# *Letter from the Editors*

**Vol. 1, No. 4, 1998**

## Realize, Neutralize, Securitize and Privatize: The Case of Crédit Lyonnais

### I. REALIZE

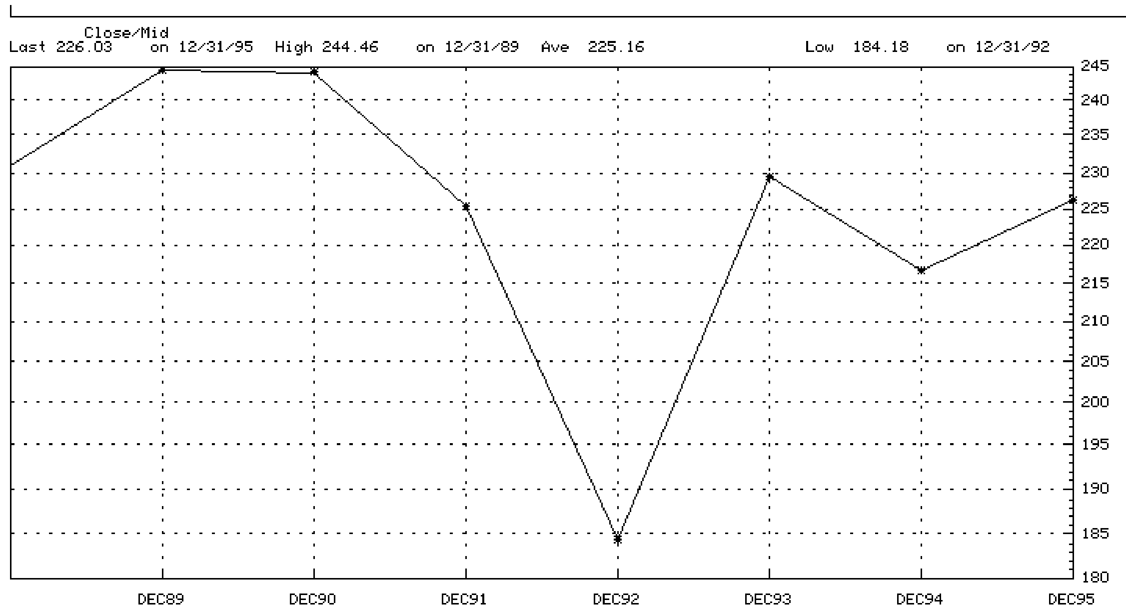
The rise and fall of Crédit Lyonnais was not symmetrical. On the way up, asset values were appreciating, making speculative investments look sure and bankers feel secure.

What better way for the French to usher in the dawn of the Euro than over the counter of the largest European financial institution. Its largest shareholder, the French government, was enthusiastic and generous. It was not to be.

With the bursting of the real estate bubble in 1991, the assets supporting Credit Lyonnais (CL) collapsed, and its equity was depleted (see exhibit 1). Exhibit 1 is the price index component of the *GPR-Real Estate Europe Securities Total Return Index* published by Global Property Research B.V. (www.gpr.nl) plotted on a logarithmic scale. On the way down CL fell with the aid of a government parachute. Credit Lyonnais is a classic example of a financial institution being "way too big to fail." Allowing CL to free-fall was considered too dangerous with respect to the European financial system and by extension to the real economy.

An institution is "too big to fail" when it is determined that the public cost of failure exceeds the public cost of a bailout. Perhaps we should use the term *marginally* too big to fail. It is estimated that the collapse of CL will ultimately cost the French government between FF 102 and FF 147 billion, $16.8 to $24.2 billion at an exchange rate of FF 6.06 (Commission of the European Communities Press Release IO 98/455) . These figures are calculated before taking into account proceeds from

**Exhibit 1**




**Source:** Bloomberg L.P.

**Exhibit 2**

| CREDIT LYONNAIS | | BNP | | SOCIETE GENERALE | |
|---|---|---|---|---|---|
| Senior Unsecured Debt | | Senior Unsecured Debt | | Senior Unsecured Debt | |
| Rating | Effective Date | Rating | Effective Date | Rating | Effective Date |
| A3 | 7/25/94 | Aa3 | 6/7/94 | Aa3 | 2/1/99 |
| A1 | 6/9/93 | Aa1 | 12/16/92 | Aa3 | 4/4/97 |
| Aa3 | 12/16/92 | Aaa | 4/4/95 | Aa2 | 7/27/94 |
| Aa2 | 9/19/91 | | | Aa1 | 9/9/92 |
| Aa1 | 7/17/89 | | | | |
| Subordinate Debt | | Subordinate Debt | | Subordinate Debt | |
| Baa1 | 7/25/94 | A1 | 6/7/94 | A1 | 2/1/99 |
| A2 | 6/9/93 | Aa2 | 12/16/92 | A1 | 4/14/97 |
| A1 | 12/16/92 | Aa1 | 6/29/88 | Aa3 | 7/27/94 |
| Aa3 | 9/19/91 | | | Aa2 | 9/9/92 |
| Aa2 | 11/1/89 | | | | |

**Source:** Bloomberg LP

privatization and a better fortunes clause that is part of the aid structure. The scale of the fiasco can be appreciated by comparing it to the S&L debacle in the U.S.

Between its establishment in 1989 and its termination in 1995, the Resolution Trust Corporation (RTC) took over and resolved 747 failed thrifts having assets of $400 billion in book value. CDR (Consortium de Realisations) acquired $135 billion of net assets from CL ($22.2 billion at FF 6.06 per dollar). Assets transferred to CDR from CL's balance sheet represent 5.5% of the assets the RTC acquired from failed thrifts. As a French professor whom we greatly admire would say, "a respectable loss." RTC disposed of all but $8 billion in "hard to sell" assets.

Overall costs of the S&L crisis over 1986-1997 are estimated at $156.4 billion, of which U.S. taxpayers financed $128.4 billion. The RTC was given 6 years to resolve the portfolios of the failed savings and loan institutions. CDR was given twenty years to resolve its portfolio. The original aid plan approved by the EC decision 95/547/EC was to sell or liquidate 50% of CL's assets in three years and 80% within 5 years, "if market conditions allowed." Market conditions have not enabled CDR to liquidate its portfolio in accordance to this tight schedule.

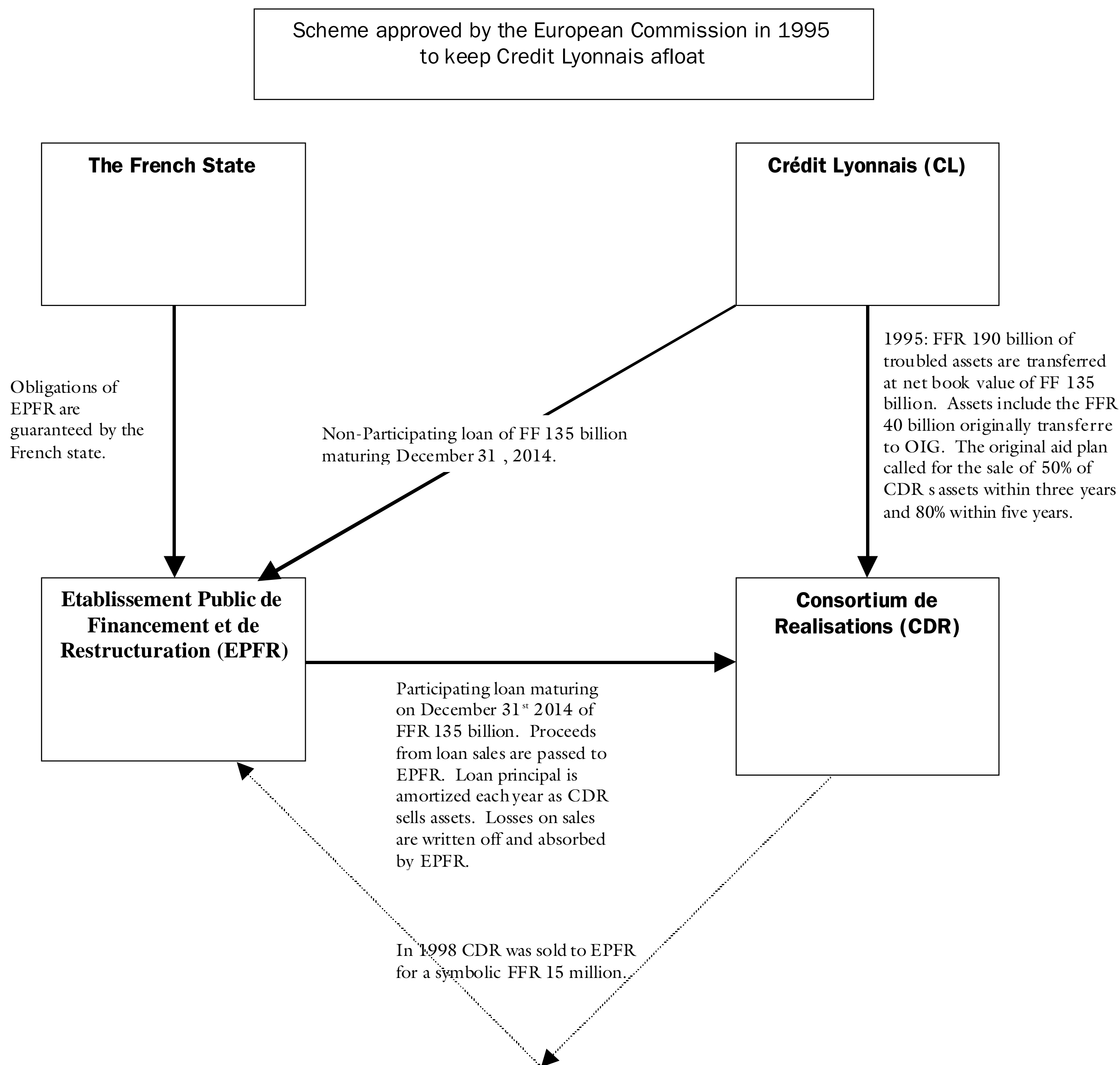
In 1997 the French government changed its strategy with respect to the assets held by CDR. Rather than seek a quick resolution via liquidation, it was decided to recapitalize many of CDR's assets before marketing them to private investors.

Credit Lyonnais' aggressive lending and acquisition strategy brought it to the brink of greatness. CL's total assets doubled between 1988 and 1993, its industrial portfolio increased by 500% over this period, and its exposure to real estate exceeded FF 100 billion. By 1993 it had become the largest banking group in Europe in terms of asset size. The turning point was 1992. Credit Lyonnais' losses of FF 1.8 billion in 1992 and 6.9 billion in 1993 would have breached the required solvency ratio had the French Government not injected additional capital into the bank. A rapid deterioration in the credit quality and the bankruptcy of many of its holdings was a portent for losses well beyond 1993.

Exhibit 2 summarizes the rating history of CL's senior unsecured and subordinate debt. As credit ratings deteriorated, CL's cost of capital increased, compounding its distress. CL's competitors, BNP and Société Générale, were better positioned to weather the collapse of the European real estate market. Although their credit ratings suffered, they did not slide to the same extent.

Within the European Community, governments cannot simply bail out failing enterprises or enterprises experiencing financial distress. State aid must be approved by the EC. EC regulations also mandate that banks must meet specific minimum levels of solvency and capital adequacy standards or face actions from their respective national banking regulators.

Since the French state was the majority owner of CL at December 31, 1993, with a 55% stake in CL equity and 76% of the voting rights, any investments on the part of the State in CL had to be examined by the EC. The EC had to decide whether the French state's capital injection and underwriting of CL risk could be justified on purely financial terms. If the state's investment in CL could not be defended as a market driven transaction it would be treated as state aid. "There is an aid component in a transaction if it would not have been acceptable to a private investor operating under normal conditions" (OJEC 95/




547/EC). Ultimately the EC decided that there was a state aid component embedded in the French government's 1995, 1996, and 1998 investments in CL.

In order to have access to aid from the French state CL was forced to retreat from markets outside France and liquidate many of its newly acquired assets. Retreat from its diverse geographical banking and financing empire, participation in the costs of the bailout, and ultimately privatization were the three pillars of the quid pro quo set by the European Commission. Aid was given to Credit Lyonnais in the form of equity investments, financial guarantees and underwriting of the special purpose financing vehicle EPFR (Etablissement Public de Financement et de Restructuration). CL has sold its foreign retail banking subsidiaries in Europe, Latin America, and Africa. As a condition for aid, in 1995 the government agreed to shrink commercial presence in Europe outside France by 50%.

**Exhibit 4.** Assets Securitized by Credit Lyonnais
via French Fonds Commun de Creance (FCC)

1990 CL FCC 90 (first securitization of consumer loans in France, FRF 1 billion)
1991 CL FCC 2 (second securitization of consumer loans in France, FRF 2 billion)
1992 Revenus Garantis 06-92 (securitization of an interbank loan)
1993 Revenus Garantis 06-93 (securitization of an interbank loan)
1993 Revenus Garantis 08-93 (securitization of an interbank loan)
1993 Revenus Garantis 10-93 (securitization of an interbank loan)
1994 TITRIMMO 05-94 (securitization of mortgages, FRF 2 billion)
1994 TITRICARTE 12-94 (securitization of credit card accounts, FRF 2 billion)
1994 TITRIMMO 06-95 (securitization of mortgages, FRF 2 billion)
1995 TITRICOURT 07-95 (securitization of consumer loans, FRF 4 billion)
1996 TITRIPHAR 06-96 (securitization of loans to Pharmacies, FRF 5 billion)
1996 CYBERVAL 07-96 (securitization of loan to EPFR, FRF 40 billion)
1997 TITRILOG 06-97 (securitization of housing loans, FRF 9 billion)
1997 CYBERVAL 09-97 (securitization of loan to EPFR)
1998 TITRILOG 11/98 (securitization of loans to private individuals, FRF 10 billion)

In 1994 after two years of losses, Credit Lyonnais was recapitalized with a FF 4.9 billion investment by its main shareholders, the French state, Thomson-CSF, and Caisse des Depots et Consignations. The French Government also underwrote the risk associated with FF 42.7 billion of assets transferred to a special purpose company Omnium Immobilier de Gestion (OIG).

## II. NEUTRALIZE

In 1995 CL's losses worsened, and a new refinancing structure was set up. The structure that was put in place is outlined in Exhibit 3 (with the exception of EPFR, which was originally SPBI. SPBI was transformed into EPFR and became a public administrative institution by the law of 28 November 1995. As a public administrative institution, its liabilities are guaranteed by the French government.

Terms of the structure were designed to tie Credit Lyonnais to the cost of the financial aid package. This was necessary for EC approval of the plan. Shifting the cost of the financial aid to CL was achieved through a subsidized loan from CL to EPFR in the amount of FF 135 billion (which EPFR had the option of drawing to FF 145 billion), a better fortunes clause by which CL would pay EPFR a 34% percent of its pretax profits (before inclusion of the better fortunes clause and allocation to the reserve for general banking risks and French income taxes); and dividends of 26 % of net profits in excess of 4% of CL's equity capital. The last FF 10 billion tranche of the CL loan to EPFR was to be used to purchase zero-coupon bonds. The return on the zero-coupon bonds would have financed part of EPFR's losses.

Between 1994 and 1998 the French state has discreetly ratcheted up the support it has given CL. As relatively optimistic economic forecasts upon which initial support structures were built did not materialize and losses continued to mount, the French government sought to amend the terms of the refunding structure outlined in Exhibit 3. Amendments included cancellation of EPFR's option to draw the loan up to FF 145 billion from FF 135 billion and neutralization of carrying the loan to EPFR. Each amendment to the original 1995 aid plan needed approval from the EC.

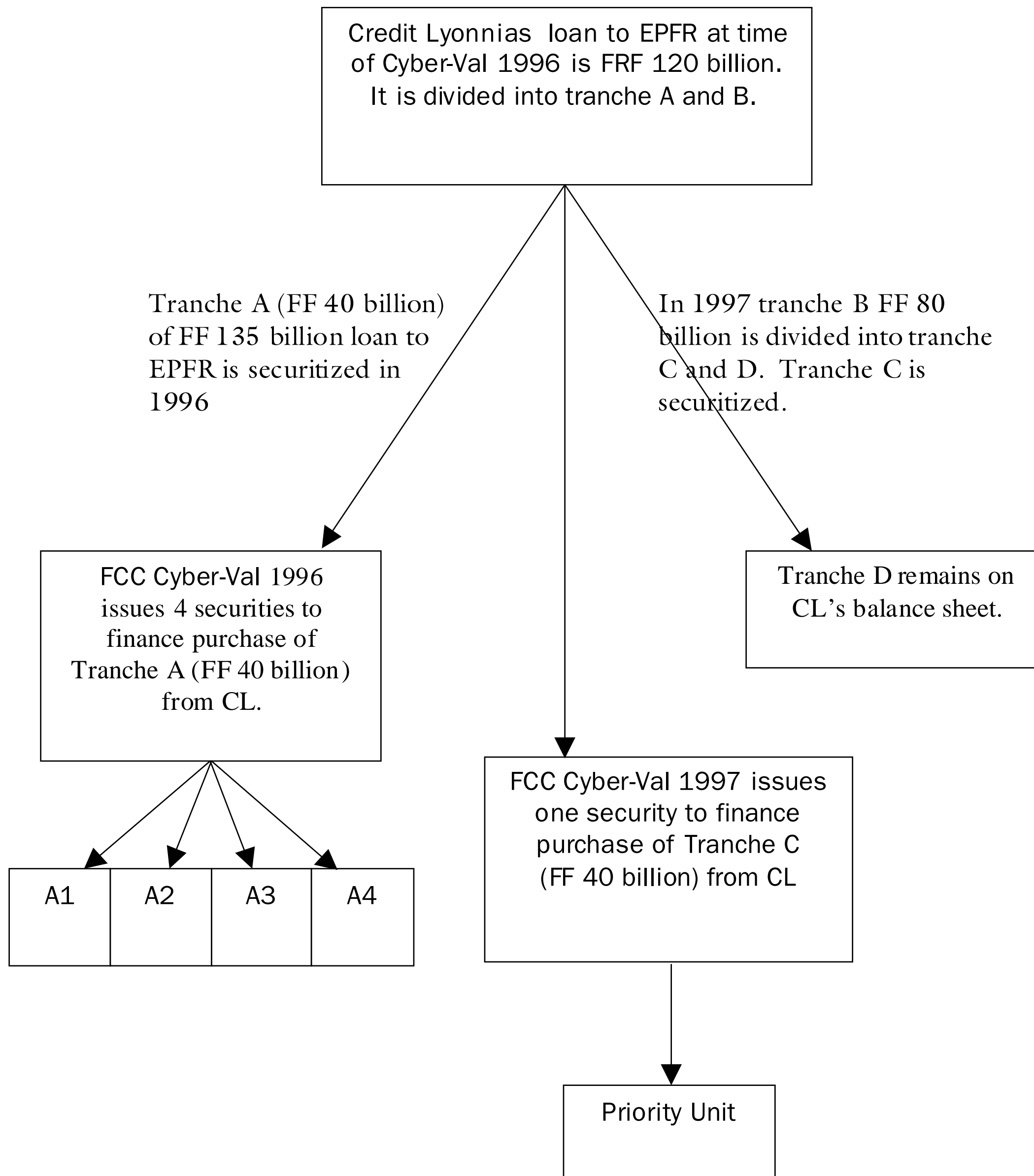
## III. SECURITIZE

Keeping CL afloat was the French government's primary objective. The EC also wanted CL to remain afloat, but on a much smaller scale. Ultimately the EC is requiring CL to sell FF 655 billion of assets and cut its domestic branch network from 2,200 to 1,850. Each amendment to the initial 1994 aid package was eventually approved by the EC, but for each amendment the EC extracted an additional quid pro quo from CL.

It is interesting that the EC specifically states that asset securitization would not satisfy the requirement for asset sales. This is an important decision that clarifies the value of securitization to banks facing increasing costs of equity.

"The sales undertaken in 1995 account for more than FF 120 billion of assets in CL's consolidated balance sheet. The French authorities have also stated that CL is planing almost FF 14 billion of securitization. However, the Commission considers that securitization is not a valid quid pro quo for the aid since it means that CL simply

**Exhibit 5**




transfers the risk involved in the assets in question, while maintaining commercial links with its clients" (Commission Decision of 26 July 1995 giving conditional approval to the aid granted by France to the bank Credit Lyonnais, 7.2.4, 95/547/EC.)

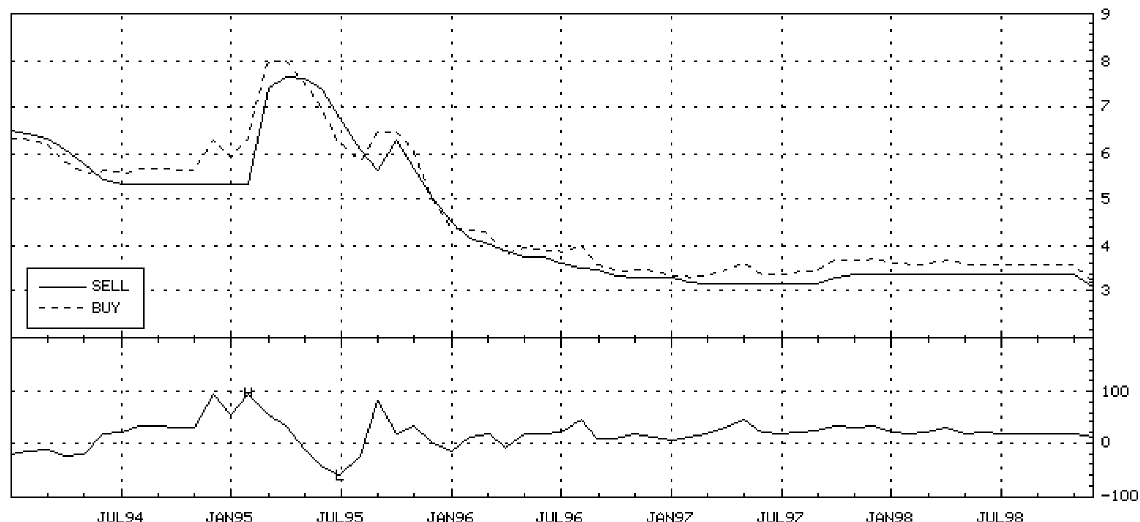
Exhibit 4 lists the securitization transactions undertaken by CL of its own assets between 1990 and March 1999. The list does not include transactions that CL underwrote or structured for other institutions. CL maintains an internet site (http://deef.creditlyonnais.fr/TITRIS) that offers good information about these transactions.

Even though the European Commission has not recognized securitization as a valid quid pro quo, CL has certainly used securitization to its advantage. With an A3 rating on its senior unsecured debt, CL has been able to tap the capital markets at a margin above AAA. The degree of the margin depends on the cost of equity associated with the securitized pool of assets, typically a subordinate tranche.

Terms of CL's FF 135 billion loan to EPFR were such the loan was draining CL's capital. Originally the interest rate was set at 7% for 1995 and 85% of the Taux Moyen Mensuel (TMM) for 1996 and beyond. In 1996

**Exhibit 6**

HISTORICAL YIELD SPREAD PAGE 2 OF 5
SELL TMM/T4M RATE Mid (3.111 )
BUY FRANCE - PIBOR 3 MONTH Ask (3.093 )
RANGE 1/31/94 TO 12/31/98 PERIOD M CLOSE/Mid vs CLOSE/Ask
HI 96.318 - 2/28/95 CURR 15.23 AVE 18.3286 LOW -59.69 - 7/31/95




**Source:** Bloomberg L.P.

the EC approved adjustment of the interest rate from 7% to 7.45% for 1995 and from 85% of the TMM to 5.58% in 1996. CL had financed two-thirds of the loan on the money markets and one-third on the capital markets at 9%. CL securitized FF 80 billion of its loan to EPFR in two separate transactions, Cyber-Val 96 and Cyber-Val 97. Since the transactions were completed before the EC approved neutralization of the underlying loan, CL was shifting basis risk and payment risk to the unsecuritized portion of the loan. Tranche D would absorb delayed repayment caused by slower-than-expected asset sales on the part of CDR and would absorb increases in PIBOR relative to TMM. Exhibit 5 illustrates the scheme of the Cyber-Val transactions. Securitization of the loan enhanced CL prudential ratios but did nothing to enhance its profitability. In fact, the burden of the loan to EPFR remained. CL was leveraging the part of the loan that was not securitized. The loan to EPFR was originally tied to the rate at which CDR sold its assets. As asset sales have taken place at a much slower pace than originally expected, the loan will remain on CL's balance sheet for longer than expected.

Although the amortization of EPFR's loan to CDR was uncertain, the units issued by Cyber-Val 96 and 97 have definite payment schedules and finite maturity dates. It is still somewhat of a mystery how this was arranged. Either tranche D was deemed sufficient to absorb payment delays, or EPFR committed itself to amortize the loan to CL at a rate that is independent of the rate at which CDR liquidated assets.

In May 1997 the terms of EPFR's loan to CDR were amended so that CDR was no longer obligated to repay EPFR in advance an amount corresponding to the sums collected from asset sales net of operating costs and interest owed. Instead CDR repays to EPFR on June 30th of each year an amount based on estimated cash flows based on sale proceeds set out in CDR's annual budget. The budget may be constructed to accommodate the terms of the Cyber-Val transactions.

Before the interest rate on the underlying loan to EPFR was renegotiated in 1998, the FF 40 billion tranche D would have been burdened with an interest rate on the order of 85% of TMM less PIBOR. Exhibit 6 illustrates that 85% of TMM was on average insufficient to finance the Cyber-Val 96 and Cyber-Val 97 transactions, which were issued at PIBOR plus 2 bp and PIBOR flat, respectively. In effect, CL chose to accept a larger loss on a smaller piece of the loan in return for improving its prudential ratios through the securitization of FF 80 billion of the EPFR loan. That is, CL leveraged the D tranche in order to raise capital. The gambit was successful; in 1998 the EC approved complete neutralization of the loan from

CL to EPFR. Tranche D is now above water, at least with respect to the money markets. Now that the cost of the loan has been neutralized by resetting the rate EPFR pays to 100% TMM, CL can securitize all or part of tranche D.

## IV. PRIVATIZE

Details of the privatization of CL, a quid pro quo imposed by the EC in return for approving the massive state aid CL has received, will be released the week of 15 March 1999. Privatization, the final turn in CL's drift back to earth, will not free CL from its deals with the EC. By the time this issue of *The Securitization Conduit* is published, the privatization plan should be operational.

A deadline of October 1999 has been set for CL's complete privatization. The aid supplied by the French state to the Credit Lyonnais group was not open-ended. State aid was negotiated to finance the time between CL's collapse and its privatization.

A fundamental condition to the approval of aid by the EC was CL's privatization. "France undertakes to transfer Credit Lyonnais to the private sector no later than October 1999, in accordance with an open, transparent and non-discriminatory procedure. The Process can begin in 1998, when a privatization order will be made, and will take place in several stages. It will in any event be launched before March 1, 1999. The State's holding in the capital of Credit Lyonnais will be reduced to no more than 10% and the State will no longer be Credit Lyonnais' lead shareholder" *(98/490/EC: Commission Decision of 20 May 1998 concerning aid granted by France to the Credit Lyonnais group notified under document number C(1998) 1454)*.

Once the final numbers are in, it may be that CL was not "too big to fail," but that it was too costly to save. As obvious as it may seem, it is worth restating, removing the constraint of market discipline leads to undisciplined behavior.

**Charles A. Stone, *Université Paris Dauphine***
**Anne Zissu, *Temple University***