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# Senior Non-Preferred Notes
## French law aspects

The Sapin 2 Law, which introduces a new type of security in France, was published in the Official Journal of the Republic of France on 10 December 2016 and took effect the next day.

## 1 Regulatory framework

*European Union legislation and implementation in France*

On 15 May 2014, the European Parliament and the Council of the European Union adopted Directive 2014/59/EU, establishing an EU-wide framework for the recovery and resolution of credit institutions and investment firms[1] ("**BRRD**"). This Directive is intended to provide relevant national resolution authorities with common tools and powers to address banking crises pre-emptively thereby safeguarding financial stability and minimizing taxpayers' exposure to losses. The BRRD was implemented in France by the *Ordonnance portant diverses dispositions d'adaptation de la législation au droit de l'Union européenne en matière financière* dated 20 August 2015[2] (the "**Ordonnance**").

The Ordonnance introduced a new Article L.613-30-3 into the French *Code monétaire et financier* which provides for the hierarchy of different classes of depositors if an issuer enters into judicial liquidation proceedings (*liquidation judiciaire*).

*Global initiatives : the Financial Stability Board and implementation in France*

On 9 November 2015, the Financial Stability Board ("**FSB**") finalised international principles and a term sheet (the "**FSB TLAC Term Sheet**") that, together, set out an internationally agreed standard on the adequacy of total loss absorbing capacity ("**TLAC**") for global systemically important banks ("**G-SIBs**")[3]. The FSB TLAC Term defines a requirement for G-SIBs to have in place securities and other liabilities that should be readily available for bail-in in the event

1 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=en
2 https://www.legifrance.gouv.fr/jo_pdf.do?id=JORFTEXT000031070122
3 http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf

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of its resolution. As a result, the FSB now requires G-SIBs to maintain significant amounts of liabilities that are subordinated to certain priority operating liabilities, such as guaranteed or insured deposits, to ensure that losses are absorbed by shareholders and the subordinated creditors rather than being borne by taxpayers.

At the EU level, the closest concept to TLAC can be found in the "minimum requirement for own funds and eligible liabilities" ("**MREL**") for banking institutions under the BRRD[4]. The purpose of MREL is to ensure that the bail-in powers given to resolution authorities are effective if they are ever needed by requiring institutions to maintain a minimum level of own funds and eligible liabilities that can be bailed-in.

The FSB TLAC Term Sheet will likely be implemented in Europe via amendments to the CRR, building on the existing framework of the BRRD. MREL, as modified, would serve as that implementation tool under EU law of the TLAC principles and FSB TLAC Term Sheet.

To that end, the European Commission has published on 23 November 2016 its proposals to amend and supplement certain provisions of, *inter alia*, the Capital Requirements Directive ("**CRD**"), the Capital Requirements Regulation ("**CRR**") and the BRRD.

The European Commission's proposals are contained in a proposed new directive (the "**New CRD Directive**")[5] to amend CRD and a proposed new regulation (with direct effect) (the "**New CRR Regulation**")[6] to amend CRR. While the standard minimum level of TLAC for EU G-SIBs will be introduced into CRR by the New CRR Regulation to maximise harmonisation within the EU, a firm-specific TLAC add-on for G-SIBs and a firm-specific minimum requirement for own funds and eligible liabilities (MREL) for non-G-SIBs in the European Union will mainly be implemented through amendments to BRRD contained in a proposed new directive[7] (the "**New BRRD Directive**")[8].

The New CRR Regulation introduces a new Article 72b defining those eligible liabilities that, taken together with own funds, may satisfy the TLAC minimum requirement. It is also proposed that the current definition of eligible liabilities laid down in the BRRD's provisions relating to MREL[9] be repealed and replaced by a cross reference to the definition in Article 72b of the New CRR Regulation.

[4] As set in accordance with Article 45 of the BRRD (as transposed in Article L.613-44 of the French Code monétaire et financier) and the Commission Delegated Regulation (C(2016) 2976 final) of 23 May 2016

[5] https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-854-F1-EN-MAIN.PDF

[6] https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF

[7] https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-852-F1-EN-MAIN.PDF

[8] For further analysis of the contemplated reforms, please refer to our Client Memo, "CRD and BRRD Reform Proposals, a road-map for DCM practitioners" http://linklaters.com/pdfs/mkt/london/CRD_and_BRRD_Reform_Proposals.pdf

[9] See New BRRD Directive, Article 45 b)

No final legislation in this respect has been enacted yet at the European level. However, the French government stated its intention to move ahead at the national level in order to anticipate and facilitate compliance with TLAC ratios by the 2019 deadline, in particular by French G-SIBs.

Various legal vehicles were contemplated to achieve the stated goals of the French government, and the modification of Article L.613-30-3 was chosen as the most suitable solution. Article 151 of the law on transparency, anti-corruption and the modernisation of the economy ("**Sapin 2 Law**") now divides senior bondholders into two categories: holders of senior preferred notes (the "**Senior Preferred Notes**") and holders of senior non-preferred notes (the "**Senior Non-Preferred Notes**"). It therefore amends Article L.613-30-3 and modifies the hierarchy of creditors of credit institutions in order to facilitate the implementation of the bail-in tool. It gives preference to all creditors who currently belong to the class of senior creditors, which will be categorised as senior preferred creditors in the event of a judicial liquidation.

Article L.613-30-3, as amended (free translation) is set out as Annex 1.

## 2 Features of the new Senior Non-Preferred Notes

Pursuant to the Sapin 2 Law, the new Article L.613-30-3-I-4° of the French *Code monétaire et financier* provides that for debt securities to qualify as Senior Non-Preferred Notes they must be issued by any French credit institution after the enactment of such law and meet the following criteria:

– their terms and conditions must expressly provide that their ranking is as set forth in Article L.613-30-3-I-4° *i.e.* they shall rank junior to any other unsubordinated liability of such credit institution (including Senior Preferred Notes) in a judicial liquidation proceeding and senior to any subordinated obligations of the credit institution;

– the Notes must have a minimum maturity of one year; and

– the Notes must not be structured products (to be defined in a separate decree).

## 3 Senior Non-Preferred Notes are bail-inable instruments

Senior Non-Preferred Notes and Senior Preferred Notes are within the scope of the bail-in tool and will not benefit from any exclusion provided for in the BRRD[10].

There is no change for existing senior notes previously issued by credit institutions other than the fact that both they and new Senior

[10] See BRRD, Article 44 - Article L.613-55-1 of the French *Code monétaire et financier*

Preferred Notes will now benefit from a new layer of more junior creditors below them in any application of the bail-in (or other) tools in resolution proceedings or in case of the opening of a judicial liquidation.

## 4 Senior Non-Preferred Notes could be counted as eligible liabilities for MREL/TLAC purposes

The BRRD currently sets out certain conditions for eligible liabilities to be included in the MREL ratio[11] in addition to the Sapin 2 Law requirements.

Also, MREL as it currently stands does fully meet the TLAC requirements and European legislative initiatives are evolving to implement TLAC under EU law. One of these is the proposed New CRD Directive and New CRR Regulation. Another, is the proposed Art. 108 BRRD Directive (as defined and described in Section 6 below).

New Article 72b of the CRR sets out what can qualify as "eligible liabilities". The definition is more restrictive than the existing definition of eligible liabilities in Article 45 of the BRRD in a number of important respects, including among others:

– the liability must be subordinated to all excluded liabilities;

– there must be no set-off arrangement or netting rights;

– no issuer calls with any form of incentive to redeem are permitted;

– early redemption requires supervisory approval as contemplated in Articles 77 and 78 of the CRR;

– there should be no events of default giving rise to a right to accelerate; and

– "the contractual provisions governing the liabilities" require their conversion or write down upon bail-in…

Because of the changes to the regulations giving effect to MREL that are currently under consideration at the European level, credit institutions will be very cautious when preparing the terms and conditions of these new Senior Non-Preferred Notes to avoid being left with costly senior notes that may not later qualify for MREL/TLAC eligibility.

[11] See BRRD, Article 45§4 - Article L.613-44 of the French *Code monétaire et financier*

## 5 Senior Non-Preferred Notes will not be counted as own funds under the CRR[12]

Senior Non-Preferred Notes have been created under French law for MREL/TLAC resolution purposes and not as regulatory capital instruments. This new category of notes is not subordinated and should not qualify as Additional Tier 1 or Tier 2 as defined in the CRR[13].

As a result, and unlike subordinated obligations qualifying as Tier 2, the Senior Non-Preferred Notes will not be written-down or converted to capital instruments independently of a resolution measure at the point of non-viability[14]. Nevertheless, new Articles 59 and 60 of the BRRD provide that in certain circumstances, the existing pre-resolution statutory powers to write down or convert into equity liabilities at the point of non-viability would be extended to eligible liabilities (instruments issued to resolution entities by other entities which are not themselves resolution entities in order to meet their solo firm-specific requirements).

The new layer constituted by Senior Non-Preferred Notes would only be operative when the bail-in tool is exercised, as these new instruments are considered senior instruments falling under Article L.613-55-5 of the French *Code monétaire et financier,* which implements the sequence of write-down and conversion in accordance with the hierarchy of claims in normal insolvency proceedings[15] ("no creditor worse off" principle).

## 6 An influential reform in the context of the BRRD amendments

A separate new directive (the "**Art. 108 BRRD Directive**")[16] proposes amendments to the BRRD to facilitate the creation of a new asset class of "non-preferred" senior debt which will be eligible to count as TLAC and MREL.

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12 Regulation (Eu) No 575/2013 of The European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the "**Capital Requirement Regulation**") http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:321:0006:0342:EN:PDF

13 See Capital Requirement Regulation, Articles 51 and 52, 62 and 63 - Article L.613-34-1 of the French *Code monétaire et financier*

14 See BRRD, Whereas (81): "Member States should ensure that Additional Tier 1 and Tier 2 capital instruments fully absorb losses at the point of non-viability of the issuing institution. Accordingly, resolution authorities should be required to write down those instruments in full, or to convert them to Common Equity Tier 1 instruments, at the point of non-viability and before any resolution action is taken. For that purpose, the point of non-viability should be understood as the point at which the relevant authority determines that the institution meets the conditions for resolution or the point at which the authority decides that the institution would cease to be viable if those capital instruments were not written down or converted. The fact that the instruments are to be written down or converted by authorities in the circumstances required by this Directive should be recognised in the terms governing the instrument, and in any prospectus or offering documents published or provided in connection with the instruments."

15 See BRRD, Article 48

16 https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-853-F1-EN-MAIN.PDF

The text of the Art.108 BRRD Directive contemplates that member states will adopt it by “[June 2017]” and apply it from “[July 2017]”. Although it, too, will have to go through the ordinary legislative procedure, it is a short piece of legislation and has been proposed by the European Commission in response to specific calls for it by the European Parliament (in its Report on Banking Union) and by the Council of the EU to do so.

The Art.108 BRRD Directive proposed some very specific amendments to the existing Article 108 of the BRRD to facilitate the issue of a new asset class of so-called non-preferred senior debt. The proposals are similar to those in the Sapin 2 Law. Such debt would be bail-inable during resolution only after capital instruments but before other senior liabilities. As such, it is designed to meet (by statute) the requirement in the TLAC term sheet for “subordination” and also to be eligible to count as MREL.

The Art.108 BRRD Directive requires member states to provide for ordinary unsecured senior claims to rank in liquidation (and therefore also in resolution in a way which does not offend the no creditor worse off principle) ahead of those under debt instruments which:

- have an initial maturity of at least one year;
- are issued after the implementation of the Art.108 BRRD Directive;
- have no derivative features; and
- are documented in a way which explicitly refers to their statutory ranking.

Before issuing any such instruments for the first time, institutions will have to consider whether the creation of such a lightly-subordinated layer of debt is compatible with the terms of their existing capital instruments. Some older-generation Tier 2 obligations, for example, contractually rank as the most senior form of subordinated obligation. The Sapin 2 Law managed to avoid this difficulty by expressly stating that these instruments were senior instruments thus not concerned by any contractual restrictions on issuing subordinated instruments that do not rank *pari passu* with the existing Tier 2 securities of French credit institutions.

## Annex 1: Article L.613-30-3, as amended (free translation)

The **parts in bold correspond to the additions or modifications made**.

Article L.613-30-3

I. – Where a court-ordered liquidation procedure is opened against a credit institution under Book VI of the French Commercial Code, the following debtholders, for the portion of their debt entitled to the proceedings, shall rank below the creditors with security interests but senior to **the holders of subordinated debt:**

1° First, the entitled debtholders for the guaranteed amount of their deposits and the Deposit Insurance Fund for its claims against the relevant credit institution;

2° Second, the natural persons as well as the Micro, Small-Sized and Medium-Sized Companies (definition as per paragraph 1 of Article 2 of the Annex of the EU Commission Recommendation 2003/361/EC)

(a) For the amount of their deposits guaranteed under paragraph 1° which is in excess over the Deposit Insurance Fund indemnification cap;

(b) For their deposits which would be guaranteed if they had not been made with non-EU or non-EEA branches of the relevant credit institution;

**3° Third, the debtholders not mentioned in paragraph 4°;**

**4° Fourth, the following and only the following holders of unsecured debt which are:**

(a) **owners of a non-structured debt security mentioned in paragraph II of Article L. 211-1;**

(b) **owners or holders of an instrument or right mentioned in Article L.211-41 which displays features similar to those of the debt securities mentioned in paragraph a) of the present paragraph 4°;**

(c) **owners or holders of a *bon de caisse*, within the meaning of Article L.223-1, or of any instrument, right or debt issued under the legislation of another Member state of the European Union and presenting similar characteristics to those under the first sentence of the first paragraph of the same Article L.223-1, provided that they are not structured and that they were not the object of an offer to the public during their issuance,**

**for the amounts to which they are entitled to as per these securities, debts, instruments or rights, which may not have an initial maturity of less than one year and provided that their terms and conditions specifies that their owner or holder is an unsecured debtor under the meaning of the present paragraph 4°.**

**II. – A decree of the *Conseil d'Etat* specifies the conditions under which a security, a debt, an instrument or a right is held as non-structured under the meaning of paragraph I, 4°. This decree may provide for a minimum initial maturity of more than one year for the securities, debts, instruments and rights mentioned in paragraph I, 4°.**

**<u>Dates of coming into force :</u>**

**I. – Paragraph I, 4° of Article L.630-30-3 of the French Monetary and Financial Code is applicable to securities, debts, instruments or rights issued as from the coming into force of this present Law.**

**II. – Paragraph I, 3° and 4° of this same Article L.613-30-3 are applicable to liquidation procedures opened as from the coming into force of this present Law.**

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