSB "Implementation Standards for sound compensation practices" issued on September 25, 2009. Then, the new regulations were issued just before the St Andrews G-20 Finance Ministries of 6 November 2009. The rules were also fleshed out by the FBF[127] so that the measures result from hard law and soft law provisions.

These measures provide that a significant part of compensation must be variable, based on individual, business-unit and firm-wide measures that adequately measure performance. They provide that guaranteed bonus should be limited to one year maximum and only admitted in case of hiring. A significant part of variable compensation must be deferred, paid pro rata temporis, tied to performance, subject to appropriate clawback and vested in the form of stock or stock-like instruments. At least 50 % (60 % for the highest paid) of variable compensation for one fiscal year (N+1) must be deferred on the three following years (FBF professional norms, November 2009). At least 50 % of variable compensation granted for one fiscal year must be in share or share-linked instrument (FBF professional norms, November 2009). There must be a minimum vesting or holding period of two years.

124 FBF, Groupe de travail de Place, Rémunération des professionnels des marchés financiers, 9 February 2009.

125 Art. 5 g), Regulation 97-02. Ministerial order of 14 janvier 2009 modifiant le règlement n° 97-02 du 21 février 1997 relatif au contrôle interne des établissements de crédit et des entreprises d'investissement, OJ of 30 January 2009 p. 1703.

126 See. Art. 31-4, Regulation 97-02. Ministerial Order of 3 novembre 2009 relatif aux rémunérations des personnels dont les activités sont susceptibles d'avoir une incidence sur l'exposition aux risques des établissements de crédit et entreprises d'investissement, JO 5 November 2009, p. 19115.

127 FBF, Professional norms regarding the governance and variable compensation for financial markets professionals (November 2009)

Deferred compensation must be reduced or suppressed in case of losses in the activity. The determination of the global amount of variable compensation must take into account liquidity risk, capital requirements, and must be subject to reduction in case of loss. Credit institutions must establish a compensation committee, composed of a majority of competent independent directors. The annual report to the banking commission must include developments on traders compensations policy and practice. Finally, the Firms' compensation policies and structures must be disclosed in one place to be chosen by the firm and disclosed before the general shareholders' meeting.

French regulation and self-regulatory norms on traders' compensation closely implement the FSB principles and G-20 decisions. This is not surprising since France was quite influential in the debate on traders' compensation.

IV. Conclusion

France has been very active in order to react to the financial crisis both from a financial and an economic point of view, although its financial sector was less severely hit than the United States and other large countries. The financial rescue plan has been quickly introduced and was financially profitable for the French State. France also adopted several effective economic support measures. Therefore, the French approach to the financial crisis can be considered a success.

At the national level, the French State has been very interventionist, requesting and generally obtaining management changes. The French government has also been very interventionist and active in the area of compensation and has targeted stock-options, golden parachutes and bonuses. It succeeded in forcing several managers to give up stock-options (*Société Générale*) or golden parachutes (Dexia). The provisions adopted by the AFEP-MEDEF were also adopted under very strong political pressure. Although there is no law foreseen on the issue of managers' compensation by the end of the first semester 2010, the issue could return to the first stage before the end of 2010 when the temporary measures included in the financial rescue plan will lapse. There is a some degree of probability that these temporary measures will be turned into hard law at that time, or at least that the issue will be raised.

At the European and international level, France has also been very active to try to promote its agenda on banking regulation and bankers' compensation. France, who benefited from the support of the labour Government in the United Kingdom, has also been quite successful in this area in promoting its agenda.

However, taking a longer view, there are two points which can be raised. First, it is regrettable that France did not size the opportunity to pass a law, like in Germany, to allow for nationalizing or taking control of an ailing financial institution. An opportunity might have been missed. Second, France, like Germany, successfully took advantage of the crisis to fight tax heavens and request wider cooperation by countries having a strong banking secrecy laws. France and Germany also insisted to request a stronger regulation of hedge funds in Europe. However, it can hardly be considered that tax heavens or countries with strong banking secrecy law contributed to the financial crisis. The crisis started in the United States and the United Kingdom whose financial regulation was the most developed in the world. The same can be said of Hedge funds which, as an industry, were generally hurt by the crisis. The financial crisis provided the opportunity to tackle these issues which like the issue of compensation are politically attractive. However, it would be dangerous to give too much attention to issues which were not at the heart of the financial crisis if this would led to walking away from the really necessary financial reforms.