OECD Journal: Financial Market Trends www.oecd.org/daf/fmt
Volume 2013 – Issue 1
Pre-print version

Structural reform and supervision of the banking sector in France

by
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The crisis has shown that there is no such thing as an optimal banking structure or model. The Liikanen report highlighted excessive risk taking and excessive reliance on short term funding not matched with adequate capital protection. The French reform of the banking sector builds on this insight as well as the agreement reached by the Basel Committee on Banking Supervision and the European CRD 4 to foster financial stability. Risky speculative activity will have to be separated from the rest of the banking sector while taking into account the assets of the universal banking model. Further, the reform introduces a strong resolution framework and new macro-prudential powers.

JEL Classification: G18; G38; G33; G32.

Keywords: banking system; bank supervision; bankruptcy; liquidation; systemic risk; macro-prudential policy.

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I. Introduction

The crisis has shown that there is no such thing as an optimal banking structure or model. Some pure investment banks (e.g. Lehman Brothers or Bear Stearns), some pure retail banks (e.g. Spanish *Cajas*, Irish banks, Northern Rock), and some universal banks *(e.g.* ING or RBS) alike either failed or were absorbed or required exceptional government support. Accordingly, the European High-Level Expert Group chaired by Erkki Liikanen came to the conclusion that no particular business model fared particularly well, or particularly poorly, in the financial crisis, but the Group rather pointed out excessive risk taking as well as reliance on short term funding, not matched with adequate capital protection.[1] To address these weaknesses many key reforms have been adopted at the international level over the last years or will be finalised in the coming months.[2] Most notably, the agreement reached by the Basel Committee on Banking Supervision (BCBS, 2011) on the new bank capital and liquidity framework will raise the quality, quantity and international consistency of bank capital and liquidity, constrain the build-up of leverage and maturity mismatches, and introduce capital buffers above the minimum requirements that can be drawn upon in bad times. Systemically important financial institutions (SIFIs) will also be required to have higher loss absorbency capacity. These multi-pronged reforms lay down much stricter rules for banks within a short timeframe. However, in addition, there is a broad consensus that the regulatory framework needs to be complemented in new directions through structural reforms regarding, in particular, recovery and resolution on the one hand, mandatory separation of purely speculative risky financial activities from deposit-taking banks on the other hand. Such a reform of banking structure must be very thoroughly designed as it has to smoothly articulate with the already quite comprehensive overhaul of banking and market regulation. French authorities support the view that a well-designed structural reform should complement on-going regulatory reforms by insulating banking activities that are useful for the financing of the economy from risky speculative trading ones.

At the time of writing (April 2013), the French reform of the banking sector is still under discussion.[3] It needs to be voted in second reading by the National Assembly. It would thus be premature to express definitive statements on a text that may still evolve, but the main lines of it now appear to have crystallised. Of course, some consider that the reform goes too far, giving the French prudential supervisory authority (*Autorité de contrôle prudentiel*; ACP) too extensive resolution powers, while others view the reform as too mild regarding mandatory separation. In the remainder of this article, the next section (II) shows that the separation of risky speculative activity in the reform is important, well-balanced and implementable within a short timeframe. But focusing exclusively on separation would be missing the point and one key aspect of the reform consists in reducing vulnerabilities of the financial sector by introducing a strong resolution framework and new macro-prudential powers that are described in section III. Some concluding remarks are provided in section IV.

II. Separation of risky speculative trading activities as main goal

The first part of the bill implements a structural reform of large banking groups which is relatively close in spirit to the proposal put forward in Liikanen (2012). This reform aims at:

- reducing the market risks that banks may take at the minimum level needed to conduct the trading activities that are necessary to finance the economy;
- protecting customer deposits from the risks incurred in proprietary trading activities. The goal of the reform is to drastically limit the risk of taxpayer and deposit insurance money to be used to cover losses incurred by trading activities;
- enhancing the prudential supervision of trading activities within credit institutions and investment firms.

In drafting the bill due account was taken of the weaknesses but also the strengths of the French banks during the crisis. A remarkable point is that, in contrast to the proposals of Liikanen (2012) which do not attempt to separate pure "speculative" driven proprietary trading from market making (both would have to be ring-fenced), the reform considers, more in line with the Volcker approach,[4] that it is possible and necessary to draw a line between those activities. It rests upon the overarching principle that the distinction should be made on whether or not activities are effectively client driven and contribute to the financing of the real economy.

1. The structural reform will preserve universal banks

The universal banking model seems to have been somewhat resilient, although it was not true in all countries. For example, two banking systems, which have historically shared common features, namely those of France and Canada, have solidly weathered the crisis. A reform of the banking structures should therefore not put into question the genuine strengths of this model. The French universal banks predominantly rely on retail banking, including specialised finance, which accounts for nearly two thirds of net banking income and provide steady revenues as well as a stable funding basis. Corporate finance, investment banking and asset management contributions make up for the rest and are well balanced. Drawing the lessons from the financial crisis, French banks have already massively reduced, and often closed, their pure proprietary trading activities. The aim of the new segregation regime is thus building closely on the experience of these past years, to stave off growth of volatile proprietary trading revenues in a next cycle.

All in all, French clients – corporations as well as households – benefit from a banking system that provides a broad range of various of financial services. The universal banking model has indeed some synergies and economies of scale to offer. A universal banking group is able to appropriately diversify its risks portfolio between business lines and products and is therefore able to mitigate a negative shock that may affect one of its activities. A reform of the banking structures should not hamper those positive externalities while a sensible and reasonable separation of risky activities may contribute to anticipating and facilitating resolution in cases of stress.

2. Necessity of a separation between trading and retail activities

The French reform of the banking sector aims at separating activities that contribute to funding the economy from speculative activities.

Above a specific threshold[5] the bill requires trading activities or unsecured financing to hedge funds to be conducted within a separated trading entity, which would be regulated and supervised as an investment firm or as a credit institution. This trading entity would neither be allowed to collect deposits nor to offer payment services to retail customers, nor to benefit from group guarantee or liquidity support beyond exposures that fall within a restrictive large exposure limit: the trading entity will be treated for the purposes of this internal limit as if it were not part of the group. In other words, retail client deposits will not be used to finance proprietary speculative activities.

More specifically, market making activities are considered as necessary to preserve liquidity capacity, but the Minister of the Economy may set thresholds above which market making activities would have to be contained within a separate entity. Moreover, the dedicated trading entities are prohibited from high frequency trading or derivatives trading on agricultural commodities for speculative purposes.

Market activities that could be useful for the financing of the economy are authorised within the entity that collects deposits.

Some trading activities will not have to be ring-fenced provided that they have a significant role in financing the economy. These trading activities, specified in the bill, are:

- trading positions involved in customer-driven investment services, such as providing hedging or other investment services to customers, with revenues being generated by customer fees and prudent handling of the related exposures; hedging positions for own purposes, which must be demonstrably related to a credit or market exposure;
- market making activities as defined in EU regulation 236/2012 and already mentioned previously;
- liquidity management activities or any other within group transaction that does not affect the consolidated prudential balance sheet;
- investment in securities with the intention of holding them over the long term.

Banks will have to build and disclose a mapping of their trading activities.

The law also aims at enhancing the prudential supervision of trading activities by forcing banking groups to establish and communicate to the prudential supervisory authorities a mapping of their trading activities jointly with a set of mandates and rules of conduct provided to their desks. The internal controls of the banks will have to ensure the implementation of these mandates. Supervisory authorities will assess the adequacy of theses mandates and rules of conduct *vis-à-vis* the constraints set by law. The regulation on internal control was already strong in France but the new bill provides thus additional specific requirements concerning banks' internal control systems of market activities.

This reform is well balanced between reducing risks from speculative proprietary trading and preserving useful market activities for the economy.

The first part of the reform project – after the consultation period and parliamentary work – has slightly evolved from the initial version but the core principles have remained untouched. The text is well balanced in the sense that it draws the line between purely speculative activities that should be ring-fenced or prohibited, and all other activities that either contribute to the financing of the economy or are carried out on behalf of clients and that should be allowed. As a consequence, and in contrast with Liikanen (2012) where market making has to be assigned to the trading entity, it was acknowledged during the consultation and the debates at Parliament on the French reform that market making activities play a crucial role in providing liquidity to markets. Market making is also closely linked to the underwriting of securities so that it would make little sense to artificially disconnect those two activities, ultimately impairing services delivered to corporate clients given the close links between trading on the secondary market and underwriting on the primary market. Indeed, banking intermediation is still important in Europe, especially for smaller companies. While Basel III aims at preventing banks from building up excessive leverage, banks have all the more a crucial role to play to organise and facilitate market financing for larger corporations. The preservation of market making is therefore essential to prevent unintended consequences of the implementation of the new regulatory framework.

To conclude with this part, the French universal bank model has demonstrated a great resilience during this exceptionally deep financial crisis. The aim of this reform it to keep the strengths of the French financial system while improving the protection of depositors and the long term financing of the economy by isolating the speculative part of the banking activity. This is an important element to appropriately channel capital towards its effective use and thereby achieving financial stability and sustainable financing of the economy. But the banking reform goes further than segregating speculative activities. It builds a new framework to prevent future systemic disruptions and reduce the cost of financial crisis.

III. Strengthening the supervisory framework

The reform of the banking sector strengthens the supervisory framework by giving new powers and responsibilities to the supervisory authorities.

The law undertakes a comprehensive review of the French banking system and supervisory framework, both nurturing a better governance of the industry and shaping supervisory powers to improve financial stability and manage bank failure resolution.

1. Improving governance under the supervision of the ACP

Preventing defaults is the most straightforward way to nip in the bud interconnections-driven systemic disruptions.

For this purpose, the Basel framework sets up not only quantitative requirements but also rules for a sound governance and risk monitoring and market discipline. Sound governance involves primarily equity holders as well as – to a lesser extent – subordinated debt holders. Meanwhile, risk monitoring is frequently delegated to management boards. The recent crisis demonstrated how an ill governance and risk monitoring leads to failures, such as the bails-out of Northern Rock in the United Kingdom, MPS in Italy or SNS Reaal in the Netherlands.

In the light of this experience, the new French banking law reinforces the ACP's ex-ante intervention tools.

During the financial crisis, evidence suggested that the quality of the board was absolutely crucial to prevent the failure of a bank. New powers are vested in the French banking supervisor to assess the suitability of board members. Notification for the fit-and-proper test – previously carried out only for managers – will be extended to board members. It will ensure greater effectiveness of the control of their reputation and professional competence. The French supervisor will be able to oppose a nomination and suspend a member if conditions are no longer met. The supervisor will indeed check whether the collegial bodies' members abide by the rules throughout their mandate. This way the bank should enjoy advice from more suitable stakeholders in its choice of the right business model.

Governance monitoring tools thereby should help preventing organisational failures. From an institution-level perspective, they reduce ex-ante the probability of a default that could spur a systemic event.

2. The ACP will be granted "resolution" powers

Following initiatives of the G20 Financial Stability Board and the European Commission, the ACP will be granted resolution powers and becomes Autorité de Contrôle Prudentiel et de Résolution (ACPR)6, to reduce moral hazard and protect the tax payer.

During the financial crisis, some public authorities were forced to bail-out troubled banks that were identified as systemically important financial institutions (SIFIs) and too-big-to-fail. From such experience, banks' equity and shareholders may consider they benefit from an implicit guarantee by governments, covering all activities, as the deposit guarantee scheme protects the depositors. This expectation lowers their incentive to assess the risk they bear. This makes a default both more likely – since market discipline disappears – and more costly – since the resolution is complex.

To stem this behaviour, the new French banking law will require banks to define their "living wills". A recovery plan will detail preventive actions to be undertaken in case of significant deterioration of the situation. A resolution plan will organise and ease the supervisor's intervention in case of crisis. The supervisor may require reorganisation of the bank's structure if deemed necessary, including the possibility to isolate or segregate some activities.

Within the new ACPR, a devoted board will be in charge of resolution measures in case of default.

This board has the power to change managers, designate provisional ones, transfer or sell the whole or part of the institution. Most importantly, the new French banking law establishes losses are to be borne by equity holders and subordinated creditors. A write-down and conversion mechanism could affect share and subordinate bond holders, in accordance with their seniority. An EU directive will complete these measures, which adapt the liquidation process to properly strengthen the institution's capital base. Risks and risk bearers are thus explicitly defined, withdrawing the expected implicit guarantee enjoyed by equity and shareholders and promoting a cautious management.

At the same time, it improves the protection of depositors and the stability of the financial system at large by increasing the size of the existing guarantee scheme, thus enhancing its potential to contribute to the rescue or the resolution of an institution.

3. The law introduces the concept of macro prudential supervision

Financial fragility is also a result of banks' interactions. The banking activity is inherently cyclical, with financial cycles potentially exacerbating business cycles. Furthermore, banks are exposed to common macroeconomic shocks, weakening them all simultaneously. Their organisation in a network structure spurs contagion in case of a default. These risks threaten the public good of financial stability. This is the reason why the 2009 de Larosière report[7] called for the implementation of macro-prudential supervision to complement the micro-prudential approach.

In France, the institutional set-up is a board named the *Conseil de la Stabilité Financière* (Financial Stability Board) gathering the ministry of finance, the central bank, the bank and insurance supervisor, the financial markets supervisor and the accounting standards authority. The *Conseil* could publish notifications and recommendations deemed necessary to the preservation of financial stability. It will be in charge of setting the counter-cyclical buffer, the systemic buffer[8] and tightening standards for credit granting[9].

The counter-cyclical buffer is a 'lean against credit' tool. This additional requirement becomes stricter along the upward phase of the credit cycle and is released in a downturn. It makes banks more resilient by strengthening their capital buffers. It has the interesting side-effect of curbing credit growth by making it more expensive to banks in the expansion phase.

If the counter-cyclical buffer anticipates the sector-wide build-up of systemic imbalances, systemic capital surcharges target systemically important banks. These institutions are sizeable enough to be sources of contagion. Their status makes them key contributors to systemic risk. Consequently, they have to be even more resilient than their smaller counterparts. Monitoring credit granting standards limits the development of speculative bubbles. In a bubble, credit counterparties are not adequately screened. Investigating credit standards hampers drifts towards excessive credit growth.

Macro-prudential instruments thus handle systemic risk both ex-ante by decreasing the probability of the event to materialise (leaning against the financial cycle) and ex-post by minimising the loss if it does take place (higher capital). Failure management tools enhance their action at the institution's level.

IV. Concluding remarks

In conclusion, several directions have been explored to address the issue of the necessary structural reform of the banking sector with the Volcker rule in the United States, the Independent Commission on Banking chaired by Sir John Vickers in the United Kingdom,[10] and the High-Level Expert Group chaired by Erkki Liikanen in Europe. The French reform builds upon their in-depth analysis and conclusions but also considers the hurdles that still have to be overcome. In France the reform is a change of paradigm in the sense that it introduces in a coordinated manner preventive and curative measures by giving legal force to the principle of separation and by strengthening macro prudential and resolution tools.

The separation part is well suited to keep the advantages and resilience of universal banking while diminishing the risks, with implementation already by 2015. It constitutes a promising venue at the European level. Indeed German authorities are also considering moving in a very similar direction. It would be a real chance if a common framework could emerge in Europe so as to prevent fragmented national legislations.

The new set of tools is well suited to handle systemic risk and to tackle individual and sector-wide sources of systemic disruptions, lowering the probability of their materialisation and decreasing their costs. If the systemic event cannot be avoided, it ensures that costs will not be borne primarily by the tax payer[11] but that risk takers duly take their part in the resolution process.

Notes

1. Liikanen (2012).
2. See G20 (2010a) and G20 (2010b).
3. See the documents and procedure at the link provided in Assemblée nationale (2012).
4. Section 619 of the Dodd-Frank Act (U.S. Congress, 2010).

5. Threshold specified by decree from the Conseil d'État (Council of State). The Conseil d'État is the French highest administrative jurisdiction. It advises the government on the preparation of bills, ordinances and certain decrees.

6. Supervisory and Resolution Authority.

7. See High-level Group on Financial Supervision in the EU (2009).

8. The systemic buffer is a flexible capital surcharge, not to be confused with the systemic capital surcharges for Global Systemically Important Institutions (GSII) or Other Systemically Important Institution (OSII).

9. The Conseil de la stabilité financière will also acknowledge capital requirements imposed to French institutions due to exposures in other member states.

10. ICB (2011).

11. The tax-payer is also protected by various measures ensuring an improved transparence and functioning of the French insurance and banking markets (better information about insurance prices, removing obstacles to insurer's offers comparison, easing access to bank services and defining a limit to bank account charges for individual customers).

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