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FOOLS RUSH IN?
Banking legislation in France

Editorial

The financial transaction tax that Europe intends to adopt would yield a whopping €35 billion per annum. But that figure actually says a lot about the economic effects of the proposal because raising such a huge amount is unlikely to be painless.

It is true that, under the residence principle, transactions conducted outside as well as inside the FTT zone would be taxed if they relate to persons located elsewhere than the zone or if they involve a product issued within it. Even so, that will not dispel a dual risk, which is actually a certainty. First, concerning the increased costs borne by FTT-zone issuers and investors, it is unrealistic to assume they can absorb the burden painlessly, given that it is huge compared with their business. Second, whole swathes of market activity could be destroyed or transferred out of the zone.

In fact, what lies ahead is not a deceptive rise in tax revenue but a loss that will deal a devastating blow to employment (see p. 7).

For France, this is hugely important. We have the largest capital market of the eleven countries concerned by the FTT, and hence the most to lose by far.

As with the domestic FTT last year, this issue will be a key focus for AMAFI in the months ahead. Its first task will be to objectively assess the economic effects of a tax based on a political vision that overlooks stark realities.

Pierre de Lauzun
Chief Executive, AMAFI

Feature

Like many countries, France is seeking ways to ensure that taxpayers do not foot the bill for a future financial crisis. The Banking and Financial Reform Act currently going through parliament may be a step in the right direction. But is it a step too far and too fast?

As the aftershocks of the financial crisis rumble on, governments and regulators have been seeking ways to beef up supervision and protect their citizens – and the rest of their economies – from another meltdown. One of the key areas of focus has been the banking industry, where the crisis broke out in 2007 as a result of over-lending, subprime mortgages and excess leverage. The big challenge for policymakers has been to find measures appropriate not only to a global system but also to each country's own particular risk culture.

The US has adopted the Volcker Rule to separate banks' consumer lending business from their speculative activities; the UK is preparing legislation based on the Vickers report on banking; and the European Commission is working on its own plan. In France, a new statute has been drafted "to address the excesses of finance and the causes of the crisis and strengthen political and democratic oversight of the sector," in the words of Finance Minister Pierre Moscovici.

Feature

The Banking and Financial Reform Act, currently going through parliament, aims to modernise the banking sector and separate speculation from activities deemed "useful to investment and employment". Be that as it may, the initiative focuses squarely on banking separation whereas the top priority should be to re-organise financial markets as a whole. As one industry observer put it, "Market reform is more important than business separation. To win back the confidence of investors and issuers, we need markets that are more transparent and integrated".

What the new law says

At the outset, there were four main aims: combat speculation and ensure that banks focused on financing economic activity, protect depositors and make certain their funds were not being used for capital market business involving undue risk, allow the authorities to ring-fence a bank's retail business in the event of problems, and limit or forbid businesses with no useful social or economic purpose. In the end, the Banking and Financial Reform Act has only two main thrust, dividing up banks' business into "economically useful" and "speculative" and setting up a recovery and resolution regime.

The legislation does not seek to dismantle France's universal banking model but it changes the structure and behaviour of banking institutions, notably by ring-fencing some of their activities. By 2015 banks will be required to set up special subsidiaries to handle speculative activities, including proprietary trading and algorithmic arbitrage, that do not contribute to financing the economy.

Another key aspect is the creation of a recovery and resolution regime. Banks and investment firms with a balance sheet exceeding a statutory threshold will have to file a recovery plan – a "banking will" – setting out the measures they would take if their financial situation worsened dramatically. If a market participant goes under, the state will not bear the cost. Banks and investment firms will be required to contribute to a resolution fund that will cover failures. And if an institution runs into difficulty and the capital held by shareholders is insufficient, a creditor will have to stump up.
Other provisions include enhancing the powers of the supervisory authorities and regulatory institutions in the financial sector. A financial stability board in charge of macro-prudential policy will be empowered to impose additional capital requirements on financial institutions where necessary. The Prudential Control Authority, renamed the Prudential Control and Resolution Authority, will have broader powers, along with the securities regulator AMF, to demand a wider range of documents and information from the institutions they supervise.

Reflecting European initiatives, the bill also amends the legal regime applicable to clearing houses, and tightens regulation on high-frequency trading, money laundering and tax havens, market abuse and commodities trading. It also introduces several consumer protection measures, such as caps on bank charges for the most vulnerable customers and better access to banking services.

Too far?

The new legislation has been described by government officials as a bold and ambitious initiative that tackles moral hazard. But it has also been condemned, from inside and outside the industry, as either timid or excessive. Significantly, the new law will not only hand wide-ranging powers to the regulator; it will treat investment firms – even those that do not belong to a banking group – almost identically to credit institutions. They will therefore be subject to the same resolution regime as banks, though the situations in which it might be relevant are almost non-existent.

Other commentators contend that the law should be further tightened because capital market activities are rarely economically useful, and even when they are, banks do not need to be involved in them. That argument is misguided since market financing will play a greater role in future, when banks everywhere are subject to tighter capital requirements under Basel 3, which will crimp their lending capability. Since French banks lend more than they deposit, they have to rely on market financing. By restricting them, along with investment firms, the new legislation could give a much greater role to foreign institutions and ultimately detract from France's economic sovereignty. This is especially important at a time when the country's market environment is in serious difficulty.

More haste, less speed?

As France forges ahead, the situation elsewhere is less cut-and-dried.
In the UK, the government is trying to push through radical legislation in an effort to implement the recommendations made by the Vickers Commission following a string of banking scandals. The proposals will be implemented through the new Financial Services (Banking Reform) Bill, which will ring-fence retail banking, ensure that banks' losses fall on their creditors, not on depositors or taxpayers, and increase banks' capacity to absorb losses. The bill will also set the amount of exposure that a ring-fenced entity is allowed to incur to a financial institution.

Nonetheless, the reform has come in for its share of criticism. According to the UK Commission on Banking Standards, it "falls well short of what is required". More tellingly, perhaps, Paul Volker, the architect of the US regulation that bears his name,

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said that the UK's ring-fence proposals would be "difficult to sustain" and were "full of holes that would get bigger". But only time will tell, because the legislation is not due to be introduced for another five years.

In the US, the Volcker Rule separates banks' consumer lending businesses from their investment banking, proprietary trading and private equity businesses. The rule's broad outlines are very clear but the metrics are proving so complex – possibly because five regulators are involved – that it is unlikely to be enacted before the end of this year. And it, too, has come in for criticism not only from Wall Street but also from a swathe of industries concerned about its impact on their ability to raise capital. Dozens of comment letters have been filed and the main message would seem to be that if the rule is implemented in its present form, that is to say by homing in on business separation, then it would have seriously negative implications not just for markets but for America's financial system as a whole. Here, too, there seems to be no magic bullet.

Meanwhile, the European Commission is working on a plan based on the findings of an expert group chaired by Bank of Finland Governor Erkki Liikanen. The group's report does not seek to scrap universal banking but recommends mandatory separation of proprietary trading and other high-risk trading activities, but only when the latter account for a significant portion of the bank's business. Other key proposals relate to resolution and a "bail-in" mechanism requiring bondholders to surrender some of their holdings in order to refinance a failed bank. But as in the US and the UK, there are disagreements over some of the recommendations and even certain definitions, such as proprietary trading. The Commission may come up with firm proposals to coincide with European elections.

In short, the UK does not plan to adopt its legislation straight away, the US reforms are mired in practical difficulties and Europe's plans are still on the drawing board. France's determination to forge ahead might be case of more haste, less speed.

What the Banking and Financial Reform Act does

- Limits banks' capital markets business to activities useful for financing the economy
- Hives off speculative activities unrelated to retail customers or not intended to finance economic activity
- Steps up regulatory oversight of banks' capital markets business
- Permits the ACP to ban an institution from conducting activities involving systemic risk or hazardous financial products
- Enhances regulators' powers
- Requires banks to submit a "recovery and resolution" plan
- Introduces measures to combat the use of tax havens
- Outlaws index manipulation, on pain of administrative and criminal penalties
- Places tighter restrictions on high-frequency trading and agricultural commodity derivatives
- Formalises consumer protection measures

The new bill is certainly controversial. Though some commentators say it is a model for other countries, others insist it sidesteps the main issue, namely that banking is part of the broader financial system, which will be ill-served by narrowly focused legislation. Moreover, anticipating the outcome of the Liikanen process could prove risky because if the Europe Commission imposes additional constraints, especially by ring-fencing other trading activities, then France would have to push through new measures in short order.

Worryingly, the mismatch between French and European measures creates a paradox. Whereas the goal is to create a vast integrated European market, the capacity to legislate on these issues has been transferred in no uncertain terms to Europe's institutions. For the French financial industry, this will lead to higher costs and less stability. On the one hand, the industry will be saddled with tougher constraints than those endured by its competitors that offer their products and services in France; on the other hand, it will have to make one set of changes after another and very probably be forced to backtrack on some of them.

By trying to set the lead, the Banking and Financial Reform Act could ultimately harm France's financial industry and undermine its international competitiveness.

Anthony Bulger

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International

ICSA – Best Practices for Regulatory Consultation

The International Council of Securities Associations (ICSA) has published "Best Practices for Regulatory Consultation", an update of the 2004 "Statement on Regulatory and Self-Regulatory Consultation Practices". ICSA had noted that the wide-ranging finance industry reforms underway in many countries were making it impossible to comply with generally accepted principles for regulatory consultations.

The new publication lists ten best practices that ought to govern a consultation. They cover the entire process, from setting up a consultation programme to assessing the effectiveness of major reforms. Particular emphasis is placed on the need to leave sufficient time for full and comprehensive consultations.

The ICSA paper is available on www.amafi.fr under Library

Véronique Donnadieu

Europe

EFSA meeting, Frankfurt, 27 and 28 February 2013

The European Forum of Securities Associations (EFSA), an informal group of organisations from Denmark, France, Germany, Italy, Spain, Sweden and the UK, met in Frankfurt on 27 and 28 February.

High on the agenda was the issue of the European tax on financial transactions and the measures taken to that effect by France and Italy. Another key topic of debate concerned the guidelines laid down by the European Securities and Markets Authority (ESMA), notably those covering implementation of the European Regulation on short selling. Particular attention was paid to the exemption for market making, since the guidelines raise a number of issues in terms of content and legal basis.

Véronique Donnadieu

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France

Banking Separation and Regulation Bill

The draft law on the separation and regulation of banking activities in France (see Feature), adopted at first reading by the lower house of parliament in mid-February, was passed up to the senate in late March. Amendments were put forward to address concerns about hedge fund financing, high-frequency trading, agricultural derivatives, tax havens and bank fees. But the amendments made to the two main aspects, ring-fencing and resolution, have not altered the government's original architecture.

AMAFI gave its opinion on several key aspects of the legislation *(AMAFI / 13-03, 13-08 and 13-12)*. In particular it regrets that credit institutions and investment firms are still treated almost identically, even though the situations where the bill's resolution system might apply to investment firms in France will be either marginal or nonexistent. To avoid imposing pointless constraints on a French market ecosystem currently in difficulty, the resolution measures could justifiably have applied only to investment firms that are subsidiaries of credit institutions or to those whose total assets exceed a level – set by decree – beyond which they are presumably conducting a business that could expose them to resolution-related issues. AMAFI also regrets that the diversity of skills available on the Resolution Board of the future regulator, Autorité de Contrôle Prudentiel et de Résolution (ACPR), have not been expanded by bringing in someone with extensive experience of banking and financial markets.

The Association will continue to monitor the bill as it goes into second reading and will shortly send a memo to members on the amendments that involve them.

Sylvie Dariosecq, Julien Perrier

Takeover bids

With the government seeking to introduce legislative measures to shield companies from hostile bids and creeping takeovers, the securities regulator, AMF, organised two emergency consultation meetings with the financial community, including AMAFI. The main measure proposed by the regulator is to introduce an automatic "acceptance condition" of 50%, applicable to all takeover bids, whether voluntary or mandatory. Previously proposed for voluntary bids in a January 2012 consultation on takeover reform, the measure sharply divided the financial community at the time. AMAFI came out against the proposal *(AMAFI /12-08)*. After examining the new scheme through its Corporate Finance Committee, AMAFI reiterated its opposition on the grounds that, despite a broader scope, the measure seems to do little to protect minority shareholders.

The other measures discussed at the meetings elicited broader agreement. These include scrapping or reducing (probably to 1%) the "speed limit" for acquisitions, extending the possibility for takeover targets to issue poison-pill warrants (a measure ultimately rejected) and adopting measures to encourage long-term share ownership. However, the timetable for enacting the bill seems to have been slightly delayed.

Sylvie Dariosecq, Julien Perrier

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France

AMAFI's position on automated trading

ESMA published guidelines in February 2012 for uniform application of the Markets in Financial Instruments Directive and Market Abuse Directive with regard to automated trading. The French securities regulator, AMF, endorsed the guidelines in policy position No 2012-03.

However, AMAFI members expressed deep concern about three of the guidelines, prompting the Compliance Committee to publish a paper *(AMAFI / 13-15)* clarifying the key issues. These are the requirement to inform competent authorities of significant risks and major incidents, close scrutiny by compliance staff, and assignment of compliance staff to approve the overriding of pre-trade controls. AMAFI asked the AMF to examine the latter issue, which is at odds with the position and effective role of the compliance function.

Stéphanie Hubert, Julien Perrier

Complex financial Instruments Computation method

AMAFI and some of its members met with the AMF in mid-February to discuss recent amendments to the method used by the regulator to compute the pay-off mechanisms of complex financial instruments *(see AMF Position 2010-05)*. Special attention was paid to the four mechanisms posing the most significant implementation problems.

The AMF emphasised that its approach was based mainly on clients' ability to understand an instrument rather than on risk. It also agreed to inform AMAFI about the method changes so that the Association could pass the information on to members. Marketing complex financial instruments is a topical issue at regulatory level because many supervisory authorities have a negative view of these instruments. Moreover, the International Organization of Securities Commissions is currently working on a set of best practices for regulators regarding the supervision of these products.

Stéphanie Hubert

Professional certification of senior executives

The AMF consulted industry groups on whether senior executives of investment management companies should be exempt from the requirement to prove a minimum level of knowledge if they perform a function – for example, portfolio manager – that normally requires professional certification. In the regulator's view, a waiver could be justified on the grounds that executives' experience is assessed when they apply for company authorisation. The AMF plans to address this issue in an addendum to its "Q&A on Professional Certification of Market Participants".

AMAFI stressed that if the exemption were to be granted, it should apply to all investment firms, insofar as a number of them are concerned by this issue even though they are not involved in portfolio management – for example they have a senior executive who is also a sales person. Above all, given the aims of certification, AMAFI endorses the view that senior executives should be required to take the examination if they occupy a function subject to certification, although it believes that more flexible arrangements should apply, especially as regards the time period for sitting the exam *(AMAFI / 13-07)*.

Julien Perrier

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Taxation

European proposal for a financial transaction tax

The European Commission has presented its plan for a financial transaction tax (FTT) following approval by the European Parliament and authorisation from the Council on an enhanced cooperation involving 11 member states in favour of the tax: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. The FTT is slated to raise €35 billion.

The broad-based proposal, similar to the measure outlined in the September 2011 draft directive, aims to tax all financial transactions regardless of the market or participant involved, provided there is a territorial link with the "FTT zone". That link is based mainly on the place of residence of either party to the transaction and, incidentally, on the place where the traded instruments are issued. The size of the tax is up to each member state but the minimum rate is 0.1% for equities and 0.01% for derivatives. The FTT was originally due to come into force on 1 January 2014, but that ambitious deadline is unlikely to be met, as the Commission itself has since hinted.

One of the features of the European Commission's proposal, accompanied by a dubious impact study, is that it allows almost no exemptions. With regard to market making in particular, the FTT creates a cascade system that will destroy a number of business, unable to absorb the resulting additional costs. As things stand, companies within the FTT zone face a higher cost of capital and an increase in risk hedging costs. This will impose a competitive burden that firms outside the zone are exempt from. Moreover, it will be interesting to see how the proposal evolves. In all likelihood, the final version will not apply to sovereign debt, currently included. The reason is that governments will not forego this tax boon unless they fear that, as issuers themselves, they will bear the repercussions.

As the Editorial of this newsletter points out, participating member states will face a steep drop in tax and social security revenue from businesses that are transferred or eliminated, as well as a loss of jobs. For some countries, the shortfall will be all the more severe because they have a larger financial sector than the others. For France, which has the second

Issuance or residence: IOB versus Stamp Duty

The European proposal totally disregards evidence from various countries showing the dangers of a tax based on a territorial criterion. Leaving aside the reasons that prompted many governments to scrap transaction taxes in the 1990s and 2000s, a comparison between the UK's Stamp Duty, based solely on the issuance principle, and France's former impôt sur les opérations de bourse (IOB), based on the residence principle, is both enlightening and disturbing.

The IOB had to be scrapped in 2008 to curb widespread destruction in France's financial intermediation industry, undermined by London's ability to satisfy the same demand without taxing it. By contrast, Stamp Duty has provided a substantial revenue stream for the UK Treasury for several decades, even though financial markets have gone global. The reason is that although taxing transactions on the basis of the issuance principle has its drawbacks, impacting on liquidity and raising the cost of capital for the issuers concerned, it nevertheless prevents offshoring and competitive distortions among financial market participants.

For that reason, the FTT adopted by France last year, as well as the tax recently bought in by Italy, is based on the principle of issuance, not residence.

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largest capital market in Europe (though well behind the UK's), this is crucial.

AMAFI is naturally devoting much time and energy to this issue, building directly on the work it did throughout 2012 on the domestic FTT. Aside from holding discussions with its European and international counterparts in ICSA and EFSA, it recently organised a meeting with law firms and subscriber members, who have been bombarded with enquiries about the tax and its impact. AMAFI's objective at this stage is to gather data on the economic impacts that the tax would have on each business area, in a context where the ongoing attrition in the French financial centre is a matter of serious concern given the increasing role that markets have to play in financing economic activity.

Eric Vacher

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Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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