„Volcker/Vickers hybrid"?: The Liikanen Report and justifications for ring fencing and separate legal entities

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ABSTRACT

Whilst some valid and justified arguments have been put forward in favour of ring fencing, that is, constructing a fire-wall between consumer and investment banks, and that such activities can be achieved without re structuring banks into separate legal entities, the Liikanen Report highlights why there is need for such re structuring. As well as considering the merits of ringfencing and the establishment of separate legal activities and entities, this paper aims to highlight why a suitable model aimed at mitigating risks of contagion can to a large extent, be justified on a cost-benefit analysis basis.

Furthermore, the paper ultimately concludes that even though a greater degree of separation of legal entities and activities persist with the model which is referred to as „total separation", a certain degree of independence between bank activities would also be necessary under ring fencing if its purposes and objectives are to be fulfilled.

Key Words: Vickers Report, Volcker's Rule, Liikanen Report, ring fencing, recovery plans, resolution plans, bail-outs, loss absorption, systemic risks, leverage ratios, liquidity, capital requirements, de-leveraging

„Volcker/Vickers Hybrid"?: The Liikanen Report and Justifications For Ring Fencing and Separate Legal Entities

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A. Introduction

In the Final Report of „The High-Level Expert Group on Reforming the Structure of the EU Banking Sector, chaired by Erkki Liikanen,[1] the need for re structuring banks into separate legal activities is highlighted. In assessing such a need, two considerations were given due attention:[2]

- The important role of recovery and resolution plans – whereby the decision on possible separation of bank entities was to be conditionally based on the assessment of such plans;
- The mandatory separation of banks' proprietary trading and other risky activities.

The mandatory separation of banks' proprietary trading and other risky activities could be distinguished from the case which exists with Volcker's Rule in that an outright ban or prohibition on proprietary trading (all forms of risky investment practices) and certain relationships with hedge funds and private equity funds is not implied under such mandatory separation.

The „Volcker Rule" which can be found under Section 619[3] of Title VI of the Dodd Frank Act states that :

''(1) PROHIBITION: Unless otherwise provided in this section, a banking entity shall not—
''(A) engage in proprietary trading; or
''(B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.

''(2) NONBANK FINANCIAL COMPANIES SUPERVISED BY THE BOARD: Any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule, as provided in subsection (b)(2), to additional capital requirements for and additional quantitative limits with regards to such proprietary trading and taking or retaining any equity..........."

Whilst the Volcker Rule is considered by some commentators as being parallel to a separation of banking activities and entities, it is more draconian in the sense that the model allows for less scope

1 Hereinafter referred to as the Liikanen Report (Final Report, 2nd October 2012) „The Liikanen Review was established in November 2011 by EU commissioner, Michel Barnier, to conduct a full scale analysis of Europe's lending sector and recommend banking reforms for the region." See G Varriale, „Liikanen Poll: Volcker/Vickers Hybrid Wrong For Europe's Banks, 18 September 2012

2 See page i of the Report

3 SEC. 619. PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS.

and flexibility than the „hybrid" model which is being considered under the Liikanen Review. Those arguments which increasingly favour a more flexible model and which is directed in favour of ring fencing, arise from the inherent difficulties in the definitions attributed to financial and non bank financial companies. Since such definitions present some ambiguities, is it really possible to effectively establish „completely" separate legal entities and activities? As the case has always been, ambiguities with legal definitions will always provide a leeway for financial institutions (whether non bank financial or financial institutions) to manipulate the rules. Furthermore, other complexities arise from corporate ownership structures of banking groups across various jurisdictions – particularly where such groups operate across various jurisdictions with huge differences in legal definitions and operating activities.

The Vicker's Report also adds that prohibiting only those activities caught by the Volcker rule would not achieve all of the objectives of ring-fencing.[4]

It is interesting to note that the Liikanen Report also highlights that „in the discussions within the Group, some members expressed a preference for a combination of measures: imposing a non-risk-weighted capital buffer for trading activities and leaving the separation of activities conditional on supervisory approval of a recovery and resolution plan, rather than a mandatory separation of banking activities."[5]

„In the spirit of transparency both basic alternatives and their motivation" were presented in the report - however, the option was made to recommend „mandatory separation of certain trading activities."

As stated earlier, the mandatory separation of banks' proprietary trading and other risky activities, such as that opted for under the Liikanen Report, could be distinguished from the case which exists under Volcker's Rule and could be considered a hybrid in the sense that it does not impose such stringent requirements as those applicable under Volcker's Rule whilst not being as „watered down"[6] as the ring fencing recommendations in the Vickers Report.

Whilst a hybrid model for European banks may appear to have its merits, it will be demonstrated that risks are inherent in both models – whether these relate to complete separation of legal entities or whether these are based on ring fencing alone. The distinction between what could be considered to be risky bank trading activities and less risky ones and whether the goals to be achieved through such a distinction could effectively be realised through the re structuring of banks into separate legal entities, as well as cost considerations involved in undertaking such re structuring will be discussed in subsequent sections of this paper.

B. Objectives of the Legal Separation of Financial Activities and Banking Entities and Arguments in Favour of Ring Fencing

In concluding that „it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within a banking group", the High Level Expert Group

4 See The Independent Commission on Banking (ICB), Final Report, Recommendations, September 2011 at page 45

5 See page ii of the Liikanen Report.

6 See Daily Telegraph, Paul Volcker: Ring-fencing Banks is Not Enough, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9561624/Paul-Volcker-ring-fencing-banks-is-not-enough.html>

highlighted the „central objectives“ of such a separation, which are as follows:[7]

- To make banking groups – particularly their socially most vital parts safer and less connected to high risk trading activities;
- To limit the implicit or explicit stake of tax payer in the trading parts of banking groups.

Further objectives could be the Group's opinions that:[8]

- Separation of such activities (between high risk and less riskier ones) into separate legal entities is the „most direct way of tackling banks' complexity and interconnectedness and that;
- As such, separation would make banking groups simpler and more transparent; as well as
- Facilitate market discipline and supervision and, ultimately, recovery and resolution.

As re iterated earlier, those not in favour of a mandatory separation of banking activities, whose objectives are listed above, opted for a „preference for a combination of measures which consists of imposing a non risk weighted capital buffer for trading activities and leaving the separation of activities conditional on supervisory approval of a recovery and resolution plan.“

Whilst such objectives of a mandatory separation of banking activities are justified, proponents of ring fencing, namely those opting for ring fencing rather than a complete separation of retail banking from riskier investment banking divisions, have put forward several arguments in favour of ring fencing activities.

The following sub section considers the purpose of ring fencing as well as arguments in favour of ring fencing.

According to Vickers Report[9] the purpose of ring fencing is „to isolate those banking activities where continuous provision of service is vital to the economy and to a bank’s customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such provision can be maintained in the event of the bank’s failure without government solvency support.“ Furthermore, it was added in the Report[10] that in achieving the purposes of ring fencing, that retail banking activities should have economic independence,[11] as well as the requirement of measures for independent governance which is aimed at enforcing „the arm's length relationship“.

7 See page i of the Liikanen Report. „The Group's recommendations regarding separation concern businesses which are considered to represent the riskiest parts of trading activities and where risk positions can change most rapidly“
8 See page ii of the Liikanen Report.
9 Page 35; For further information on the location of the ring fence see page 36
10 See page 12
11 Economic independence, it is added „ requires firstly, that the UK retail subsidiary of a wider banking group should meet regulatory requirements for capital, liquidity, funding and large exposures on a stand alone basis, and secondly, that the permitted extent of its relationships with other parts of the group should be no greater than regulators generally allow with third parties and should be conducted on an arm's length basis.“

Arguments in favour of ring fencing are as follows:[12]

- Ring fencing should generate „significantly lower economic costs“ than full separation;
- Ring fencing would secure principal benefits such as guarding against certain contagion risks;
- The fact that challenges encountered by ring fencing are manageable and not materially greater than those of full separation;
- Legal impediments which exist with full separation;
- It is not certain whether total separation would necessarily facilitate greater financial stability[13]
- That total separation is harder to enforce under European Union Law inasmuch as universal banks in other member states remain entitled to own UK retail banking operations.
- The „workability“ and „practicability“ of ring fencing and the fact that ring fenced banks would be easier to monitor, supervise and manage than universal banks „other things being equal.“
- The argument that it can be „robustly“ implemented within the current EU framework and the difficulty in securing changes to relevant EU Law;
- Legal obstacles which persist with „full separation“ particularly since European Law places constraints on the degree to which ownership of companies can be controlled;
- That ring fenced banks should be able to engage in effective risk management.“

Ring fencing, hence, obviously has immense benefits attached to its implementation – however prominent proponents of complete legal separation, include Mr Volcker who adds that „even though the Vickers Report (John Vickers) and himself have the same concerns in mind, the logic would be to separate the two parts of banking, not to keep them within the same institution.“[14] Furthermore, he adds that it was unclear how the two parts of banking could be entirely independent when under ring fencing they would be subordinated to the holding company. Whilst the Financial Services Authority Prudential chief, Bailey, has publicly supported the need for a separation of trading activities into separate legal entities,[15] the Bank of England's Mervyn King has also expressed his disappointment over the decision to opt for ring fencing rather than total separation.[16]

Vickers Report also acknowledges those advantages inherent in the separation of legal entities:[17]

- 1) Argument that common ownership increases contagion from the rest of the financial

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12 The Independent Commission on Banking (ICB), Final Report, Recommendations, September 2011 at pages 12, 26, 59 and 65.

13 „It would remove a channel of contagion risk from investment banking to retail banking (and vice versa) but preclude support for troubled retail banks from elsewhere in banking groups.“

14 See Daily Telegraph, Paul Volcker: Ring-fencing Banks is Not Enough, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9561624/Paul-Volcker-ring-fencing-banks-is-not-enough.html>

15 See G Varriale, „Liikanen Poll: Volcker/Vickers Hybrid Wrong For Europe's Banks, 18 September 2012

16 See Daily Telegraph, Paul Volcker: Ring-fencing Banks is Not Enough, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9561624/Paul-Volcker-ring-fencing-banks-is-not-enough.html>

17 The Independent Commission on Banking (ICB), Final Report, Recommendations, September 2011 at page 63

system to retail banks through increased reputational links.

- 2) Argument that it is not possible to implement effective rules governing economic links between banks unless they are in separate corporate groups.“

The Report however adds that „the risk that the rest of the group could bring down a ring-fenced bank could be managed by insisting that the ring-fenced bank is not dependent for its solvency, liquidity or continued operations on the rest of the group.“[18] In bolstering arguments which favour ring fencing, the Report also adds that **even though arguments persist in favour of complete separation,** namely, that:

- i) by removing difficult to resolve wholesale/investment banking activities from ring-fenced banks, the problem is transferred elsewhere but not solved,
- and ii); that in a world of ring-fencing, governments would continue to bail out non-ring-fenced banks,[19]

that reforms introduced in the aftermath of Crises such as that of Lehman Brothers including greater use of central counterparties and proposals included in Chapter 4 of the Report (Vickers Report) **ensure that creditors are appropriately exposed to losses**.

Having considered both models, it (ultimately) has to be said that both involve some degree of separation of legal entities or banking activities. The difference between both lies in the extent of such a separation. Whilst achieving the purposes of ring fencing would require some degree of economic independence for retail banking activities, a greater degree of independence, is certainly characteristic of a complete separation of banking activities or legal entities within the group.

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18 „ Full separation has risks as well as benefits. Reputational links mean that it is likely that a ring-fenced bank would if possible be saved from failure by the rest of its corporate group if it got into difficulty. When domestic retail banking is suffering losses but the rest of the banking system is doing well, more retail banks would fail under full separation than under ring-fencing.“ See ibid

19 See ibid page 46

C Conclusion

Given the risks and benefits inherent under both models of ring fencing and complete legal separation, it appears that the more favourable model will largely be decided on a cost analysis basis. It is most certain and apparent that no model could ever completely eliminate risks and that a complete and total separation of legal activities or entities also, would practically be impossible or not feasible.

„Significant differences in the ownership structure and corporate governance arrangements between different banks“ as well as „significant diversity in bank business models across the EU and across EU Member States, numerous labels which exist to classify banks and their business models“,[20] would also present immense challenges for the model being proposed under the Liikanen Report.

Potential legal impediments and leeway for banks in manipulating rules owing to existing definitions of financial institutions also persist – particularly with the option involving a „complete“ separation of legal entities and activities.[21] While cost arguments have been advanced in favour of ring fencing, the same arguments are considered to be instrumental in compelling some universal banks to consider the option of complete separation.

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20 „These labels typically focus only on one or two of the numerous dimensions along which different bank business models may differ. The labels may conceal that, for example, some of today's universal banks operate quite differently from how they operated 30 years ago. In general, bank business models can be characterised in terms of several key dimensions or attributes: (i) size; (ii) activities, as evident from a bank's customer base, asset structure and income model; (iii) capital and funding structure; (iv) ownership and governance; (v) corporate and legal structure; and (vi) geographic scope, including how cross-border operations are legally and operationally structured. „ See pages 32 and 50 of the Liikanen Report

21 In respect of definitions see pg 58 of Vicker's Report and also http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/en/een00074.htm.
Financial institutions are considered to be “all corporations and quasi-corporations which are principally engaged in financial intermediation and/or in auxiliary financial activities”. Financial intermediation is in turn defined as “the activity in which an institutional unit acquires financial assets and liabilities on its own account by engaging in financial transactions in the market”.

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