Ring fencing Volcker's Rule? : The Liikanen Report and justifications for ring fencing and separate legal entities revisited

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ABSTRACT

The predecessor paper to this publication, "Volcker/Vickers Hybrid": The Liikanen Report and Justifications For Ring Fencing and Separate Legal Entities, considered the merits, objectives and cost-benefit attributes of respective models associated with the Vickers Report, Liikanen Report and Volckers Rule – by way of reference to the degree of separation of legal entities or banking activities involved, as well as whether an outright ban or prohibition on proprietary trading is involved.

This paper is aimed at highlighting why ring fencing not only presents a more feasible and cost effective option to other models, but also why its degree of flexibility provides the more appropriate balance in a financial environment whose trend is increasingly inclined towards conglomeration.

Key Words: Vickers Report, Volcker's Rule, Liikanen Report, ring fencing, cross-sector services' risks, liquidity risks, systemic risks, capital requirements, leverage ratios

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A Introduction

In assessing the need for re-structuring banks into separate legal activities, two considerations which have been given due attention are:[1]

- 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 first of these considerations is justifiable on the basis of the lessons learned from Northern Rock. Northern Rock highlighted the important role of recovery and resolution plans and illustrates a situation where the Bank of England was unable to act as effectively to perform its traditional role as lender of last resort without such a role being made public. The Northern Rock crisis also highlighted problems which were inherent in the tripartite arrangement between the Treasury, the Financial Services Authority and the Bank of England for dealing with financial stability - which includes amongst others, the inability of the Bank to act as lender of last resort for a limited time without such a role being made public.

The rationale for the second consideration, that is, the mandatory separation of banks' proprietary trading and other risky activities, however, appears less convincing given the challenges attributed to shadow banking activities, as well as the corresponding difficulties in achieving what could effectively be regarded as a separation of banks' proprietary trading and other risky activities.

As indicated in the predecessor paper to this paper, arguments which increasingly favour a more flexible model and which are directed in favour of ring fencing, arise from the inherent difficulties in the definitions attributed to financial and non-bank financial companies – as well as certain ambiguities presented through these definitions. Furthermore, the extent to which „completely" separate legal entities and activities can be achieved, as well as cost implications involved, provide greater justifications for the adoption of a more flexible model directed at ring fencing.

B. Justifications for Ring Fencing

Why should jurisdictions which have invested so much in restructuring their regulatory systems to cope with particular risks (for instance, cross sector services risks associated with

[1] See page i of the Liikanen Report (Final Report, 2nd October 2012)

conglomeration), be compelled into imposing further laws aimed at facilitating the restructuring of the legal entities of their banks? If further restructuring were to occur, should the rules governing such restructuring be so draconian such that they allow for little scope and flexibility – a situation which appears to be similar to that presented under the Volcker Rule model? Whilst the Volcker Rule model certainly has its merits, it has been argued by many that a number of ring fencing objectives might not be achieved if the mere prohibition of just certain activities under the Volcker rule were only taken into consideration.

According to Vickers Report (pages 35, 36), 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."

Arguments in favour of the adoption of the Ring Fencing Model, as highlighted in the predecessor paper are as follows:[2]

– 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
– 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;

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

– That ring fenced banks should be able to engage in effective risk management.“

The Liikanen Review considered a “hybrid” model which embraces features of models presented by Volcker’s Rule and the Vicker’s Report. In so doing, it does not impose such stringent requirements as those applicable under Volcker’s Rule whilst not being as flexible as the ring fencing recommendations in the Vicker’s Report.

Preference for a combination of measures which consists of imposing a non-risk weighted capital buffer for trading activities and the operation of the separation of activities conditional on supervisory approval of a recovery and resolution plan, rather than a mandatory separation of banking activities, under the Liikanen Report, also appears to offer a more flexible route - even though this is still not as flexible as the model under the Vicker’s Report. Such a flexible preference appears more feasible than a mandatory separation of banking activities given:

- The costs associated with mandatory separation of banking activities

- The difficulties of achieving what is reasonably considered to be an effective and acceptable degree of separation of banking – owing to the rise of the conglomeration over the years.

In view of the above mentioned attributes of ring fencing and given the need to consider the increased trend towards conglomeration, ring fencing would appear to be the most economic, appropriate and more time-relevant model to adopt.

Whilst commending Volcker’s Rule, some flaws identified by Sheel and Ganguly as being associated with the Rule are as follows:[3]

i) The fact that Volcker’s Rule “merely prohibits an entity that accepts public deposits from undertaking certain types of trades – and that even as it prohibits, proprietary trading, it allows hedging and market making.

ii) The inability of efforts aimed at separating banking (from trading activities) to guarantee that commercial banking is more immune from risky lending practices.

In addressing Sheel and Ganguly’s question as regards whether Glass-Steagall would have prevented the global financial melt-down of 2008, it needs to be remembered that the financial environment has evolved over the years. More complex forms of risks have evolved over the years and the firewall which existed with Glass-Steagall could not reasonably be expected to cope with the less advanced and less complex risks which existed some decades ago. Credit risk is certainly a major risk to be addressed – however so are counter party risks.

[3] A Sheel and M Ganguly “Ring Fencing Wall Street” http://www.indianexpress.com/news/ringfencing-wall-street/1210651/0

Furthermore, other numerous types of risks have manifested themselves in recent years. Other risks emanating from complex OTC derivatives trading and shadow banking further complicate the problem.

Ultimately, the distinction between commercial banking, insurance and securities sectors has become more blurred as a result of the rise of conglomerates. Hence the Glass-Steagall Act would not have effectively addressed these developments – as well as the more complex forms of risks which have resulted from OTC derivatives trading and other cross services sector risks – for which the adoption of integrated regulation (single financial services regulation) in many Scandinavian countries, Germany and the UK has been commended.

C. Conclusion

Whilst the Liikanen Report highlights why there is need for re-structuring of banks into separate legal entities – as a means of achieving ring fencing activities, 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 position under Volcker's Rule in the sense that it does not impose such stringent requirements as those applicable under Volcker's Rule – whilst not being as flexible as ring fencing recommendations proposed in the Vickers Report.

However the level of flexibility – such as that offered in the Vickers Report recommendations, or the second option under the Liikanen Report consisting of a preference for a combination of measures – leaving the separation of activities conditional on supervisory approval of a recovery and resolution plan, is to a large extent, necessary given the cost-benefit considerations involved in facilitating a mandatory separation.

Having regard to the need to manage cross sector services' risks, the extent to which conglomeration has assumed control over the structure of many bank entities and enterprises, justifications for consolidated regulation of financial services' sectors, as well as the questioning of the logic to reverse efforts aimed at effectively managing evolving risks within the financial environment, ring fencing appears to be the most favourable, more feasible and cost-effective option.

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