# Structural Regulation of Banking

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**Note to readers:** this is a (very) preliminary draft of a chapter for a book I am co-authoring, entitled *Principles of Financial Regulation*. Some additional elements referred to in the text ('box text' material and figures) are not as yet prepared. Comments are most welcome: **john.armour:@law.ox.ac.uk.**

## 1. Introduction

'Structural regulation' refers to measures designed to limit the range of activities that may be carried on by a banking firm. The basic idea is to reduce the risk of bank failure by prohibiting banks from getting involved in activities which are judged by policymakers to be 'too risky'. Bank failure gives rise to significant externalities, hence society has an interest in reducing its probability below that which private parties running the bank might permit. Moreover, the provision of deposit insurance tends to exacerbate these problems, by creating moral hazard for those running the bank.

To implement activity restrictions, several policy choices must be confronted. First, which activities are thought to be 'too risky' for banks, and why? Conversely, which are not? Second, what counts as a 'bank' for the purposes of the restrictions? This has to be determined by reference to a functional classification of activities as well, because otherwise firms could evade the regulation by structuring themselves as 'non-banks' but carrying on what in substance was banking activity. Third, at what structural *level* is the restriction: does it prohibit the activity in question by a bank *entity*, or anywhere in a *group* that contains a bank entity? Fourth, for entity-level restrictions, what constraints on *intra-group* transactions are put in place to ensure that activity restrictions are not undermined?

Structural regulation of the financial sector is a tremendously controversial topic. The merits of such separation are hotly debated, as we shall see. And lurking in the background is the problem that implementing structural separation imposes particularly large costs on the financial sector, because it requires wholesale reorganization of corporate structures. Thus even if introducing

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structural regulation has net benefits, there remains a question whether the size of the benefits are sufficient to overcome the costs of switching. Against this background, it should come as no surprise that structural separation has been implemented only at times when it was possible for legislators to harness widespread popular demand for reform of the banking sector.

Structural regulation was first introduced in the US by the Banking Act of 1933, better known as the Glass-Steagall Act. This imposed separation of deposit-taking from investment banks at both the entity and the group level. However, by the end of the twentieth century, investment-commercial bank combinations were seen as a desirable advance for the industry, and the 'old fashioned' Glass-Steagall restrictions an unwelcome hindrance. Comparisons were drawn with the position in Europe, where structural regulations had never hindered the operation of universal banks. The provisions requiring structural separation at the group level were relaxed, following extended industry lobbying, by the Gramm-Leach-Bliley Act of 1999. However, entity-level restrictions remained in place in the US.

Given how soon the financial crisis came after the relaxation of group-level separation in the US, it is unsurprising that many saw this step as a contributing cause. There was vigorous popular support for a proposal originally aired by Paul Volcker for separation of proprietary trading activity from banking groups. This proposal, dubbed the 'Volcker rule', was implemented by the Dodd-Frank Act of 2010 and the final rules came into force in April 2014.

For Europe, where the universal banking tradition has long been strong, structural separation is a novel idea. However, in the aftermath of the financial crisis, the UK's government established an Independent Commission on Banking, chaired by Sir John Vickers of Oxford University, to explore whether some form of structural separation might be a desirable way to reduce the risks to the state associated with very large universal banks. The Commission's report recommended, amongst other things, that 'retail banking' activities—that is, deposit-taking, payments and lending from and to individuals and small businesses—be structurally separated at the entity level from investment banking activities. These proposals were reviewed and slightly adjusted following a further review by the UK's influential cross-party Parliamentary Committee on Banking Standards. The measures made it to the statute book in late 2013, in the form of the Financial Services (Banking Reform) Act of 2013. They are due to be implemented by 2019.

Whilst the UK proposals were undergoing domestic debate, the European Commission also became interested in the idea. A High-Level Expert Group, chaired by Erkii Liikanen, Governor of the Bank of Finland, reported in 2012, recommending structural separation of investment and retail banking activity at the EU level for banks in the Single Supervisory Mechanism. Like the Vickers proposals, Liikanen recommended separation at the entity, rather than the group, level. The Commission consulted further on this report and in early 2014, produced its legislative proposals. To the surprise of many, these added to the basic proposal for entity-level separation a further requirement of group-level separation of proprietary trading activity from banking groups. This proposal, which bears some similarities to the Volcker rule, appears to be inspired by a desire to ensure that the EU's regime is equivalent in effect to that of the US, so as to mitigate the effects of extraterritoriality.

The rest of this chapter is structured as follows. Section 2 considers the policy case for structural partition of commercial and investment banking activities. Sections 3, 4 and 5 respectively discuss UK, US and EU measures that have been implemented, or are proposed, in order to give effect to structural separation. Section 6 briefly reviews their international interaction, and section 7 concludes.

## 2. The idea of structural regulation

This section introduces the rationales for structural separation measures, and considers their critics.

### 2.1 Financial stability

The principal rationale for structural separation, at least in Europe, has been understood in terms of financial stability. The leading account of the case for structural separation is the report of the UK's Independent Commission on Banking, which recommended this approach. The ICB identify four distinct ways in which separation enhances stability,[1] which are to some degree fleshed out by the Report of the Parliamentary Commission on Banking Standards.[2]

First, it helps to shield *core activities* from *within-firm* contagion. By separating core banking activities from others, the risk that a loss in another activity will trigger a run on the bank is reduced. This provides better protection from contagion for those parts of the banking system that are most crucial for stability, namely the payments system and lending to small businesses.[3] The ICB saw these functions as unique not only because of their importance for the real economy—investment banks also provide valuable screening services for their underwriting clients—but because of the interaction between this and the particular difficulties they face in obtaining substitute financing. A large firm, which raises funds via the stock market using an investment bank as an intermediary, is able to access international markets for investment banking services. Consequently the collapse of domestic investment banks will not be such a shock to the non-financial firms that rely on them as would be a collapse of domestic retail banks.

The second rationale is closely related to the first. It emphasises that structural separation facilitates the imposition of *additional capital* requirements on core banking activities, further lowering their risk of failure. Such capital requirements can, policymakers reasoned, be imposed on domestic retail banks without triggering too great a risk of regulatory arbitrage. Matters are different, however, for investment banks, which are usually global in their operations and client base. A unilateral domestic imposition of higher capital requirements on investment banking operations might counter-productively result in such banks either shifting assets offshore, or withdrawing from domestic markets—itself imposing costs on the real economy.[4]

[1] Independent Commission on Banking, *Final Report,* 2011; Vickers, 2013.

[2] Parliamentary Commission on Banking Standards, *Final Report.*

[3] ICB, *Final Report*, 25.

[4] PCBS*, Final Report*, 23.

Third, by separating core functions from others, structural separation facilitates *resolution* of a banking group.[5] The thinking is that resolution authorities need only focus on the core activities in order to effect a successful resolution. Structural separation permits the government to identify and support the retail components more readily.

Fourth, structural regulation can reduce moral hazard. By separating 'core' banking from peripheral (eg investment banking) functions, the state sends a signal to those dealing with a bank that it will focus its energies on resolving troubled 'bank' entities. Those whose exposure is to peripheral functions cannot expect to be bailed out. As a result, this will increase their scrutiny of the riskiness of borrowers at the outset. This reduces the implicit government guarantee enjoyed by non ring fenced sections.[6] In turn, this will reduce the moral hazard that is widely believed to have happed in the banking sector as a result of implicit state guarantees.

These justifications have been highly controversial. Critics challenge the idea that separation will reduce fragility, by pointing to the loss of diversification benefits it will entail. A universal bank pursues many different lines of business, and its overall returns are shielded from volatility by this diversification. Firm-level diversification is generally thought to be unnecessary in modern corporate finance theory, because investors have access to diversification themselves. An important exception to this, however, is where the firm faces significant bankruptcy costs. A financial firm bankruptcy is very costly and so diversification at the firm level may be highly desirable. A 'core' bank is likely to be heavily exposed to domestic property markets. This is a highly volatile sector, prone to boom and bust, and has been at the centre of most financial crises for the past 100 years.[7] Structural separation, it is argued, would force core banks to specialise in this highly risky sector.[8] This objection receives support from empirical studies of US banks prior to the enactment of the Glass-

[5] ICB, *Final Report*, 24-5.

[6] ICB, *Final Report*, 25.

[7] Reinhart & Rogoff 2009.

[8] PCBS*, Final Report*, 26.

Steagall Act in 1933. These suggest that banks with securities affiliates were, holding other things constant, *less* likely to fail than those without.[9] The affiliates' operations were more risky than those of the banks, but there is little evidence of correlation, suggesting that they may have helped the banks to diversify.[10] Moreover, the presence of security affiliates was not correlated with lower bank capital or liquidity.[11]

However, the force of this 'diversification' objection depends on whether what is proposed is entity or group level separation. If separation is only at the entity level, then there can still be diversification at the group level, and the parent company can support a troubled core banking subsidiary. None of the live proposals suggests group-level structural separation, although this was historically implemented by the Glass-Steagall Act.

Second, structural separation is likely to result in increased ongoing costs for financial institutions. For retail banks, this increase will come in the form of increased capital requirements. If the purpose of separation is to ensure a continuous supply of funds to consumers and small businesses, this could be problematic, as it may make such business much more expensive.[12] Against this, advocates of higher capital requirements for banks point out that a firm's cost of equity capital is a function of its riskiness.[13] Banks in recent years have faced very high costs of equity capital, precisely because they have been so highly leveraged. Raising capital requirements will reduce default risk and so the cost per unit of capital will reduce. Moreover, non-retail banks will also be permitted to lend to SMEs, meaning that the latter have access to both 'protected' and non-protected sources of credit.

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[9] Eugene N. White, 'Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks' (1986) 23 *Explorations in Economic History* 33, 41.

[10] Ibid 43-44.

[11] Ibid 47-50.

[12] It is widely expected that the introduction of structural separation in the UK , for example, will result in the demise of "free" bank accounts, replaced by a monthly fee.

[13] Admati & Hellwig 2012.

If structural separation is successful, investment banks will also face higher costs. They will be unable to rely on retail deposits for financing, and so be forced to rely on wholesale markets. This may prove to be quite unstable. This increase in costs, however, is socially desirable, as it will force such financial firms to internalise the expected costs of failure. Firms that make profits only by increasing default risk will have to compensate their creditors accordingly. It will result in a better market allocation of risk.

A third, and potentially troubling, objection is that, contrary to expectation, structural separation may actually *hinder* successful bank resolution. The idea underpinning separation as a step to resolution is to see this as a form of 'hard' rescue and recovery plan, which requires the part of the firm which will be rescued—the 'good bank'—to be hived off from the rest *ex ante*, thereby facilitating its transfer under a purchase and assumption type resolution process. However, the most recent thinking about bail-in advocates a so-called 'single point of entry' (SPE) approach. Under SPE, the financial firm's external finance is organised through as few entities as possible—ideally just a single holding company which raises group finances. As a consequence it is only necessary to put that entity into resolution and restructure its debts, and all the operating subsidiaries are able to continue trading without any events of default. Ironically, requiring the retail bank subsidiary to be separately capitalised from the rest of the group may hinder this process. At the very least, it will make the necessary resolution planning more complex.

Fourth, critics—particularly in the UK—argue that structural separation will render UK banking less internationally competitive. This argument is doubtful. As compared with the US, the vestiges of Glass-Steagall which remain in the US still leave in place entity-level restrictions of a type very similar to what will be implemented by the UK legislation. And turning to the EU, the Commission has proposed the introduction of a form of structural separation across Europe.

[Box Text about here: HSBC's corporate structure]

Interestingly, financial stability was not a mainstay of the arguments for the Glass Steagall Act, which many view as the model for the current crop of reforms. To the extent that prudential concerns featured in the rationale for that Act, these mainly took the form of suggestions that commercial banks had been induced to make unsound margin loans to their depositors by the lure of brokerage revenues for their investment banking affiliates.[14] There was only a passing mention of the notion that proprietary trading by banks had lead to losses,[15] and it wasn't clear the extent to which the concern here was that their involvement in securities markets fanned the flames of speculation or had lead to instability on the part of commercial banks.

**2.2 Consumer protection**

A distinct rationale for structural separation has to do with concerns about conflicts of interest between banks and their clients. In terms of our categorisation of regulatory objectives, we can understand this as being concerned with 'consumer protection', although the affected clients are often not 'consumers' in the legal sense of the term.

Concern with conflicts of interest was one of the original rationales underpinning the Glass-Steagall Act. There was widespread concern about advisory conflicts of interest during the 1920s. Banks had directed their depositors, seeking investment advice, to their investment affiliates, who 'pushed' the stocks which these same affiliates were underwriting.[16] There was a strong inference that investment banking compensation patterns, which offered upside-only returns, had lead management for push poor underwritings upon to their unsuspecting depositors.[17] And investment

[14] Pecora Report, 156.

[15] Ibid 183-4.

[16] Pecora Report, 163-66.

[17] Ibid 206-7

bank affiliates returned the favour for commercial banks by organising stock pools to support the latter's' stock prices, and maintain their soundness in the eyes of depositors.[18]

During the period leading up to the financial crisis, there was concern, especially in the US, about the way in which conflicts of interest had returned to the banking sector. These conflicts were of a different variety. The major change in investment banking business during the 1990s was the rise of proprietary trading. This put the *investment* banks into conflict with the interests of their clients who rely on them for brokerage and market-making services. It was this kind of activity that was the original impetus for the Volcker Rule introduced in the US.

[Box text about here: the ABACUS transaction]

## 3. The UK regime

The UK's structural separation regime was first proposed by the Independent Commission on Banking in 2011. Given the very large size of the UK's universal banks relative to the country's GDP, and the extent of their underperformance during the financial crisis, the UK had a particularly strong incentive to initiate this kind of inquiry. Following further discussion in the Parliamentary Committee on Banking Standards, the outline of the regime was set out in the Financial Services (Banking Reform) Act 2013, amending the Financial Services and Markets Act 2000. Implementing secondary legislation will be passed before 1 May 2015, with a view to bringing the regime into force by 2019.

### 3.1 Exclusivity of banking activity

The activities which are protected by structural separation are termed 'core activities', and may only be undertaken by a 'ring fenced body' (RFB).[19] These comprise core deposit-taking, payments, and

[18] Ibid 168.

[19] FSMA 2000 (as amended), s 142B.

associated services.[20] *Core* deposits comprise those from EEA persons: either individuals with less than £250,000 in free assets,[21] or corporate persons with less than £6.5m annual turnover and who are not financial institutions.[22] Deposits from these groups are specifically targeted by the legislation because, it is argued, they would face the greatest disruption were a bank to fail. Whilst investment banking clients also face losses following the failure of such a firm, the ICB reasoned that large companies which typically rely on underwriting services would have access to international substitutes, as the market for underwriting is global.

Slightly more puzzling is the case of lending to SMEs, which are not within the definition of 'core activities'. This means that both RFBs and non-RFBs will be permitted to lend to SMEs. The likely impact of structural separation on the supply of funds to the SME sector is ambiguous. As RFBs are likely to face a higher cost of capital, given their additional capital requirements, a pessimistic prediction would assert that SMEs are likely to obtain finance more cheaply from non-RFBs. Consequently the failure of a non-RFB might have a significant impact on the availability of credit for SMEs. This seems to cut against the policy rationale for the provisions, which was to prevent the transmission of shocks from bank failure to the real economy. However, this overlooks the fact that RFBs will have a monopoly over retail deposit-taking. Consequently, they will be able to pass higher costs on to consumer depositors. Moreover, they will need to earn a return on the deposit funds raised, and SME lending will be one of the ways they can do this. Consequently they are unlikely to offer uncompetitive loan rates to borrowers. On this view, the domestic SME sector would be insulated against the risk of failure of a non-RFB.

The structural separation regime only applies to very large banks; that is, those with more than £25bn of core deposits.[23] Although this is described in the consultative document as a '*de*

[20] *Ibid* s 142C.

[21] That is, net assets excluding domestic residence, insurance policies and pension entitlements.

[22] Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order. [draft SI July 2013]

[23] *Ibid*.

*minims* exception', in international terms, such institutions are very large banks. However, the British high street lending market is very concentrated, with the result that the government estimates that 90% of UK retail deposits are held with firms exceeding this size threshold.[24]

[Figure 1 about here: UK RFBs]

**3.2 Prohibited activities**

Broadly speaking, the UK regime prevents RFBs from engaging in any investment banking activities, or from having exposures to other financial institutions (other than ring-fenced bodies).

The 2013 Act contains a very sparse account of restrictions, but makes clear that it is to be enhanced by secondary legislation. The resulting scheme will impose three types of restriction on RFBs.

- *Activities.* First, it will restrict the activities in which a RFB may engage.[25] 'Excluded activities' comprise, 'dealing in investments [or commodities] as principal'.[26] This excludes the RFB from engaging in proprietary trading, market-making, underwriting and derivatives transactions. It does not exclude the provision of brokerage services.
- *Persons.* Second, it will restrict the types of persons with which a RFB may contract.[27] This will prohibit exposures to other financial institutions, apart from RFBs. The idea here is to prevent circumvention of structural separation by exposure to the balance sheet of a 'risky' financial institution.

[24] HM Treasury/BIS, Banking Reform: Draft Secondary Legislation, Cm 8660 July 2013, 11.

[25] FSMA 2000 (as amended by FS(BR)A 2013) s 142D.

[26] *Ibid*. The exclusion of commodities is added by secondary legislation: Excluded Activities Order, r 3.

[27] The legislation permits the Treasury to impose restrictions on RFBs transaction with categories of persons or from opening branches or subsidiaries in certain jurisdictions. *Ibid* s 142E.

- *Geographic scope.* Third, it will restrict the geographic scope of a RFB's activity: non-EEA branches or subsidiaries will be prohibited. The idea here is to minimise the international scope of the organisation, so as to facilitate resolution.[28]

The restrictions as regards activities and persons are subject to exemptions for risk-management. These cover both management of the RFB's *own* balance sheet risks, and the provision of simple risk management products to their clients. A central challenge for the legislation is to strike a balance between facilitating the legitimate goal of risk-management, yet constraining the evasion of structural separation by the same techniques.

As regards *client* risk management, RFBs are only permitted to offer simple risk-management products. The permitted products comprise interest-rate, exchange rate, or commodity derivatives, which must be *simple*, in the sense of easy to value. Two conditions are set. First, the pricing formula must be straightforward: the contractual exposure must be 'directly proportional' to—that is, a constant multiple or fraction of—movement in the value of the underlying. Second, they must be capable of being valued using IFRS 13. There are also restrictions on the amount of position risk a RFB may assume under such transactions with any particular client, and on an aggregate basis.[29]

As regards *own* balance sheet risk management, RFBs have more freedom. They are permitted to engage in transactions, and incur financial institution exposures, for which the 'main reason' is limiting the extent of the RFB's exposure to interest rate, exchange rate, commodity prices or credit risk. This is likely to be the most problematic aspect of the restrictions to implement: how is

[28] The UK government would have preferred to prohibit any international activity, but this would potentially have contravened the EU Treaty's grant of freedom of establishment to UK banks. [Would it satisfy the *Gebhard* criteria? Doubtful that it is proportionate]

[29] The maximum aggregate position risk attributable to all derivatives offered to clients, and hedging transactions associated with them, must not exceed 0.5% of the RFB's own funds; nor may the aggregate position risk as respects any individual client exceed 20% of the RFB's regulatory capital.

it to be determined, for example, whether the 'main reason' for a credit derivative transaction is hedging own balance sheet risks?

**What is a proprietary trade and what is a hedge?**

In April 2012, it was reported that JP Morgan had incurred a massive loss on a portfolio of so-called "London Whale" positions entered into by traders in JP Morgan Chase' London office. The nickname was because the positions were so large they shook the world's markets. Closing out the positions lost the bank more than $6.2bn.

The positions in question were part of the bank's Chief Investment Office, which was a division tasked with earning a return on the bank's excess deposits. Part of its activities involved trading in credit derivatives, which it called its "Synthetic Credit Portfolio". This was originally envisaged as a way of hedging against risks in the bank's credit portfolio. The SCP began with primarily short credit derivatives, which paid out if the debtors defaulted on the underlying loans. However, over time the SCP expanded dramatically in size and began to comprise both long and short credit derivative positions, which offset one another.

The SCP started to lose large amounts of money for the firm in the first quarter of 2012. These losses first came to light in media reports in April of that year. JP Morgan's communications officer claimed in an analyst call that the SCP was simply a form of hedging activity, of which regulators were fully aware, and which would be consistent with the Volcker rule. None of these were true.

The bank's principal regulator, the Office of the Comptroller of the Currency (OCC) had been provided with no real information about the SCP, such that the media reports were news to it. The US Senate Subcommittee on Investigations conducted an inquiry into the affair, and concluded by recommending, amongst other things, that regulators should require any positions described as "hedges" to be substantiated by detailed documentation establishing which assets are hedged, how the hedge lowers the risk associated with these assets, and how it can be tested for effectiveness and unwound. Regulators should also be able to require banks to undergo periodic testing of the effectiveness of their hedges.

**Source**: US Senate Permanent Subcommittee on Investigations*, Staff Report on JP Morgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses* (March 15, 2013).

There are a series of further pragmatic exemptions to the basic restrictions on RFB activity. RFBs may engage in liquidity management, and buy and sell liquid securities for this purpose;[30] they may acquire shares under debt-equity swaps; they may enter into transactions with the central

[30] Although they may not incur financial institution exposures for this purpose. This is intuitive: it would make the RFB's liquidity dependent on the balance sheet of the non-RFB financial institution and thereby undermine structural separation.

bank; and they may engage in securitisations of its own assets.[31] Similarly, RFBs are permitted to have exposures to non RFB financial institutions for the purposes of issuing documentary letters of credit, the provision of overdraft facilities to customers, or providing guarantees for customers. They are also permitted to enter into repo transactions with other financial institutions. Where the other financial institution advances the repo asset to the RFB, then it must be a liquid asset.[32]

### 3.3 Entities and Groups

The UK structural separation regime applies at the entity level. It imposes no restrictions on the activities into which a group containing a RFB may enter.[33] However, it does extensively restrict the conduct of intra-group affairs so as to avoid undermining of structural separation. The prohibition on exposures to non-RFB financial institutions does a lot of work in the intra-group context. For intra-group transactions, the restriction is attenuated to permit within-group exposures provided they are at arm's length. Short-term intragroup exposures are also prohibited, so as to avoid the use of groupwide treasury functions of the sort that caused so many problems with Lehman Brothers' UK subsidiary.[34] Further restrictions on intra-group transactions may be imposed by PRA rules.

### 3.4 Additional Loss-Absorbency Requirements

RFBs are to be subjected to additional loss-absorbency requirements as part of the UK scheme.[35] This is to take the form of additional 'bail-inable' debt, over and above the Tier 1 and 2 regulatory

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[31] That is, securitisations where the entirety of the assets held by the SPV come from the RFB. This means that any liability the RFB incurs—whether explicit or implicit—to guarantee SPV returns is determined simply by reference to assets the RFB was originally permitted to acquire.

[32] RFBs may also enter into short term (< 5 day exposures) transactions with financial institutions, subject to a counterparty limit of 2% and a global limit of 10% respectively of the RFB's own funds.

[33] This will change when the EU regime, discussed below, comes into force.

[34] Cross-ref.

[35] FSMA 2000 (as amended) s 142Y; Banking Reform (Loss Absorbency Requirements) Order

capital. The PRA will be required to assess what level of additional loss absorbency capacity should be imposed on RFBs, taking into account their systemic importance, the amount of core deposits they hold, and their balance sheet assets. These shall be imposed up to a ceiling of primary loss absorbing capacity (PLAC) of 17% of risk-weighted assets. In effect, this treats bail-inable debt requirements as an additional form of capital. The regulator must determine the nature of the debt requirements consistently with the resolution strategy for the body in question.

## 4. The US regime

The US structural regulation regime contains both entity level and group level restrictions. These have their origins in the Glass-Steagall Act, which was enacted as a central part of the New Deal financial legislation following the crash of 1929.[36] Its regime sought to separate the activities of commercial and investment banks. This was achieved primarily through *activity restrictions* on what entities carrying on commercial or investment banking business were permitted to do, and on *intra-group* transactions. These were supplemented by rules designed to ensure that the entity-level restrictions were not circumvented via group structures, which restricted *affiliation* between entities engaged in activities subject to restrictions.

The group-level affiliation restrictions were repealed with the Gramm-Leach-Bliley Act of 1999, but the entity-level activity restrictions, and the intra-group restrictions, remained in force. The Dodd-Frank Act of 2010 has reinstated a more limited set of group-level affiliation restrictions, prohibiting banking groups from being engaged in proprietary trading—the so-called 'Volcker Rule'. The relevant implementing rules, which were the subject of an enormous lobbying pushback by the financial sector, were eventually passed in December 2013. They must be implemented by July 2015.

### 4.1 Permitted and Prohibited Activities

[36] It was amended and its scope was further enhanced by the Bank Holding Company Act of 1956. We will discuss these provisions together as the "Glass Steagall" regime.

The Glass-Steagall Act prohibited securities firms from engaging in the core banking activity of taking deposits.[37] US national banks and state member banks are also subject to entity-level restrictions imposed by the Act.[38] Such banks have power to take deposits and make loans, but they (and their subsidiaries) are prohibited from engaging in underwriting, and from buying and selling securities save on behalf of their customers, or purchasing for their own account any corporate shares. In addition, §716 of the Dodd-Frank Act generally prohibits banks from engaging in derivatives transactions, apart from hedging transactions.[39] Banks remain free to engage in brokerage on behalf of customers, subject to a limitation of 10% of their capital.[40]

These restrictions on investment contain a number of exemptions for securities thought to be highly liquid. These include permissions for banks to invest in:

- *Public debt:* Obligations of the US Government, state, or any political subdivision thereof;
- *Government-sponsored entities:* securities issued by Fannie Mae or Freddie Mac, or other GSEs;
- *Development banks:* Obligations of international development banks, which must not exceed 10% of the bank's capital;
- *Investment securities:* OCC-approved "investment securities", which must not exceed 10% of the bank's capital; and

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[37] Ibid §21.

[38] Glass-Steagall Act § 16; 12 USC §§ 24, 335. Similarly, FDIC-insured state non-member banks are also subject to activity restrictions defined by reference to those imposed on national banks: 12 USC § 1831a. Many of these entity-level restrictions actually preceded the Glass-Steagall Act. Thus, it was common for investment-commercial bank combinations in the 1920s to be structured through the use of a bank holding company, rather than a single entity.

[39] Any credit derivative transactions must be centrally cleared: Dodd-Frank Act 2010 §716(d)(3).

[40] "Customers" do not have to be *pre-existing* banking customers; that is, the bank may run a brokerage business independently of its banking business: *Securities Industry Association v. Comptroller of the Currency* 577 F supp 252 (DDC 1983).

- *Derivatives of the above:* Derivatives where the underlying security is one in which a bank would be permitted to invest.[41]

### 4.2 Intra-group transactions

The Glass Steagall Act also introduced restrictions on intra-group transactions involving Federal Reserve member banks,[42] which now form §23A of the Federal Reserve Act. These restrictions were strengthened in 1987 by the addition of §23B, and the regime was further enhanced by the Dodd-Frank Act.[43]

The most general restriction is applied by §23B, which requires that *all* transactions between banks and their *affiliates*, or with third parties for the benefit of affiliates, must be on *arm's length terms*.[44] Affiliates are members of the same group, including parents, subsidiaries, and sister companies; they also include investment funds advised by the bank or another affiliate.[45] However operating subsidiaries are treated in effect as extensions of the parent company.

Second, §23A imposes a range of restrictions on certain inter-affiliate transactions, known as "covered transactions". These comprise:

- *Advances of credit* by the bank to or for (including a guarantee of) an affiliate, which must be fully secured with a specified margin of sufficient-quality collateral;
- *Purchases of assets* from the affiliate (including repos), which must not be of impaired credits;

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[41] Introduced by Dodd-Frank Act §716.

[42] Glass-Steagall Act §13, inserting Federal Reserve Act §23A. This was supplemented in 1987 by §23B. See 12 USC §§371c, 371c-1. These restrictions are extended to all FDIC insured banks, even if they are not Federal Reserve members: 12 USC §1828(j).

[43] §608.

[44] §23B(a).

[45] Inserted by Dodd-Frank Act of 2010 §608.

- *Affiliate securities:* Investing in, or accepting as collateral from anyone, securities issued by the affiliate; and
- *Derivative transactions*, to the extent that they give the bank a credit exposure to an affiliate.[46]

The bank's total exposure under covered transactions may not exceed 20% of the bank's capital, with a single-party limit of 10% for any particular affiliate. Most of these restrictions may be exempted as between two FDIC-insured banks in the same group ('sister banks'). They are all exempt as regards transactions in US Treasuries, and those in securities traded in public markets, at market price.

**4.3 Group-level restrictions**

The US entity-level restrictions were supplemented by a ban on commercial banks being affiliated with any company 'engaged principally' in the core investment banking activities of proprietary trading, underwriting or dealing in securities,[47] and a prohibition on management and director interlocks between such firms.[48] This was the most invasive aspect of the Glass-Steagall Act, which required the break-up of US bank holding companies. As might be expected, there was initially very strong opposition to the Glass-Steagall Act from the banking sector. However, the contemporaneous publication of the Pecora Commission's report into the practices of the financial sector revealed a litany of abuses in the case of First National, a leading investment-commercial bank combine. The generated such intense public outcry that the financial sector sought to distance itself from the

[46] This was also introduced by the Dodd Frank Act. Derivatives had not previously been covered by Reg W, the FRB's implementing rules issued in 2002. The basis for this was that such transactions between banks and affiliates were thought to be for risk management, not for funding purposes: Omarova.

[47] Ibid §20.

[48] Ibid §32.

bank-securities nexus.[49] A number of banking firms took the initiative of voluntary divestment of their securities affiliates, and opposition to Glass-Steagall was dropped.

From the early 1970s, US commercial banks found themselves exposed to intense competitive pressure from capital markets as regards corporate financing activity. The story of the travails of the commercial-investment banking boundary over the next 30 years is one in which this competitive pressure spurred banks to increasingly far-reaching applications of the maxim 'if you can't beat them, join them', seeking to move into capital markets work of various hues.[50] This involved repeated testing of the boundaries of the Glass-Steagall partition. Over time, bank regulators' ideology shifted, from being one of seeking to restrain this in line with the spirit of the legislation, to one of seeking to facilitate it, in order to protect the survival of the industry against external competition.

Notwithstanding the restriction, bank holding companies ('BHCs') or their non-bank subsidiaries were permitted to engage in non-banking activities provided that the Federal Reserve considered these sufficiently 'closely related' to banking. From 1987, the Federal Reserve regularised the practice of permitting BHCs to have subsidiaries carrying on underwriting and dealing in bank-related securities: municipal bonds, mortgage-backed securities, consumer receivable securities, and commercial paper. A limit was imposed on the proportion of the revenue of the subsidiary that could come from these technically ineligible activities, which was gradually raised over a 10-year period. The Gramm-Leach-Bliley Act of 1999 largely eliminated these restrictions.[51]

The ideological shift that had taken place during the 1980s and 90s was reversed suddenly following the financial crisis. The result was Section 619 of the Dodd-Frank Act of 2010, which

[49] Jill M. Hendrickson, 'The Long and Bumpy Road to Glass-Steagall Reform: A Historical and Evolutionary Analysis of Banking Legislation' (2003) 60 *American Journal of Economics and Sociology* 849, 858-60.

[50] Cites to Macey articles.

[51] DETAILS.

reinstates some group-level restrictions on banks.[52] This is the so-called 'Volcker rule', named after its alleged proponent, Paul Volcker, former Chairman of the Federal Reserve Board of Governors. The section prohibits 'banking entities' (defined as FDIC-insured banks or their affiliates) from engaging in 'proprietary trading' or having any equity interest in, or sponsoring,[53] a private equity or hedge fund (i.e. private funds exempted from ICA 1940) above a *de minimis* threshold.

The Volcker Rule sparked a great deal of controversy, and it was not until December 2013, over three years after the Act was passed, that the final inter-Agency implementing rule was approved.[54] "Proprietary trading" is defined as "to purchase sell or otherwise acquire or dispose of any security, derivative, contract of sale of a commodity future, option, any other security ... principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)".[55]

The rule contains a number of exceptions, including:

- *Brokerage* transactions as agent for customers;
- *Market-making*, to the extent that such activities "are designed not to exceed the near term demands of clients, customers and counterparties";
- *Underwriting*: the purchase and sale of securities "in connection with underwriting ... activities";
- *Hedging:* risk-mitigating hedging positions in relation to assets of the bank;

[52] Nonbank financial companies designated for supervision by the Fed by the FSOC are not subject to this restriction. But they might be subject to additional capital requirements and quantitative restrictions with respect to these activities.

[53] To "sponsor" a private fund means to be GP, or manager, to select or control the fund's managers, or to share name with the fund for marketing or trading purposes.

[54] Treasury/OCC/Federal Reserve/FDIC/SEC, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, ands Relationships with, Hedge Funds and Private Equity Funds, December 2013.

[55] Volcker Rule ref.

- *Permitted investments* including (i) US public debt; (ii) Securities issued by Ginnie Mac, Freddie Mac and Fannie Mae; (iii) Small business investment companies; and (iv) insurance company investments.

Of these exceptions, the scope of the rules regarding market-making generated perhaps the most debate. Critics argue VR will impact adversely on market-making activity.[56] For example, Darryl Duffie argues that market making and proprietary trading cannot be meaningfully distinguished. A market maker is buying securities from market participants with a view to selling them on again later at a higher price, hence the spread. The market maker's willingness to match a client's demand for liquidity is a function of the degree of liquidity in the market generally, and their capacity to warehouse securities on their own balance sheet. To the extent that they are restricted in the amount of balance sheet risk their market making positions can take on, the more difficult it will be for them to continue to provide market making services. In the short term, this might have an adverse impact on market liquidity, price discovery and cost of capital, because market makers handle the vast majority of all trades in OTC markets. In the medium to long term it might result in the movement of market making activity to non-banks. This in turn would creates difficulties for financial stability, as *ex ante* they are outside regulatory capital controls and ex post provision of liquidity support is more difficult for such organisations.

The rationales advanced for the Volcker Rule have evolved over time. It was initially proposed as a way of responding to concerns about conflicts of interest within the banking sector; in particular, the notion that a bank could on the one hand be offering brokerage or underwriting services to clients yet on the other hand be trading in the same market. Disclosure, it was thought, was not a sufficient tool to protect customers against this practice.

[56] Darrell Duffie, 'Market Making Under the Proposed Volcker Rule', Stanford University Rock Center for Corporate Governance Working Paper No 106 (2012); Anjan V. Thakor, 'The Economic Consequences of the Volcker Rule', US Chamber of Commerce Center for Capital Markets Competitiveness Report (2012);

As the proposal found its way into the legislative timetable and then to the statute book, some also sought to justify it by reference to the mitigation of systemic risk. However, this argument has never been very strong. There is no evidence that proprietary trading activity had any destabilising effect during or before the financial crisis, and removing it from banking groups may simply reduce the extent to which they are able to diversify. Indeed, the Volcker rule would have had no impact on the activities of Bear Stearns or Lehman Bros, because these were pure investment banks with no FDIC-insured deposit-taking affiliate. Moreover, pushing proprietary trading out from banking groups into hedge funds or 'pure' investment banks is, according to some critics, likely to result in the same risks being run within the system, with less oversight.[57]

A third justification suggests that bank proprietary trading receives an implicit subsidy, in the form of access to deposit insurance and the Fed's discount window through the bank affiliate, which is inappropriate. Yet sections 23A-B serve to restrict the extent to which intra-group transactions can be used to offload losses onto bank affiliates. And it is unclear why, if a subsidy is given, it should be inappropriate for proprietary trading yet acceptable for market-making.

### 4.4 Geographic Restrictions

In addition to the restrictions imposed by Glass-Steagall, the US banking sector was also subject to a number of *jurisdictional* restrictions, because many states restricted interstate banking. These typically restricted combinations with out of state banks, with the result that the US banking sector was far less concentrated than that in most other developed economies. The restrictions on interstate banking were abolished by the Riegle-Neal Act of 1994.

## 5. The EU's Proposed Regime

EU-level proposals for structural regulation of the banking sector began with the so-called 'Liikanen report', named after that the chairman of the committee of experts who reviewed the issues for the

[57] Whithead (2011).

Commission.[58] The report made a set of proposals which echoed those of the UK's Independent Commission on Banking, save that they suggested investment banks should be spun out of universal banks, rather than the UK's proposals that universal banks should spin out retail banks.

These proposals were modified significantly by the European Commission, whose subsequent proposal, the Structural Measures Regulation ('SMR'),[59] was announced in January 2014. The Commission proposal combines elements both of the UK and US initiatives: it suggests both entity-level and group-level restrictions. However, across other dimensions, it is less demanding than either schema. The group-level restrictions on proprietary trading are narrower, and the entity-level restrictions are only applicable on a targeted basis, to entities assessed by their supervisors as necessitating such measures for the sake of financial stability. An unkind critic might consequently label the proposals 'Volcker plus Vickers plus water'.

The Commission's timetable is ambitious. It hopes to have the Structural Measures Regulation passed by June 2015, with implementing rules to follow in January 2016. The proprietary trading ban will then come into force in January 2017, and the ring-fencing rules by July 2018. Bear in mind that the UK's plan to have the Vickers proposals implemented by 2019, from a start no later than May 2015, was previously considered ambitious.

It is worth noting that the SMR is only to apply to the very largest European banks; namely those designated by the FSB as G-SIIs, or those having consolidated assets of more than €30bn and trading activity of more than €70bn.[60]

[Figure 2: EU banks to which the SMR will apply. About here]

[58] High-Level Expert Group on reforming the structure of the EU banking sector, *Final Report*, Brussels, 2 October 2012.

[59] European Commission, Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, Brussels, 29.01.2014 COM (2014) 43 final.

[60] 'Trading activities' are defined as ...

### 5.1 Group-Level Restrictions

The SMR would introduce a mandatory group-level restriction which would, put crudely, mirror the Volcker rule. It prohibits credit institutions, and any entity in the same group as one, from engaging in proprietary trading or holding equity positions in alternative investment funds. Yet the scope of this prohibition is rather narrower than the Volcker Rule. The preamble notes the difficulties in distinguishing between market making and proprietary trading, which bogged down the final rulemaking in the US for so long. The Commission's proposed solution, however, is to adopt only a narrow definition of proprietary trading, so that market making will clearly not be caught. The SMD provision defines proprietary trading as trading:[61]

> "for the *sole purpose* of making a profit for own account, without any connection to client activity, through use of a specifically dedicated desk" (emphasis added).

This is to be distinguished from the equivalent provision in section 619 of the Dodd Frank Act, which defined as own-account trading:

> "*principally* for the purpose of selling in the near term ... or otherwise with intent to resell in order to profit from short-term price movements" (emphasis added).

Thus where trading activity has overlapping purposes—for example, market-making—it falls clearly outside the EU proposal but requires clarification under the Volcker rule. The final Volcker rule, for this reason, is highly prolix, running to over a thousand pages.

The narrower scope of the EU proposal makes it easier to implement, but also to evade, than the Volcker rule.[62] Indeed, one wonders how must will actually end up being caught by such a narrowly drafted restriction. A likely explanation is that the Commission are using the measure to

[61] Art 5.4

[62] Further, the SMR prohibition excludes trading in EU sovereign bonds and cash management through trading cash assets.

seek to negotiate a reciprocal exemption from compliance with the US on the basis of equivalent home state rules.

### 5.2 Entity restrictions

The second limb of the Commission's proposed SMD requires Member States' domestic supervisory authorities to review banks subject to their supervision, with a view to determining whether structural separation (with ongoing activity restrictions) should be imposed. Domestic banking supervisors must determine whether banks' trading activities constitute a threat to the stability of the bank or to the EU financial system as a whole, using guidance to be supplied by the EBA. The review is to focus in particular on three types of trading activity thought to be particularly risky, namely market-making, investing in and sponsoring securitization, and trading in derivatives.[63] 'Trading activities' are defined very broadly to cover all activities *other* than insured deposit-taking, lending, retail payment services, and purchasing EU sovereign bonds.[64] If the authorities conclude that a bank's trading activities do constitute a threat to stability, they will then restrict the bank from carrying on such trading: this will necessitate structural separation of these activities.

In addition to the activities already noted which do not count as 'trading', the regime contains specific exceptions for risk management activities by the entity, both as regards its own risks and as regards the provision of risk management services to its clients.[65] Both types are permitted to be carried on using interest rate, foreign exchange, and credit derivatives which are eligible for CCP clearing. The banking entity must demonstrate to its supervisor how the hedging activity is designed to reduce, and in fact does reduce, 'specific, identifiable risks of individual or

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[63] Art 9.

[64] Art 8.

[65] Arts 11-12.

aggregated positions'.[66] Client risk management services may additionally be offered using emission allowances and commodity derivatives eligible for CCP clearing.

**5.3 Separate capitalisation and Intra-group transactions**

When a separation order is made, then it will be permissible for the activities in question to continue to be carried on by a separate entity within the same group as the banking entity, provided that credit institution does not hold shares in the trading entity.[67] At the same time, the trading entity must not take DGS-eligible deposits or provide retail payment services.[68] The credit institution and the trading entity are to be separately capitalised, and to issue claims on an individual basis accordingly, except insofar as this would run contrary to any resolution plan agreed by the resolution authorities under the BRRD. This is a welcome acknowledgement of the need to dovetail the two processes.

Following structural separation within a group, a series of restrictions will come into play regarding intra-group dealings. These are, as in the UK and the US, designed to ensure that the activity restrictions imposed are not undermined by contract between firms under common ownership. Contracts between the credit institution and the trading entity must be on a 'most favoured counterparty' basis; that is, they must be on terms at least as favourable to the credit institution as are comparable contracts or transactions with or involving entities not belonging to the same sub-group.'[69] There will also be corporate governance separation: only a minority of the boards of the two entities may overlap.

Several EU Member States—not only the UK but also Germany and France—had already announced structural separation schemes prior to the Commission's SMR. The SMR permits Member

[66] Art 11(1).

[67] Art 13.

[68] Art 20.

[69] Art 13(7).

States to obtain a derogation from its application where they have legislated a domestic separation regime which is comparable to the SMR scheme, provided that the relevant national legislation was passed before 29 January 2014. It looks likely that the UK will apply for such a derogation as regards the Financial Services (Banking Reform) Act 2013.

**6. International intersection**

The structural regulations that have been introduced or proposed since the financial crisis contain significant elements of extraterritoriality. Systemically important banking groups will have operations in many parts of the world. Group-level structural separation would be undermined if they could carry on proscribed activities extraterritorially. This reasoning lead the US to impose a broad extraterritorial reach onto the Volcker Rule's application. It applies to the worldwide activities of banks headquartered in the US. Moreover, it also applies to the activities of any non-US banks with branches or subsidiaries in the US, except to the extent that the trading activity in question is 'wholly outside the US' (WOTUS), or non-US private equity and hedge funds, or in US Treasuries or the sovereign bonds of the group's home country. WOTUS trading must be between two entities which have no connections to the US.

The UK's structural separation measures will apply to the UK bank subsidiaries of non-UK banking groups, but not to UK branches of foreign banks. The UK is restricting the extent to which non-EU overseas banks may open branches in the UK. This has the effect of channelling such banks into UK subsidiaries, to which the structural separation measures will apply. As regards EU overseas banks, domestic attempts to impose restrictions on their opening UK branches would constitute a restriction of their freedom of establishment. Such branches therefore constituted a potential gap in the structural separation regime; however, the size of this theoretical problem will be greatly reduced by the SMR, which will harmonize the applicable framework across Europe.

The EU's SMR will apply to the worldwide operations of large EU banks (including EU subsidiaries of foreign banks which themselves meet the size criteria) and to the 'EU branches' of large third country credit institutions.[70] This last provision looks to be limited to EU territorial activities, and consequently to be proportionate in its scope. Yet structural separation of activities from 'branches' necessarily means from the entity in question, regardless of its global scope. This is likely to create a pressure for subsidiarization within the EU so as to ensure certainty.

However, the SMR indicates that EU branches of large third country banks would be exempt from the application of its rules where they are subject (in the third country) to an 'equivalent' legal framework to that applied by the SMR.[71] This then provides leverage for the Commission to use in negotiating with the US regarding the international scope of the Dodd Frank Act.

**7. Implications and outlook**

The story of structural regulation of banking is a remarkable ideological roller-coaster. First introduced in the 1930s in response to the US experience of bank failures, it gradually fell out of favour in the last quarter of the twentieth century, on grounds that it failed to reflect fully the changing nature of the financial system. As those changes have proved less benign than previously imagined, the idea of structural regulation has come back into vogue. The new sets of measures seek to carve out a protected space for core activities, and to push activities deemed 'too risky' outside the banking entity, and even in some cases outside the group altogether.

Perhaps the most remarkable thing about the current set of measures is that they will, when implemented, achieve a very high level of convergence on this issue across both sides of the Atlantic. For many years, US banking regulation has been an outlier in that it applied structural regulation in ways that Europeans did not comprehend. The Vickers ring-fencing proposals, and the EU's Structural Measures Regulation, will (to the extent that national authorities assess separation is necessary), cause large European banks to be subject to similar restrictions to the entity-level and

[70] SMR, Art 3.

[71] Arts 4, 27.

intra-group restrictions which have remained in force throughout in the US. The SMR will also impose convergence on the prohibition of proprietary trading.

These measures will be enormously costly to implement. Will they be worthwhile? The case in favour of *entity* level restrictions has most cogently been argued in the Vickers report. It is based on the protection of domestic core activities and the facilitation of resolution. Given the uncertainties, the approach adopted by the Commission on this question—that is, to encourage it but to give national authorities the final say—is to be commended. The same cannot be said for *group* level restrictions on proprietary trading. These seem to have few compelling justifications based on financial stability. As such, they are best justified in terms of consumer protection. The case for an EU-wide rule therefore seems less compelling. The reason for its inclusion would appear to be primarily motivated as a retaliation to the extraterritoriality of the corresponding US provision.