Chapter 18
Ring Fencing Volcker's Rule?
Justifications for Ring Fencing and Separate Legal Entities Revisited

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ABSTRACT

This chapter 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. 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.

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INTRODUCTION

In assessing the need for re-structuring banks into separate legal activities, two considerations which have been given due attention are (Liikanen Report, 2012, p. 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 favor a more flexible model and which are directed in favor 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.

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 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

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