Who has the best playing field for tax competition: the United States or the European Union?

By Sarah Guillou

Two recent events demonstrate the differences in the American and European views on tax competition. First was the case of Boeing, which the European Union (EU) has brought before the World Trade Organization (WTO). The EU is challenging the tax incentives offered by the State of Washington to the American aircraft maker. Then there is the European Commission's investigation of Luxembourg's tax provisions that benefit Amazon, the Internet retailer. Boeing and Amazon both make massive use of tax competition. While this is widespread and accepted in the United States, it is being increasingly questioned in the EU, and even excluded by law if it is classified as illegal State aid.

In the Boeing affair, in December 2014 the EU filed a request for consultations with the WTO regarding the tax subsidies paid by the State of Washington for the manufacture of the new Boeing 777X. This aid would amount to 8.7 billion dollars for assembly in the State. This programme was set up in November 2013 by the State of Washington, and the governor has now decided to extend it until 2040! The incentives are conditioned on the use of local products, i.e. the aid is linked "to local content requirements ". However, these requirements are contrary to the WTO Agreement on Subsidies and Countervailing Measures. We are not going to discuss here the EU's complaint, which is awaiting a response from the US, and which is part of an ongoing dispute between Boeing and EADS about their respective public subsidies. This case,

however, offers an opportunity to take a look at the intensity of tax competition that exists between the various States in the US.

While the US, like the EU, is concerned with non-discrimination, which is set out in the doctrine of the Commerce Clause of the US Constitution, in practice it has been difficult for case law, which performs an *a posteriori* control, to provide a definition of discrimination that makes it possible to prevent discriminatory regulations. The result has been that the American States are free to offer subsidies and tax breaks to companies, or sometimes specific companies, to attract investment and jobs. Recall that in Europe, controls on State aid are performed *a priori* and that granting subsidies to any specific companies is totally excluded (see Guillou, 2014, OFCE blog). In the US, Boeing is a major player in this tax competition.

An American research center "goodjobsfirst", which tracks the aid and subsidies granted to companies by public institutions, showed that a mere 965 companies received 75% of all aid. It is Boeing that receives the most aid. This comes mainly from two States, Washington and South Carolina, with numerous subsidies (130 agreements) from all over the United States. The combination of all the aid brought to light amounts to 13 billion dollars. Boeing comes far ahead of all other companies, as second-place Alcoa receives less than half as much (5.6 billion dollars). Another study found that 22 States competed to host the production of the new 777X airliner, but Boeing ultimately decided to stay in the Seattle area and entered a 16-year tax agreement with the State of Washington that is estimated to be worth more than 8.7 billion dollars, the largest tax break in the United States. Business lobbying is much more common in the United States than in Europe, which explains much of the competition between States to attract business. While the United States has complained of foreign tax competition (especially vis-à-vis Ireland), it accepts

this completely on its own territory. This is not the prevailing position in the EU, of course, as the EU is not fiscally integrated.

Indeed, in Europe, tax harmonization is not yet on the agenda. But tax competition is being increasingly debated. This has not been in vain, as this pushed Ireland to abandon its "double Irish" system that allowed certain companies located in Ireland to be taxed in tax havens. Companies taking part in this tax scheme began the process of withdrawal in January 2015. While differentiated taxation is still accepted in Europe, excessive tax competition has been considered intolerable in the common market. When companies' tax optimization strategies come together with national strategies to attract jobs and investment, the ingenuity of the tax authorities becomes a threat to the common market. What is most worrying is the legitimization of the avoidance of common tax rules.

European controls on State aid act as a powerful guardian over the use of public resources and on non-discrimination in the European market. These controls could well become an instrument in the fight against tax "loopholes", vulnerabilities in the tax system that result in significant losses of public resources. The case against Luxembourg concerns its system of "tax rulings". The tax ruling is a procedure whereby a State negotiates with a company about its future tax status. This procedure, which has been called the "marketing of State sovereignty", is widespread in Luxembourg and was brought to light by a recent investigative report published in November 2014 (*Le Monde*), which shows that Luxembourg is not the only country to use these "tax rulings".

Luxembourg attracts a large number of multinational firms that choose the location of their European headquarters based on tax optimization. It is the EU country with the lowest percentage of GDP (the production of residents) out of GNP (domestic production): this figure was only 64% in 2013,

against just over 100% for France and Germany. In other words, Luxembourg lost more than one-third of its national income once the payment of income to resident foreign companies was taken into account (net of income received). This reveals the fiscal opportunism of the numerous multinationals located in Luxembourg, for which the local market is clearly not a target.

In this case, Luxembourg has granted Amazon a valuation of its transfer pricing that the European Commission (EC) considers overestimated, which thus leads to underestimating the tax base (see the recently released EC decision).

Transfer prices are the prices of the goods and services traded between subsidiaries of the same corporation. These exchanges should theoretically be valued at market prices, that is to say, the price that would be paid by a company that is not a subsidiary of the corporation. The way these prices are decided may change the amount of a subsidiary's purchases and revenues, and thus its profits. The logic of the corporation is to minimize profits where tax rates are high and shift them to where rates are low. It is not so much the price of goods that are manipulated as the price of intangible assets such as patents, copyrights or other intellectual property (trademarks, logos, etc.). Multinationals that hold intangible capital, such as the giants of the Silicon Valley, are the ones that most commonly engage in this type of manipulation.

One way to prevent the manipulation of transfer pricing in Europe would be to make it obligatory to calculate a common consolidated corporate tax base. This is the purpose of the draft CCCTB directive from 2011, which is still under discussion. Trade-offs between the various European countries would be pointless, as the tax base would be consolidated and then distributed among the member States based on a formula that takes into account fixed assets, labour and sales. The States would retain control of their tax rate on corporations.

It is expected that this common base scheme would be optional. It is not certain that this would suffice to get the directive passed, as in fiscal matters this demands a unanimous vote whereas, for the moment, there is a great deal of disagreement.

On the other side of the Atlantic, the United States has a consolidated tax base system at the national level and a common federal tax rate on corporations. But local taxes, which can vary between 1% and 12%, are generally deductible from the federal tax calculation. The issue of transfer pricing between subsidiaries in different States may therefore also arise. And this is especially so, given that the local tax rate on profits is subtracted from the various tax credits awarded to certain companies.

The outcome of the investigation into Luxembourg and Amazon will be important for the future of the CCCTB Directive, in particular the version that affects only digital businesses. If the day has not yet come when the EU rules that "banking secrecy is a disguised form of subsidy" (G. Zucman, The hidden wealth of nations), the investigation into Amazon indicates that the EU is beginning to put some limits on tax competition that could soon make American taxpayers jealous.

Regulating the financial activities of Europe's banks:

a fourth pillar for the banking union

By Céline Antonin, Henri Sterdyniak and Vincent Touzé

At the impetus of EU Commissioner Michel Barnier, on 29 January 2014 the European Commission proposed new regulations aimed at limiting and regulating the commercial activities of banks "of systemic importance", that is to say, the infamous "too big to fail" (TBTF).

Regulating proprietary activities: a need born of the crisis

Due to banks' particular responsibility in the 2008 economic and financial crisis, many voices have been raised demanding stricter regulation of their financial activities. This has led to two approaches: prohibition and separation.

In the United States, the "Volker rule" adopted in late 2013 prohibits banks from engaging in any proprietary trading activities as well as taking holdings of greater than 3% in hedge funds. The banks can nevertheless continue their own market-making and hedging activities. Obviously, this rule does not prohibit banks from investing their own funds in financial assets (equities, government and corporate bonds). The purpose of the rule is to prevent a bank from speculating against its customers and to minimize the use of the leveraging that proved so costly to the financial system (banks using their clients' money to speculate on their own behalf).

The European approach is based on the Vickers Report (2011) for the United Kingdom and the Liikanen Report (2012) for the European Union. These reports recommend some separation between traditional banking activities on behalf of third parties (management of savings, provision of credit, simple hedging operations) and trading activities that are for the

bank’s own account or bear significant risk, although the activities can be maintained in a common holding company. The Vickers Report proposes isolating traditional banking activities in a separate structure. In contrast, according to the Liikanen report it is proprietary trading and large-scale financial activities that need to be isolated in a separate legal entity.

The idea of □□separating banking activities is not new. In the past, many countries enacted legislation to separate commercial banks from investment banks (Glass-Steagall Act in 1933 in the United States, the 1945 Banking Act in France). These laws were revoked in the 1980s due to a growing belief in the superiority of the “universal bank” model, which allows a single bank to offer a full range of financial services to individuals (loans, deposits, simple or complex financial investments) and especially to business (loans, hedging, issuance of securities, market-making activities). The crisis exposed two defects in this model: the losses incurred by a bank on its proprietary trading and other activities on the markets led to a loss in its equity capital, thereby calling into question the bank’s lending activities and requiring the State to come to its rescue in order to ensure that bank credit didn’t dry up. The universal bank, backed by the State’s guarantee and sitting on a mass of deposits, did not have sufficient vigilance over its proprietary trading activities (as was shown by the cases of Kerviel, Picano-Nacci and Dexia).

An ambitious European regulatory proposal

This proposal for bank reform is coming in a situation that is complicated by several factors:

1) The Basel 3 regulations currently being adopted already impose strict rules on the quality of counterparties of the equity capital. Speculative activities must be covered by substantial levels of common equity.

2) The banking union being developed provides that in case of a crisis creditors and large deposit holders could be called upon to save a bank facing bankruptcy (principle of "bail in"), so that taxpayers would not be hit (end of "bail out"). But there are doubts about this mechanism's credibility, which could cause a domino effect in the event that a TBTF bank faces bankruptcy.

3) Some European countries have anticipated reform by adopting a separation law (France and Germany in 2013) or setting prohibitions (Belgium). In the United Kingdom, a separation law inspired by the Vickers Report (2011) is to be adopted by Parliament in early 2014.

The regulatory proposal presented on 29 January is more demanding than the Liikanen Report. Like the "Volker rule" in the US, it prohibits speculation on the bank's own account through the purchase of financial instruments and commodities, as well as investments in hedge funds (which prevents banks from circumventing the regulation by lending to hedge funds while holding significant shares in these funds, thereby taking advantage of the greater leverage).

Moreover, in addition to this prohibition the European legislator provides for the possibility of imposing a separation on an independent subsidiary for operations that are considered too risky, that is to say, that would result in taking positions that are too large. The aim is to address the porous border between proprietary trading and trading for third parties, as bankers could take risks for themselves while not covering the positions sought by their clients. With these new regulations, the legislator hopes that in the event of a bank crisis public support for the banks will benefit only depositors, not the bankers, with as a consequence an overall reduced cost.

Compared to French regulations, the regulatory proposal is more restrictive than the law on the separation and regulation

of banking activities of 26 July 2013. Indeed, French law provides for the legal compartmentalization only of certain proprietary activities and highly leveraged activities in an independently financed subsidiary; strict prohibition concerns only high-frequency trading activities and speculation in agricultural commodities. And there are numerous exceptions: the provision of services to clients, market-making activities, cash management, and investment transactions and hedging to cover the bank's own risks. In contrary, the prohibitions are broader in the regulatory proposal, as it applies to all proprietary trading. In addition, the regulatory proposal prohibits investment in hedge funds, whereas the French law permits it provided that such activities are compartmentalized.

The regulatory proposal nevertheless concerns only banks of a systemic size, *i.e.* 30 out of the 8000 found in the European Union, representing 65% of banking assets in the EU. It will not be discussed until the election of the new Parliament and the establishment of a new Commission.

A reform that doesn't have a consensus

Michel Barnier's proposed reform has already provoked sharp criticism from certain member countries and the banking community. Some have reproached it for intervening in an area where it has no jurisdiction, which clearly indicates the current complexity of the legislation governing the European banking system.

France, Germany, Belgium could object, "Why are you interfering? We have already enacted our banking reform." But the logic of the banking union is that the same laws apply everywhere. These countries have chosen to carry out a minimal banking reform in order to pre-empt the content of European law. This is hardly acceptable behaviour at European level. There is also the case of the United Kingdom (for which Barnier's proposal opens the exit door: the regulations will

not apply to countries whose legislation is more stringent).

The banking union provides for the European Central Bank to oversee the large European banks and for the European Banking Agency to set the regulations and rules on supervision. The Commission can therefore be reproached for intervening in a field for which it is no longer responsible. On the other hand, the crisis clearly showed that banking concerns more than just the banks. It is legitimate for EU political institutions (Commission, Council, Parliament) to intervene in the matter.

The proposal has encountered two contradictory criticisms. One is that it doesn’t organize a genuine separation of deposit-taking banks and investment banks. From this perspective, deposit or retail banks would be entrusted with specific tasks (collecting and managing deposits; managing liquid savings and risk-free savings; lending to local government, households and businesses); they would not have the right to engage in speculative activities or trading activities or to lend to speculators (hedge funds, arranging LBO transactions). These banks would be backed fully by a government guarantee. In contrast, market or investment banks would have no government guarantee for their market interventions and equity and other above-the-line operations. Since these transactions are risky, the absence of a public guarantee would lead them to set aside a greater amount of capital and to bear a high cost for attracting capital. This would reduce their profitability and thus the development of hedging and other speculative activities. A company that was in need of a hedging operation would have to have it carried out by an investment bank and not by its regular bank, so at a higher cost. Conversely, this would reduce the risk that banks suck their clients (banks and companies) into risky investments and operations. A reform like this would greatly increase the transparency of financial activities, at the cost of diminishing the importance of the banks and financial markets. Michel Barnier did not dare take

the principle of separation to this, its logical conclusion. He remains instead within the logic of the universal bank, which uses its massive size as a deposit bank to provide financial intermediary services to its customers (issuance of securities, coverage of risk, investment in the markets, etc.), to intervene in the markets (market-making for foreign exchange and public and private securities) and to underwrite speculative activities.

The reform is nevertheless facing stiff opposition from the banking community, who would have preferred the status quo. Hence Christian Noyer, a member of the ECB Governing Council, has labelled the proposals “irresponsible”, as if the ECB had acted responsibly before 2007 by not warning about the uncontrolled growth of banks’ financial activities.

The European Banking Federation (EBF) as well as the French Banking Federation (FBF) are demanding that the universal banking model be preserved. The banks are criticizing the obligation to spin off their market-making operations (including for corporate debt). According to the FBF, this regulation “would lead to making this operation considerably more expensive,” which “would have a negative impact on the cost of financing companies’ debts and hedging their risks”. However, this obligation may be waived if the banks demonstrate that their market interventions do not require them to take on any risk. The banks could therefore continue to act as market makers provided that they set strict limits on their own positions; they could provide simple hedging operations by covering these themselves.

A fourth pillar for the banking union?

European banks have of course rightly pointed out that this reform comes in addition to the establishment of the SSM (single supervisory mechanism), the SRM (single resolution mechanism), and the ECB exercise assessing the banks (launched in November 2013). The overall system does lack cohesion; a

well thought-out schedule should have been set.

However, the separation advocated by the Barnier proposal lends credibility to the banking union and its three pillars (SSM, SRM and deposit insurance). This project does contribute to convergence in banking regulations, from both a functional and a prudential perspective. The establishment of a consistent framework simplifies control by the European supervisor under the SSM (the ECB will monitor the banks' normal activities and ensure that they are not affected by speculative activities). The separation recommended by the Barnier proposal enhances the credibility of the SRM; there will no longer be any banks that are too big to go bankrupt, and investment bank losses will not rebound onto the lending activities of deposit banks and will not have to be borne by the taxpayer. By reducing the risk that deposit banks might fail, the risk of a costly rescue plan for investors (bail-in) is also lowered, as is the risk of needing recourse to deposit insurance. In this sense, the draft regulations can be considered a fourth pillar of the banking union.

For more information:

– Antonin C. and V .Touzé V. (2013), The law on the separation of banking activities: political symbol or new economic paradigm?, OFCE Blog, 26 February 2013.

– Avaro M. and H. Sterdyniak H. (2012), Banking union: a solution to the euro crisis?, OFCE Blog, 10 July 2012.

– Gaffard J.-L. and J.-P. Pollin (2013), Is it pointless to separate banking activities?, *OFCE Blog*, 19 November 2013.

The law on the separation of banking activities: political symbol or new economic paradigm?

By Céline Antonin and Vincent Touzé

Imprudence, moral hazard and systemic gridlock were key words for the banking crisis. Governments that were unhappy to have had no choice but to come to the rescue of the banks are now trying to regain control and impose new regulations. The regulations with the highest profile concern the separation of trading activities (trading on own account or for third parties) from other banking activities (deposits, loans, strategic and financial consulting, etc.). These are expected to have the advantage of creating a tighter barrier between activities, with the idea that this could protect investors if bank operations go badly on the financial markets. On 19 February 2013, the French Parliament passed a law on the separation of banking activities. Although the initial targets were ambitious, the separation is only partial, as only proprietary financial activities will be spun off. As these cover less than 1% of bank revenues, this measure tends to be symbolic. However, by giving legal force to the principle of separation, the State is demonstrating its willingness to take a more active role in supervision.

The idea of compartmentalizing banking activities is not new. In the aftermath of the 1929 crisis, the United States adopted the Glass-Steagall Act (1933), which required a strict separation between commercial banks (specialized in lending

and in managing deposits) and investment banks (specialized in financial activities). France followed suit with its own banking law of 1945 [1]. The expected benefits of separating banking activities are twofold. On the one hand, customers' deposits would be better protected, because they could no longer be asked to absorb the potential losses of market activities; on the other hand, in case of bankruptcy, State aid would be limited, because only the retail part of the bank would be covered by a government guarantee.

Forty years later, in the wake of the major wave of deregulation in the 1980s-1990s, France was one of the first to abolish this distinction, with the Banking Act of 1984, thus establishing the principle of universal banking. This principle leads to grouping activities with high needs for liquidity (the financing of the economy) with those that make it possible to gather liquidity (deposit activities). This grouping has the undeniable merit of giving the banks a more solid financial foundation. Other benefits also flow from this: greater leverage; the size factor leads to economies of scale; and the banks' ability to internationalize allows them to join the "too big to fail" category. Across the Atlantic, these arguments certainly worked in favour of the abolition of the Glass Steagall Act in 1999 by the Clinton administration.

Since 2008, the banks have been hit by a number of shocks: the subprime crisis; the fall in financial stocks; the slump in economic growth; and fear of defaults on sovereign debt (for banks in the euro zone). These shocks have shown that some of the advantages of universal banking could turn into disadvantages if leverage is used too systematically and if large banks in difficulty begin to pose a systemic risk. Many voices then began to be heard advocating a new Glass-Steagall Act, based on a view that separating market activities [2] from other banking activities is a way of preventing large-scale banking crises. Trading on own-account activities concentrates the bulk of bank malfunctions, in particular

reckless risk-taking and the occasional “mad” trader [3]. This compartment has thus now become the focus of increasing attention by the regulators.

The Dodd-Frank Wall Street Reform and Consumer Protection Act [4] adopted in the United States in 2010 did not establish the separation of banking activities in a strict sense, but adopted the “Volcker rule,” which prohibits banks from “playing” with depositors’ money. This led to a virtual ban on the speculative proprietary activities of banking entities as well as on investments in hedge funds or private equity funds. In addition to this rule, this Act also represented a major reform in favour of the tighter regulation of all financial agents (banks, insurance companies, hedge funds, rating agencies, etc.) as well as closer monitoring of systemic risks.

Europe is in turn planning legislation on the separation of banking activities. At the request of European Commissioner Michel Barnier, the group of experts led by the Governor of Finland’s Central Bank, Erkki Liikanen, presented a report on 2 October 2012. It advocates a strict bank compartmentalization [5] but also reviews the remuneration of financial managers and traders, with a view to overhauling the current arrangements, which tend to “push people into crimes” such as excessive speculation, in order to make these arrangements more compatible with long-term objectives. If this report is turned into a European directive, it will then have to be transposed into the national law in each Member State. However, this Europe-level approach is likely to be overtaken by the legislative processes in several European countries. In Germany, a bill on banking regulation [6] was introduced by the government on 6 February 2013, and could enter into force by January 2014 (with implementation by July 2015). The United Kingdom stood out in 2011 with the publication of the Vickers report [7], although the British government is in no hurry to implement its recommendations,

with a probable deadline of 2019. France, with its "law on the separation and regulation of banking activities", has not been left behind.

A MODEST FRENCH ACT …

The French law has several components. In addition to establishing the principle of separation, it also provides for measures to protect bank clients and to strengthen the supervision and control of the banks.It does this in several ways:

– Each bank will be forced to develop a preventive recovery plan [8] for dealing with a crisis and a resolution plan in case it is failing (a bank testament). The resolution plan will be submitted for the appreciation of the Prudential Control Authority (ACP), which becomes the Prudential Control and Resolution Authority (ACPR).

– The Deposit Guarantee Fund (FGD) becomes the Deposit Guarantee and Resolution Fund (FGDR), with an increased capacity to intervene in the event of a bank failure.

– Macro-prudential supervision is strengthened by the establishment of the Financial Stability Council (CSF).

– The rights of bank clients are enhanced (transparency on the cost of loan insurance, free choice of loan insurers, right to a bank account, etc.).

However, the flagship measure in the reform is the separation between "activities useful to the economy" and speculative activities. Banks are to confine their proprietary or "own account" activities in an ad hoc subsidiary that is subject to specific regulation and funded independently. These subsidiaries will be prohibited from practicing certain speculative activities that are deemed "too risky or that may be harmful to the economy or society", such as activities on the markets for derivatives whose underlying assets are

agricultural commodities, or high-frequency trading. Many activities will nevertheless be spared, such as providing services to customers, market-making activities, cash management, and bank investment or hedging operations to cover its own risks.

This law separating bank activities, which was initially presented as ambitious, will ultimately have only a limited impact. The universal banking model is not called into question. The admission of the head of the Société Générale bank could not be any clearer [9]: less than 1% of revenues are concerned. We are therefore a long way from how banking was compartmentalized prior to 1984. The criterion for separation is ambiguous. In fact, the border is porous between hedging risk and pure speculation: the law advances a fuzzy principle of "economic relevance", and the banks may be tempted to play around in this legal vacuum. As for market making [10], it is difficult to distinguish between speculative proprietary activities, which have to be spun off, and activities to promote market liquidity: high-frequency trading is for instance usually practiced under the guise of market-making agreements, so the law may be no more than a sword slashing water if the status of market maker is not defined more precisely [11].

The law also provides for prohibiting a banking group from holding shares of a speculative type, like a hedge fund. However, the loans granted by banks to hedge funds are always accompanied by guarantees. From this point of view, the law will also have little impact.

… BUT COULD IT GO FURTHER?

Finding a new financial paradigm for a banking model is a complex exercise. In practice, it is not easy to separate banking activities purely and simply without causing problems,

and there are generally many limits to banking reform.

First, limiting investment banks' access to deposits as a source of liquidity, or eliminating this outright, would lead them to resort to more debt financing, which might be difficult to reconcile with the constraints set by the Basel III prudential regulations, which took effect on 1 January 2013. It is already very demanding in terms of equity levels.

Furthermore, it is important to note that banking risk is not inherent just in market activities. There are many other recent examples. Mortgage lending has also been an important source of risk: in Spain, falling house prices and the insolvency of borrowers virtually bankrupted the banks; in the United States, the subprime crisis is a crisis of real estate loans that affected the markets through sophisticated securitization mechanisms that allowed the banks to take the risk off of their balance sheets (at least ostensibly); in the UK, Northern Rock is a retail bank that specialized in mortgages and was hit hard by the credit crunch and the housing crisis. To some extent, universal banks have played an important role in saving banks that were too specialized, for example, JPMorgan Chase (Universal) took over Washington Mutual (savings and loan) and Bear Stearns (business), and Bank of America (universal) rescued Merrill Lynch (business).

In addition, the separation is supposed to wall off banking activities more tightly. But what happens if the subsidiary that manages the proprietary speculation goes bankrupt and causes heavy losses to the parent? In the past, two of the four major French groups, Crédit Agricole and BPCE, had insulated their market activities in their respective subsidiaries, Natixis and Cacib, but nevertheless had to come to their rescue in 2008 and 2011, respectively. The insulation seems to be very permeable.

In a context of financial globalization, compartmentalization may never be very effective. By its very principle globalized

finance makes it possible to connect everything. This is in particular the role of the interbank markets [12].

In practice, it is difficult for a government to reform its banking sector in the absence of coordination with other countries. The domestic banks have foreign subsidiaries that may not be subject to the regulations. And above all, the profitability of rival foreign banks might improve, which would weaken the competitiveness of the domestic banks. At the European level, national interests differ, and each country may be tempted to impose its own bill. If the Liikanen report is turned into a Directive, then each Member State will be required to transpose it into their legal system. For the moment, the legislation of Germany and France is taking the lead. It is possible that these changes will influence any future directive.

If the effort to compartmentalize goes too far, there is also a risk of shifting the interconnections to less visible levels. It is essential to avoid falling into the trap posed by the dangerous illusion of thinking that we have eliminated a risk, when in fact it has just been moved.

Finally, too much regulation can sometimes kill regulation. In the financial sector, regulatory constraints may serve as a basis for speculation. So if a bank is having difficulty meeting certain regulatory constraints, the markets will be encouraged to speculate in order to provoke its failure and then profit from this. Caution is therefore needed before introducing new regulations.

Trying to apply the principle of separation too strictly could also lead to not supporting a commercial bank that is facing significant liquidity problems. However, according to the principle of “too big to fail”, such a decision is not always wise. The failure to support Lehman Brothers was punished in a way that had a significant long-term impact, as its collapse hit the entire economic and financial network.

It is also worth noting that taking banking and financial regulation to be a miracle cure could have deleterious effects on individual and collective responsibility. People think that the law can resolve any problem. Yet at the same time, it is very likely that the vectors of the next financial crisis will manage to circumvent the regulatory constraints, hence the importance for the supervisory authorities to remain vigilant and adopt a critical approach at all times.

GOING BEYOND THE POLITICAL SYMBOL

The government undeniably has little leeway to separate banking activities, because too much regulation may be ineffective or even dangerous. As a consequence, this law separating banking activities is not radical and will have a moderate effect on the banks. For its part, the government may have a clear conscience for having done something along the lines of its foreign counterparts. The bankers in turn are probably not unhappy at having given the impression of serving the public interest, especially at such a low cost.

Some will view this as just a poor political symbol. Others will try to go further and view this as giving hope that this reform will be seen as a strong signal to the banking world. This hope may not be in vain, as the principle of separation is now enshrined in law, and future governments will have plenty of time to strengthen it.

In practice, a change in economic paradigm that would lead to harmful speculation becoming increasingly rare will not result simply from a separation of activities. Banking laws should not be too complicated, because the devil has a tendency to hide in the details. The supervisory authorities must constantly keep a critical eye on the functioning of the markets, and the law needs to allow them some flexibility in determining when and how they should intervene. On these

issues, Volcker's statement in 2011 is unambiguous [13]: "I'd write a much simpler bill. I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance. And I'd have strong regulators. If the banks didn't comply with the spirit of the bill, they'd go after them." It is also worth examining various measures to make financial professionals (managers and market operators) more responsible. In this respect, the Liikanen report proposes revising the pay systems for bank executives and financial managers in order to make these systems more compatible with a long-term vision. It is also necessary to explore the possibility of increasing the criminal liability [14] of financial leaders. The permeability of the interface between careers in the regulatory sector and in the regulated sector also needs to be examined. In this regard, there are certainly ways to make the system less permeable. After all, recent history has shown that it is possible to go from being Chairman of the Fed to being a trusted advisor for a rich and powerful hedge fund….

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[1] Law 45-15 of 2 December 1945 provided for the specialization of financial institutions by classifying the banks in three categories: deposit banks, business banks and long-term and medium-term lending banks (Articles 4 and 5).

[2] Asset management can be exercised:

– for one's own account (*proprietary trading*): the bank buys or sells financial instruments that are funded directly out of its own resources. These resources include not only the bank's capital, but also savers' deposits and loans. This means that, in addition to its own funds, the other categories involved in the bank's financing, including customer deposits, indirectly bear a risk.

– or on behalf of third parties (*non-proprietary trading*):

unlike proprietary trading, the market or borrowing risks are borne mainly by the client. However, on certain products, the bank could face significant operating risks.

[3] http://lexpansion.lexpress.fr/economie/trading-pour-compte-propre-la-face-cachee-des-banques_233686.html.

[4] Title VI of the Act proposes improving regulation and is considered to be an application of the "*Volcker Rule*", *http://useconomy.about.com/od/criticalssues/p/Dodd-Frank-Wall-Street-Reform-Act.htm*.

[5] The report recommends a separation of proprietary market activities but also of certain other activities on the financial markets and derivatives for third parties.

[6] Germany is also preparing a bill, under which the German banks will be obliged to wall off their proprietary trading. As in France, the universal banking model will not be called into question. http://m.lesechos.fr/redirect_article.php?id=reuters_00495696&fw=1.

[7] In September 2011, the Vickers Report recommended separating retail banking services from investment activities, by ringfencing retail banking services in subsidiaries, along with the requirement of a 10% equity cushion for retail banks. The British government is committed to introducing the reforms into law by 2015, with implementation set for 2019.

[8] This plan provides for different possibilities for recovery (recapitalization, a savings plan, restructuring, etc.) and excludes any call for public financial support.

[9] "We believe that, while in 2006-2007, 15% of activities could be considered market activities, 15% to 20% of which could be classified as disconnected from the customer, and consequently transferred to a subsidiary, this proportion is

now less than 10%, and ranges from 3.5% to around 5% on average." Frédéric Oudéa, 30 January 2013, at a hearing before the Finance Committee of the National Assembly, http://www.assemblee-nationale.fr/14/pdf/cr-cfiab/12-13/c1213060.pdf.

[10] Market-making corresponds to the permanent presence of an operator who provides liquidity to the market.

[11] In this respect, we should mention the amendment tabled by Karine Berger, who wants Bercy [the Ministry of the Economy] to set the threshold above which market activities must always be spun off.

[12] Since 2008, the crisis of confidence in the banking market has posed great difficulties for access to liquidity in some banks, even though they are perfectly solvent, which has forced the central banks to intervene and take the place of the interbank market.

[13] 22 October 2011, http://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?pagewanted=all&_r=0.

[14] In this respect, the American authorities have not hesitated to take action against financial institutions that have failed to meet their obligations. See, for example, the recent action taken against Standard & Poor's, http://www.bloomberg.com/news/2013-02-06/s-p-lawsuit-portrays-cdo-sellers-as-duped-victims.html. See too the proceedings taken against a former employee of Goldman Sachs: http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf and http://dealbook.nytimes.com/2013/01/31/trader-accused-of-misleading-clients-leaves-goldman/ or the investigation into the infamous "London whale": http://www.reuters.com/article/2013/02/15/us-lehman-jpmorgan-londonwhale-idUSBRE91E00W20130215.