Olivier Klein and Karine Berger discuss the draft law on the separation and regulation of banking activities

Published on 17 July 2013 by Olivier Klein

At a roundtable jointly organised by law firm Carlara, Bulletin Quotidien and Correspondance Economique*,* Karine Berger, *rapporteur* for the draft law on the separation and regulation of banking activities, and Olivier Klein, CEO of Bred Banque Populaire, stressed the need to guard against financial instability.

At the roundtable, which took place on 27 June and was jointly organised by law firm Carbonnier Lamaze Rasle & Associés (CARLARA), *Bulletin Quotidien* and *Correspondance Economique*, Karine Berger, the French member of parliament (PS) for the Hautes-Alpes and rapporteur for the draft law on the separation and regulation of banking activities, and Olivier Klein, CEO of Bred Banque Populaire and a professor at HEC, emphasised the need to reduce financial instability whilst maintaining the competitiveness of French banks.

The discussion, which was introduced by Edouard de Lamaze, focused on the draft law on the separation and regulation of banking activities. The draft law, which was passed by the French Senate at its second reading on 27 June and is scheduled for review by a joint committee today (before a formal vote on 17 July), is a key measure in President François Hollande's programme, as Mr. de Lamaze pointed out. Alongside Germany, France will be one of the first countries in Europe to implement the separation of banking activities.

Reducing the systemic risk and moral hazard that lead to financial instability

Ms. Berger and Mr. Klein stressed the need to regulate the systemic risk and moral hazard intrinsic to the financial system to avoid recurrent financial crises. Ms. Berger said that the separation of speculative banking activities from those that are useful for the economy (Title 1 of the draft law) was an effort to respond to this issue. "To understand speculation, we have to go right back to the roots of the crisis in the autumn of 2008. A combination of insufficient liquidity and solvency was involved, which Basel 3 is designed to tackle, but the most important aspect was the discovery of systemic risk and moral hazard. The systemic risk can be seen in the fact that a single bank can jeopardise an entire economy by ceasing to operate. The fact that the banks know that their governments will rescue them whatever happens, effectively encouraging them to take unacceptable risks, represents moral hazard," she said. Michel Rouger, chairman and joint founder of the PRESAJE institute (the French thinktank that carries out social research in the fields of law and economics), former chairman of the Paris commercial court (1992/1995) and former chairman of the Consortium de Realisation (the defeasance entity for Crédit Lyonnais) (1995/1998), argued that the system should "have the courage to allow banks to fail, which the French people and their government refuse to do, for the good reason of protecting 'deposits, which are just what is available before taxation takes it off you.' (…) The Americans didn't hesitate with Lehman Brothers, and neither did the UK. The only truly effective way of making bankers responsible is confronting them with their own failure."

Mr. Klein said that the 2008 crisis had not, in the strictest sense, originated with the banks, but "from a transitional phase in the globalisation process, with global overproduction, which had been masked for some time by global over-indebtedness. The financial system was at fault in that the investment banks, particularly in the US and the UK, found highly imaginative ways of preventing this over-indebtedness from coming to light." BRED's CEO stressed the "intrinsically procyclical and unstable" nature of finance. "Finance cannot self-regulate indefinitely, as traditional economic theory suggested, because there is no clear equilibrium value for the price of financial assets that are based on a promise of future return when the future is hard to predict. This is why prudential regulation is necessary." However, he added, although there were market errors, these had been compounded by errors in economic policy and prudential regulation. These regulations need to be appropriate and take full account of their macro-economic effects, avoiding any procyclical tendencies.

Picking up on a road safety analogy made by Ms. Berger, Christian Walter, associate professor at the IAE at the Université Paris 1 Panthéon-Sorbonne and head of science for the History and Epistemology of Finance programme at social research institute FMSH, pointed out the limitations of the conventional diagnosis of the crisis, and, therefore, of the remedy provided by the new banking regulation, because the blinding effect of the technical instruments used had not been taken into account: "Even if the highway code (regulation) has been properly established and the signage (information) is in place, and even if he is driving legally and not under the influence of alcohol or drugs (ethics), if the speedometer is faulty, the driver will believe that he is travelling at 30km/h rather than 100km/h, and the car will come off the road. The current remedies (regulation, information, ethics) do not include instruments. Misleading instruments helped to destabilise finance and increase moral hazard." Mr. Walter wondered whether the problem could be due to "a faulty speedometer. Even if the highway code is rewritten, if the driver believes he is travelling at 30km/h when he is at 100km/h the rules are not enough."

Ms. Berger responded that “information has a cost, and the asymmetry of information is precisely why the financial markets are not efficient. But there is no solution, it’s a negative factor that we cannot correct.”

In view of this, international financial regulation would appear to be necessary. However, Yves Jacquot, Deputy Chief Executive of BRED, commented that errors in regulation could also represent a “systemic macro-risk”. Ms. Berger, citing the example of the International Financial Reporting Standards, which have created “volatility and instability”, said that it was international debate that led progressively to good regulation, and that she no longer had faith in purely local regulations. Mr. Klein agreed, stressing that regulation had to be international to avoid risks relating to inadequate regulation.

Mr. Klein also said that the issue of the separation of banking activities needs to be supported with a raft of measures, such as stronger bank solvency and liquidity rules (cf. Basel III), spreading risk-takers’ remuneration and adequate regulation of “shadow-banking”. Title II of the draft law therefore aims to establish a winding-up mechanism to prevent crisis contagion. "This is a vital tool, as the crisis in Cyprus showed," said Karine Berger. "But it's not enough - we have to have international regulation, starting with Europe and the creation of banking union."

The creation of a High Authority for Financial Stability (Title III) by the draft law – “a first in France and in Europe," as Ms. Berger pointed out – would improve supervision of systemic risks. Equipped with “extraordinary macro-prudential powers”, the authority could, amongst other things, “decide on the unilateral reinforcement of prudential solvency and liquidity ratios."

“There are indicators for speculative drift, which can pick up bubble development with a good level of probability, alert the markets and act accordingly at macro-prudential level,” added Mr. Klein. On this subject, Michel Rasle, a partner at CARLARA, enquired about the situation in the Chinese banking system. Ms. Berger reassured him that it was not a global systemic problem. China had a combination of too-rapid lending growth and over-developed shadow banking, which had created some jerkiness, she said. But China definitely had the means to regulate this, because national savings as a percentage of GDP were very substantial and the central bank had huge reserves.

Separating useful market activities from speculation: the dividing line is hard to establish

The key thrust of the legislation, which is the separation between speculative market activities, to be ring-fenced within a specialised subsidiary, and activities regarded as “useful for the economy”, was not easy to define, pointed out Ms. Berger. The Liikanen report, submitted to Brussels, recommended hiving off all market activities, including market making, within a single subsidiary. The French legislation initially stipulated only the separation of proprietary market activities, leaving market making within the parent company.

Mr. Klein said that, while there was "some porosity" between trading and market making, the two activities were different: "Pure trading relies on short-term market price variations. It is, in theory, and in practice, useful for setting an equilibrium price on the markets: but since the equilibrium price is hard to define, pure trading, through mimetic behaviour, may also strengthen speculative bubbles. Trading should therefore be allowed, but it should be regulated to make these transactions slightly more difficult to carry out. Market making, which consists of transactions carried out according to the requirements of buyers and sellers, is useful in creating liquidity and depth in the financial markets, allowing each party to find the appropriate counterparty at the right time.” In the end, the legislation had achieved a good balance in this regard, he said.

Ms. Berger said that she had reached the conclusion that market making was no different from any other market activity, which was why the National Assembly wanted to go further, with an amendment enabling the minister for the economy to set the proportion of market making to be separated by ministerial order. The decree would allow for *a posteriori* adjustment to European legislation, separating out 0 to 100% of market making. Olivier Klein shared this concern: “The banking law relies on France and Germany being able to influence Europe upstream. If European legislation doesn't go our way, we have to make an adjustment to avoid a patchwork of regulation in Europe and a potential disadvantage for French banks."

Philippe Croizat, a partner at CARLARA in Lyon, expressed concern about spin-off costs for the parent company, remarking that the subsidiary dedicated to speculative activities would have to be overcapitalised. Ms. Berger said that there had been some difficulty with communication on this subject, but that she could categorically state that the major risk criterion would prohibit the parent from transferring equity or cash above a certain ratio. She explained that the parent company would not be 100% responsible for the segregated subsidiary, but would regard it as a third party, and therefore could not lend to it as it did under current legislation, which stipulated risk limited to 25% of equity, when in practice a 10% limit was applied. The subsidiary would therefore have to seek third-party financing and be subject to scrutiny, which would increase its borrowing costs. Mr. Klein concluded by saying, "I don't think that many subsidiaries will be created, because they will probably be very expensive to operate. But while we know that speculative risk must not be allowed to place banks in fundamental danger, we have to be careful not to suppress trading completely.” He added that, if any danger of systemic risk relating to derivatives was to be avoided, their use had to be subject to better international regulation, favouring organised markets, which offered more security.

In response to a question about banking governance from Arnould Bacot, a chartered accountant at audit firm Tilia, Karine Berger explained that the draft law had been designed to ensure that members of the board of directors could not hold office simultaneously in parent companies and subsidiaries. The subsidiaries would also have different managers and different names from the banks spinning them off. Thibaud de Gouttes, executive director in charge of the hedging of financial institutions at Nomura Bank in Paris, wondered whether the draft law would be compatible with mutual and cooperative groups formed of regional banks and central bodies. Mr. Klein said that, regardless of their structure, if these groups had to segregate their activities, they would be able to create their subsidiaries under the terms of the law.

Safeguarding competitiveness in the French banking industry

The roundtable members also voiced concerns about the effects of the draft law on the competitiveness of French banks. Mr. Klein pointed out that “market making also includes the derivatives markets, in which the French banking industry is strong. We also have to protect the French banks' market-making capacity so that this position is not destroyed by non-French banks.”

Another cause for concern is the bank charges payable in the event of payment incidents. The caps on these charges are the main bone of contention between the National Assembly and the Senate. The lower chamber wants to establish a single, universal cap for all consumers, while the upper chamber aims to set a second, lower cap for the more vulnerable. Mr. Klein said, “Over the past five years, we have undergone so many successive regulations on bank charges that we have lost 4.5% of net banking income.” He warned that the environment was so unfavourable to growth in net banking income that banks' profitability models could be negatively affected and they might stop hiring when the banking sector employs over 400,000 people. He also said that, as well as removing responsibility from the persons concerned, there was a risk that “low-cost" banks could be created, with no customer service, which would eventually penalise the French economy. "The bank charges regulation should only concern the most vulnerable," he added.

“The new international standards tend to generalise the Anglo-Saxon model of financial disintermediation whose excesses caused the 2008 crisis. Is it not worrying to see European banks withdrawing from their core business by offloading their debt portfolios onto insurers seeking returns? Doesn't this new wave of securitisation carry new risks?" said Yves Bazin de Jessey, director of institutional management at Banque Saint Olive. Ms. Berger stressed that the phenomenon of loan securitisation by banks was still marginal in France and was worth an estimated €10 billion: "We shall do all we can to ensure that banks continue to carry out their business, i.e. lending. But on this issue, I am more concerned about the choices banks may make with regard to returns than about the impact of the regulations.”