Resolution powers and OTC derivatives under French new law

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Reminder

As a reminder, the purpose of the French Resolution Regime is to be able to handle a credit institution's problems as far ahead as possible hence avoiding State intervention.

This prevention and resolution regime was widely inspired by the draft European directive on crisis management which should be finalised before the end of the year. Adjustments will be necessary for the French mechanism to comply entirely with European Union law, in particular the concepts of bail-in and senior debt still need to be introduced.

Another source of this regime was the work of the FSB referred to above, which provides for the principle of coordination between resolution authorities, on implementing plans. Nevertheless, in the event of failure of this coordination or in the event of an autonomous decision by a resolution authority (be it the home or host authority), we can expect to see, as for common law procedures, the domestic regime applied to entities (subsidiaries or branches) located abroad.

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I. Triggering resolutions

Resolution implementation can only be decided by the Resolution Board of the ACPR and only after referral to the Governor of the *Banque de France* or the Director-General of the Treasury.

The Board then decides whether the institution is failing and whether there is any possibility that this failure could be avoided other than by a resolution procedure.

An institution is considered to be failing if it is or is likely to be in the short term in one of the following situations:

- it no longer meets the capital requirements necessary to maintain its license;
- it no longer has the capacity to meet payments immediately or in the short term;
- it requires exceptional financial support from public authorities.

II. Possible resolution measures

While respecting a principle of proportionality of these measures compared to the targeted objective, the ACPR may:

- appoint an interim administrator, bearing in mind that this appointment cannot constitute an event of default allowing early termination of contracts;

- remove the accountable managers. In this case, any remuneration, compensation or benefits due or likely to be due as a result of the termination of their duties, or prior to these, cannot give rise to payment ;

- transfer all or part of one or more business activities. Such a transfer is *ipso jure* and does not require any specific legal formality. It must be noted that the transfer alone does not give grounds for termination or compensation of the contracts to be transferred, even when the parties have contractually provided for such a possibility.

It should be stressed that the assets, rights and obligations governed by an agreement subject to article L.211-36 of the French Monetary and Financial Code (i.e. early termination and compensation or close-out netting) cannot be assigned or transferred other than in their entirety (this is also true for all the examples of types of transfer given below). The aim is to avoid « cherry picking » in other words the ACPR's right to select among the transactions covered only those which are favourable to the institution;

II. Possible resolution measures

- decide to have recourse to a bridge institution in charge of temporarily receiving all or part of the assets, rights and obligations of the failing institution with a view to disposal. Here again, the transfer is ipso jure and does not justify close-out netting or set-off;

- transfer to the FGDR or to a bridge institution the shares issued by the failing institution. One could expect that this transfer will make decision-making easier. The FGDR or the bridge institution, as owner of the securities, would become the sole shareholder. It could exercise the shareholders' rights alone (for example in the case of a decision needing to be taken by the shareholders' general meeting) ;

- suspend the right to early termination and close-out netting provided for in article L. 211-36-1 of the French Monetary and Financial Code for 24 hours ;

Regarding close-out netting, it should be noted that the implementation of resolution measures such as for example the transfer of part of the business activity, cannot as such be grounds for exercising the right to early termination and close-out netting. Nevertheless, this remains possible in the case of contracts which have not been transferred to a third party entity, if such a transfer is decided by the ACPR. Moreover, in the case of transferred contracts, the early termination right could be exercised if justified, not by the transfer in itself, but by another event of default (for example, a default on payment).

II. Possible resolution measures

- Make certain classes of creditors bear the losses through reduction or write-off of capital or claims or by converting the claim into equity (internal recapitalisation procedure known as a « bail-in », as opposed to a « bail-out » which involves state intervention).

III. Resolution powers and master agreements

Which contracts could be affected by resolution measures, in particular those forbidding close-out netting resulting from the mere fact of having entered into a resolution procedure and from the mere fact of having transferred the master agreements to a bridge bank? Is the law applicable to these contracts irrelevant or does it only apply to contracts subject to French law?

1. In the first place, these provisions will apply to counterparts, French or cross-border, which have concluded a convention under French Law with the entity under resolution, for instance an FBF master agreement (derivatives), an AFTI contract (securities lending / borrowing), an FBF (repos) or secured financing (SCF/SFH, i.e. mortage credit insitutions, issuing covered bonds …).

   On the one hand, these agreements do not at present consider resolution to be an event of default. On the other hand, assuming that these master agreements are updated to include such events as additional events of default, such stipulations would - by operation of law - be deemed unwritten.

III. Resolution powers and master agreements

2. What is the present situation concerning contracts subject to foreign legislation? These are without question the most numerous when considering international standards: ISDA contracts (subject to US or UK law) for derivatives, LMA (UK) and LSTA (US) for financing, GMRA (UK) for repos and GMSLA (UK) for securities lending / borrowing.

   Let us take as example the ISDA agreement, which could be entered into between a French and a foreign bank. It contains event-of-default clauses (triggering close-out netting) which could apply notwithstanding any resolution provisions. This for example is the case for the clause concerning the appointment of an administrator.

   What would be the effectiveness of such a clause, bearing in mind that the French legislator intended to confer upon resolution provisions a status of over-riding mandatory provisions (laws which must be respected in order to safeguard political, social or economic organisation) which can be enforced whatever the legislation applicable to the agreement.

III. Resolution powers and master agreements

3. Before a French judge, the effectiveness of the resolution provisions would not create any particular difficulty (the “Rome 1” regulation of 17th June 2008 on the law applicable to contractual obligations resulting in the obligation for the competent court to apply over-riding mandatory provisions).

   If the dispute was brought before a British judge, the latter could also apply these French over-riding mandatory provisions in accordance with Rome 1, but this enforcement is not systematic; for it to be systematic, this would require that obligations resulting from the contract be, or had been, executed in France, in so far as their execution would make the execution of the contract illegal. On the other hand, as soon as the European resolution regime legislation comes into force, one cannot see how a British judge could oppose it (assuming naturally that at this point the UK is still a member of the European Union). On this point, one can reasonably assume that the location in France of the “booking” of the transaction, of the flows paid in or out, or of the collateral would be relevant criteria to meet the Rome 1 Regulation requirements with respect to over-riding mandatory provisions. The mere location of back offices would seem on the other hand more debatable.

III. Resolution powers and master agreements

4. If the dispute was brought before a non-EEC member state judge (an American judge for instance), the latter could even more easily deny an over-riding mandatory character to this provision and refuse its application. It remains to be seen whether his decision could have consequences (if the point is to determine whether the American counterpart in our example would be entitled to cancel the agreements and net off its obligations, this appears conceivable to us).

5. It is quite another matter to determine whether this netting off could apply to the collateral received. In order to clarify this question, in addition to what has been said above, legislation applicable to the location of the collateral would need to be taken into account.

   To put it simply, if the collateral is located in France, it would appear fairly difficult for a foreign judge who has not acknowledged the over-riding mandatory character of the French resolution regime to get his decision applied in France (failing to obtain the execution of his judgement). On the other hand, if the collateral is located abroad, it would not appear totally inconceivable that a foreign judge could block French law.