To ring-fence or not, and how?
Strategic questions for post-crisis banking reform in Europe

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With the proposals of the United Kingdom's Independent Commission on Banking (now enacted in legislation), the "ring-fencing" of core banking functions and their legal and commercial insulation against the risks emanating from investment banking has attracted widespread attention in both academic and regulatory circles world-wide. This concept is but one emanation of a broader move towards the segregation of commercial and investment banking, which is being accomplished in the United States under the so-called "Volcker Rule" (Dodd-Frank Act, § 619), in a number of Continental European jurisdictions under national legislation since 2012, and promoted within Europe by the recommendations of the Liikanen commission and a recent draft for an EU Regulation on structural measures improving the resilience of EU credit institutions. Moreover, the term has been used to describe older regulatory strategies employed by host-country authorities in cross-border settings, which involve the segregation of local branches and subsidiaries from a multinational banking, with a view to protecting domestic creditors against the fallout from the insolvency of foreign institutions both ex ante *and* ex post. *Against this background, the present paper promotes an integrated, functional understanding of ring-fencing in the context of banking regulation and defines some core strategic questions for future structural reform of the European banking systems.*

Keywords: *EU banking regulation; Liikanen Report; ring-fencing; structural bank reform; Vickers Commission; Volcker Rule*

JEL-Codes: G01, G15, G18, G21, G24, G33, K19, K22, K23, L22

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I. Introduction

In the context of the prudential regulation and supervision of banks,[1] the term "ring-fencing" has been used with a variety of meanings over time. Prior to the global financial crisis of 2007-9, it would be associated, first and foremost, with a specific approach to the insolvency resolution of financial institutions that formed part of larger cross-border group of banks or financial companies more generally: Once a branch or subsidiary, or indeed the group as a whole, became insolvent, host-country authorities would try to protect the branch's or subsidiary's depositors, other clients or local creditors as a whole by "ring-fencing" its assets against inclusion in insolvency administration or liquidation administered abroad, which would usually have been initiated and administered exclusively by home-country authorities. In the case of branches, this would be accomplished by confiscating some or all assets held within these branches that would otherwise become part of the insolvent estate administered under foreign insolvency law.[2] In the case of subsidiaries, by contrast, host-country authorities would subject the subsidiaries to separate insolvency proceedings, and prevent any foreign regulator or insolvency administrator from interfering with these proceedings. In the same context, in view of growing experience with the administration of complex cross-border bank insolvencies, and out of concern about the implications of the prevailing concept of home-country supervision for local depositors and markets, host-country authorities also adopted another, preventive sort of ring-fencing, in the form of restrictions on upstream intra-group payments from local subsidiaries (or even intra-firm payments from local branches) to (parent) companies in another jurisdiction.[3] Throughout the present paper, both the *ex ante* and *ex post* form of ring-fencing in this sense will be referred to as "jurisdiction-oriented" ring-fencing.[4]

Lately, ring-fencing has acquired even greater prominence as a catchphrase for the legal and commercial isolation of certain banking activities deemed to be particularly important in macro-economic terms within a banking group, with a view to protecting such activities against the risks emanating from less economically important functions (such as proprietary trading and other investment banking business). This concept, developed in the United King-

[1] See also, discussing a broader range of meanings than those of relevance within the context of the present paper, Steven L. Schwarcz, "Ring-Fencing", 87 *S. Cal. L. Rev.* 69 (2013) pp. 74-81, who differentiates between the following concepts: "ring-fencing to make a firm bankruptcy remote," "ring-fencing to help a firm operate on a standalone basis," "ring-fencing to preserve a firm's business and assets" and, finally, "ring-fencing to limit a firm's risky activities and investments".

[2] See further *infra*, II. A.

[3] *Infra*, II. B.

[4] See also, employing a similar terminology, Katia D'Hulster and Inci Ötker-Robe, "Ring-fencing Cross-Border Banks: An Effective Supervisory Response?" (2014), available at http://ssrn.com/abstract=2384687, p. 2 ("geographical ring-fencing," "territorial approaches").

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dom under the auspices of the Independent Commission Banking (also known as the "Vickers Commission" after its chairman, Sir John Vickers)[5] and recently enacted in law by the Financial Services (Banking Reform) Act 2013 (ch. 33), is only one aspect of a global trend towards the segregation of commercial and investment banking for prudential reasons, which could eventually trigger the demise of the very concept of traditional universal banking.[6] Hereafter, this form will be referred to as "activities-oriented" ring-fencing.[7]

The present paper examines those different meanings and suggests a harmonised functional definition of ring-fencing as a protective concept, employed either *ex ante* or *ex post* (i.e., ahead of, or upon, insolvency) (*infra*, II.). On this basis, the rationale – as well as potential conceptual shortcomings – will then be discussed, with a particular emphasis on a comparison between the UK approach and a recent Commission proposal on an EU Regulation on structural banking reform in Europe (*infra*, III.). The paper concludes with a summary of the respective merits and shortcomings of the different approaches, and identifies key issues for future research and analysis in this context (*infra*, IV.).

II. The evolution of ring-fencing as a regulatory concept – comparison and consequences

A. "Ex post" Ring-Fencing as an Instrument for the Protection of Domestic markets and Market Participants in Cross-Border Bank Insolvency

In what appears to be its oldest form in the context of banking regulation, the term "ring-fencing" has been used to describe a specific form of the treatment of branches of foreign banks by host country authorities in insolvency, namely the strict treatment of such branches as separate entities with assets and liabilities separate from those of the foreign institution. The separation of "local" assets and their distribution to "local" creditors, *i.e.*, the separation of property and transactions conducted through the local branches from business activities conducted in other parts of the firm or group, thus facilitates the preferential treatment of local

[5] See Independent Commission on Banking, "Final Report – Recommendations" (September 2011, the "Vickers Report"), available online at https://www.gov.uk/government/policies/creating-stronger-and-safer-banks (last visited 20 June 2014). And see id., "Interim Report" (April 2011), available at http://webarchive.nationalarchives.gov.uk/20121204124254/http://www.hm-treasury.gov.uk/d/icb_interim_report_full_document.pdf.

[6] *Infra*, II. C.

[7] Hereafter, the focus will be exclusively on a comparison of reforms implemented, or initiated, in the United States of America and Europe. While a number of other, structurally different but functionally related concepts are discussed in the international debate, such alternatives are beyond the scope of the present paper. For further discussion of such models, e.g., those promoting the creation of "narrow," or "utility" banks, see generally Julian T.S. Chow and Jay Surti, "Making Banks Safer: Can Volcker and Vickers Do It?, IMF Working Paper WP/11/236 (2011), available at https://www.imf.org/external/pubs/ft/wp/2011/wp11236.pdf.

creditors over creditors of the same legal entity who have contracted with the firm in other jurisdictions.[8] In practice, this essentially amounts to a strict denial of cooperation with home country supervisory or resolution authorities, administrators or liquidators appointed under home country legislation, whatever powers such actors may enjoy under that legislation. If the home country regime provides for the entity-wide equal treatment of all creditors, irrespective of domicile and the law applicable to their individual relationship to the insolvent firm, the ring-fencing of assets located in a specific host country runs counter to that guiding principle. This may come with potentially drastic economic consequences for creditors of the company elsewhere, and indeed for the management of insolvency proceedings as a whole, if the respective branch holds sizeable assets which, as a consequence of ring-fencing, are no longer available for distribution in the main insolvency proceedings run abroad.

The application of this approach first attracted a broader attention among regulators and standard-setters world-wide in the context of the infamous collapse of the global operations of *Bank of Credit and Commerce International SA (BCCI)*, a Luxemburg-based international bank holding with operations, branches and subsidiaries in 78 countries. The holding and group became insolvent in 1991 and were liquidated in a globally coordinated but still inevitably haphazard and protracted effort.[9] The complexity of the global unwinding of the bank's operations, as well as the repercussions on regional and global markets, brought to light not just the absence of any form of universally agreed legal standards and frameworks for the cooperation of home and host country authorities in the insolvency of multinational banks. More specifically, it also highlighted the consequences of host countries applying the ring-fencing approach in such contexts, which, for example, US regulatory authorities did with regard to the local outfits of *BCCI* in New York and California, making use of their statutory powers under the New York Banking Law[10] and the Californian Financial Code[11], respectively.[12] In a report on lessons learnt from the *BCCI* case released by the Basel Committee on Banking Supervision, the broader implications of this approach was succinctly summarised as follows:

[8] *Cf.*, e.g., Eva Hüpkes, *The Legal Aspects of Bank Insolvency* (2000), p. 143; see also Basel Committee on Banking *Supervision*, "The Insolvency Liquidation of a Multinational Bank" (December 1992), available from http://www.bis.org/publ/bcbs10c.pdf; Basel Committee on Banking Supervision, "Report and Recommendations of the Cross-Border Bank Resolution Group" (2010), available at www.bis.org/publ/bcbs169.pdf, at p. 16.

[9] See generally, e.g., Basel Committee, *supra* n. 8; Brian Quinn, Robert M. Morgenthau and Lord Thomas Bingham, "Banking supervision after BCCI", in: *The Emerging Framework of Financial Regulation* (Charles A. E. Goodhart ed., 2000), p. 445. On the events leading to the insolvency in this case, and on frictions between home and host country supervisory authorities in this respect, see "Return to an Address of the Honourable the House of Commons dated 22 October 1992 for the Inquiry into the Supervision of The Bank of Credit and Commerce International", Cmnd. 198.

[10] See N.Y. [Banking] Law § 606(4).

[11] See Cal. [Financial] Code §§ 1810, 1811(g)-(h).

[12] See, for further discussion, Hüpkes, *supra* n. 8, pp. 143-4.

> "The separate-entity doctrine is followed in the United States. Under this doctrine each branch or agency (branch) of a foreign bank operating in the United States is treated as a separately incorporated legal entity for some purposes. In the event of a liquidation of a foreign bank with a US branch, the branch would be liquidated separately from the entity as a whole. Creditors of a US branch would be paid from the assets of that branch and other assets of the bank in the jurisdiction. The US liquidator would marshal not only the assets of the branch worldwide but all assets of the bank in the United States. If the assets of the branch were insufficient, the creditors of that branch might be able to prove their claims in other jurisdictions. Creditors of other branches could not participate in the US liquidation."[13]

The doctrine is clearly motivated by concerns about the position of local creditors of foreign banks, who might be confronted with legal and logistical problems when forced to file, and potentially to defend, their claims in insolvency proceedings abroad. At the same time, ring-fencing in this sense also allows host country authorities to balance out potential weaknesses of home country authorities in terms of both the on-going supervision and their willingness to act promptly and decisively in the event of financial problems occurring within the firms under their supervision. In particular, home country authorities may be found to adopt a lenient approach in order not to compromise interests originating in their home turf, and pay less regard to interests of foreign stakeholders, to whom they are neither directly nor indirectly accountable.[14] In such cases, ring-fencing by host country authorities can operate so as to reduce the externalities for local constituents. In other words, the concept reflects – at least to some extent, understandable and legitimate – reservations with regard to a lack of protection for local constituents. These are directly attributable to shortcomings of the prevailing concept of home-country supervision as the internationally accepted standard for the delineation of regulatory and supervisory powers for local depositors and markets, which has been promoted as international "best practice" on the initiative of the Basel Committee on Banking Supervision since the 1980s,[15] and also has been implemented, by a series of consecutive directives since

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[13] Basel Committee, *supra* n. 8, p. 2.

[14] *Cf.*, e.g., Joseph D. Gatto, "Branches, Subsidiaries and Foreign Bank Insolvency," 7 *J. Comp. & Cap. Markets L.* 173 (1985) p. 182 (expressing characteristic concerns that the submission to a single-entity approach "would put U.S. depositors at the mercy of a potentially hostile foreign receiver); and see Hüpkes, *supra* n. 8, p. 144.

[15] Starting with the first Basel "Concordat" in 1983, the Basel Committee developed the concept and an increasingly complex set of recommendations on conditions for its effective implementation through a series of documents over time. See, e.g., Michael Gruson and Wolfgang Feuring, "Convergence of Bank Prudential Supervision Standards and Practices Within the European Community", in: *Bank Regulation and Supervision in the 1990s* (Joseph J. Norton, ed., 1991), pp. 45 et seq.; Joseph J. Norton, *Devising International Bank Supervisory Standards* (1995), pp. 122-46 (Europe); George A. Walker, *International Banking Regulation – Law, Policy and Practice* (2001), pp. 83-131; see also (recounting the negotiations within the Basel Committee that led up to the 1983 Concordat) Charles Goodhart, *The Basel Committee on Banking Supervision – A History of the Early Years* 1974-1997 (2011), pp. 96-126.

the Second Banking Law Directive of 1989, as a guiding principle for the allocation of responsibilities for the supervision of cross-border activities within Europe.[16] Finally, ring-fencing in this form has also been justified on the grounds that it fosters healthy competition among the respective (home and host country) authorities, by improving incentives for ongoing effective monitoring of their respective turfs and reducing incentives for forbearance in view of financial problems.[17]

While the BCCI case has illustrated the advantages of ring-fencing for host country authorities,[18] it has also highlighted significant drawbacks of the concept, however. The separate treatment of foreign-owned branches obviously runs counter to the smooth, coordinated treatment of multinational banks in distress. By ranking the economic interests of host country creditors above those of creditors elsewhere, it also provokes conflicts between different groups of stakeholders in insolvency, which in turn may have an adverse bearing both on the smooth implementation of liquidation or administration and, to the extent that the resulting unequal treatment of creditors in the same rank causes unanticipated losses, indeed on the stability of local and global markets. Against this backdrop, regulatory ring-fencing of the sort

[16] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, OJ L 386 p. 1. This instrument was substituted by Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126 p. 1, which in turn was superseded by Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ L 177 p. 1. The present regime has been established by Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176 p. 338, and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176 p. 1. Under this new framework, the principle of home-country supervision is now stipulated by article 49 of Directive 2013/36/EU, while the "European Passport" principle is set out by the provisions of Title V (articles 35-43) of that instrument. See generally, e.g., Lisa Dragomir, *European Prudential Banking Regulation and Supervision* (2010), pp. 76-8, 165-81; Christos Gortsos, *Fundamentals of Public International Financial Law* (2012), pp. 238-43; Roel Theissen, *EU Banking Supervision* (2013), pp. 32, 41, 200-3.

[17] Ernest T. Patrikis, "Role and Functions of Authorities: Supervision, Insolvency Preventive and Liquidation", in: *International Bank Insolvencies: A Central Bank Perspective* 283, 290 (M. Giovanoli and G. Heinrich, eds., 1999); discussed critically by Hüpkes, *supra* n. 8, p. 144.

[18] See, e.g., Statement by Ernest T. Patrikis, then First Vice President, Federal Reserve Bank of New York, in: Group of Thirty, *International Insolvencies in the Financial Sector, A Study Group Report* (1998), p. 87:

> "BCCI presented a complex cross-border insolvency. What would you do if you were a host-country supervisor facing such an event? I would wager that you would do your best to ensure that the branch had sufficient assets to cover its liabilities to unaffiliated persons. You would do this by requiring the office subject to your jurisdiction to maintain assets exceeding liabilities in your jurisdiction. (…) When the bank closed, you would hope to have sufficient assets to pay creditors of local offices. Is that fair? In a bank bankruptcy, not all liquidators will be in a position to pay creditors of local offices. Is it not fairer to combine all assets and have a single, home-country liquidation? Perhaps, but the problem was that BCCI had branches in some countries where bank supervisory practices were lax and there would be a substantial shortfall of assets. For the United States, BCCI was the typical case. In recent years, no failure of a foreign bank has resulted in losses to creditors of the United States offices of the bank."

provided for under US American banking legislation[19] is even less cooperation-friendly than ancillary insolvency proceedings, which, in the context of international insolvency law, have come to be accepted if not as an optimal, but at least workable concept, with established and, by and large, universally agreed principles for mutual recognition and coordination with main proceedings.[20]

In view of these considerations, it is hardly surprising that this emanation of jurisdiction-oriented ring-fencing has met with severe criticism from academics, regulators and standard-setters, who strongly advocated improved international coordination along the principle of single-entity home-country responsibility for insolvency treatment, especially since the fallout of *BCCI* had drastically exposed the shortcomings of the territorialist approach in the early 1990s.[21] Not surprisingly, such criticism turned out to be particularly influential within the European Union, where the First and Second Banking Law Directives[22] had already paved the way for formalised cooperation between home country and host country authorities in the context for the ongoing supervision of banks. As a result, notwithstanding considerable controversy on technical solutions for the delineation of powers and conflicts-of-laws rules in cross-border insolvencies, Directive 2001/24/EC on the winding-up and reorganisation of credit institutions[23] was finally adopted as a corollary to the EC Insolvency Regulation[24], and as a functional substitute for the Regulation in the context of bank insolvencies.[25] By expressly allocating the responsibility for the reorganisation and liquidation of credit institutions to home country authorities[26], and by providing for the Community-wide immediate effect of reorganisation and liquidation measures,[27] the Directive ruled out the application of the separate-entity treatment of branches by home country authorities, be it in the form of formal ancillary insolvency proceedings (as allowed by the EC Insolvency Regulation[28]) or indeed in

[19] See again *supra*, nn. 10 and 11.

[20] See *supra*, n. 16 and accompanying text.

[21] See, characteristically, Group of 30, *supra* n. 17, p. 38; Hüpkes, *supra* n. 8, p. 144; see also Basel Committee on Banking Supervision, *supra* n. 8, at p. 9 (discussing the implications for insolvency management and possible remedies).

[22] First Council Directive of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking up and Pursuit of the Business of Credit Institutions (77/780/EEC), OJ L 322/30 (1977); Second Council Directive, *supra* n. 16.

[23] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, OJ L 125, 5 May 2001, p. 15.

[24] Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings OJ L 160/1 (2000).

[25] See generally, e.g., Gabriel Moss and Bob Wessels (eds.), *EU Banking and Insurance Insolvency* (2006); Georgina Peters, "Developments in the EU", in: *Cross-Border Bank Insolvency* (Rosa M. Lastra, ed., 2011), pp. 128-60.

[26] Directive 2001/24/EC, *supra* n. 23, arts. 3(1) (on reorganisation measures) and 9(1)(1) (on winding-up).

[27] Directive 2001/24/EC, *supra* n. 23, arts. 3(2) and 9(1)(2), respectively.

[28] Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160 p. 1.

the form of supervisory ring-fencing. Interestingly, the principle of mutual recognition was prescribed without substantive harmonisation with regard to the powers and procedures available to Member States' authorities.[29] The Directive thus left aside the question whether the established frameworks in the Member States would be adequate in terms of technical effectiveness and of their capacity to sufficiently guarantee the equal treatment of creditors in the relevant home and host countries. In this respect, the Directive prescribed only a few safeguards[30] that could be difficult to enforce especially in the context of non-court-administered, exclusively supervisory-led reorganisation or winding-up measures.

Arguably, given the lack of consensus both as to the policy objectives to be pursued by bank insolvency regimes, and as to the technical design of the framework (including mechanisms for cross-border cooperation between competent authorities and liquidators or administrators), the concepts of universality and single-entity resolution followed by Directive 2001/24/EC, modified only by some exceptions with regard to the law applicable to specific rights and contractual relationships,[31] certainly are not free from doubt.[32] Especially in the absence of binding legal arrangements for the cross-border cooperation of authorities in bank insolvencies, i.e., outside the territorial scope of the Directive, a skeptical approach by host-country supervisors preferring ring-fencing over reliance on the fair and effective management by foreign authorities could still be justified on the grounds of public policy concerns, irrespective of the potential systemic implications of the application of the separate-entity approach.[33] It remains to be seen whether or not the reluctance to submit to foreign-run insolvency resolution will decrease over time, in view of recent significant steps towards a greater substantive harmonisation of national bank resolution regimes that have been accomplished on the initiative of the Basel Committee[34] and the Financial Stability Board,[35] which have also influenced the har-

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[29] Cf. Directive 2001/24/EC, *supra* n. 23, preamble, recital 6: "The administrative or judicial authorities of the home Member State must have sole power to decide upon and to implement the reorganisation measures provided for in the law and practices in force in that Member State. Owing to the difficulty of harmonising Member States' laws and practices, it is necessary to establish mutual recognition by the Member States of the measures taken by each of them to restore to viability the credit institutions which it has authorised."

[30] See Directive 2001/24/EC, *supra* n. 23, articles 7 and 16 (right of creditors to lodge claims in reorganisation and winding-up measures, respectively); see also *ibid*., preamble, recitals 12 and 16 (stressing the equal treatment of creditors as a key objective of the Directive).

[31] See Directive 2001/24/EC, *supra* n. 23, Title IV.

[32] For further discussion, see Jens-Hinrich Binder, *Bankeninsolvenzen im Spannungsfeld zwischen Bankaufsichts- und Insolvenzrecht* (2005) (in German), pp. 697-711.

[33] For a similar conclusion, see also Rosa M. Lastra, "International Law Principles Applicable to Cross-Border Bank Insolvency," in: *Cross-Border Bank Insolvency*, supra n. 25, p. 161, at pp. 170-1; D'Hulster and Ötker-Robe, *supra* n. 4, pp. 4-5 (same).

[34] See, in particular, Basel Committee on Banking Supervision "Report and Recommendations of the Cross-border Bank Resolution Group" (March 2010), available at www.bis.org/publ/bcbs169.pdf.

[35] See Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (October 2011), available at www.financialstabilityboard.org/publications/r_111104cc.pdf.

monisation of national regimes in Europe by the recently adopted Bank Recovery and Resolution Directive (BRRD).[36]

To be sure, within Europe, the BRRD has not just introduced a consistent set of resolution tools for application in all Member States, but also significantly reinforced the framework for cross-border cooperation both within the EU and beyond.[37] Within Europe, group resolution efforts, as a rule, are to be coordinated by the consolidated group-level resolution authority, with only limited scope for independent resolution action by national resolution authorities for individual group companies.[38] Within this framework, *ad hoc* ring-fencing of assets by host authorities *ex post* are hardly conceivable. However, whether this will be sufficient so as to remove incentives for host authorities located in non-EU Third countries to protect their constituents by ring-fencing the domestic operations of branches or subsidiaries of EU banks probably will depend on their assessment of the potential implications of foreign insolvencies on their domestic markets. Representatives of US authorities have indicated that they may, over time, adjust past policies in this respect,[39] possibly reflecting a greater trust in the willingness, and ability, of foreign (home country) authorities to apply the same standards to US branches and their relationships to counterparties as they would vis-à-vis their regulatees in their home turf. On the other hand the Federal Reserve System, on the basis of § 165 of the Dodd-Frank Act of 2010,[40] has just established a highly comprehensive set of specific requirements for large foreign banks, including the requirement to concentrate all US operations under the roof of a domestic intermediate holding company, which clearly reflects the desire to secure full autonomy over resolution action and independence from policy choices made by the home authorities with regard to these operations.[41] At any rate, with substantial technical

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[36] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173 of 12 June 2014, p. 190.

[37] See BRRD, Titles V (on “Cross-border Group Resolution” within the EU) and VI (on “Relations with Third Countries”).

[38] See generally BRRD, articles 87 (general principles), 88 (resolution colleges), 91 and 92 (procedural and substantive requirements for resolution action in relation to groups); specifically on the conditions for independent action by host authorities in this context, see articles 91(8) and 92(4).

[39] E.g., Remarks by William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the 2013 Resolution Conference “Planning for the orderly resolution of a global systemically important bank,“ Washington DC, 18 October 2013 www.bis.org/review/r131021d.pdf (indicating that US authorities might be open to submit to greater international cooperation as a result of growing convergence of resolution approaches); speech by Jerome H. Powell, Member of the Board of Governors of the Federal Reserve System, at The University Club, New York, 2 July 2013, available at www.bis.org/review/r130703b.pdf (same).

[40] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[41] Cf. Federal Reserve System, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations (amending 12 CFR Part 252), Federal Register vol. 79 no. 59, p. 17241 (27 March 2014), at pp. 17268-17269 (stressing the need for independence, but noting that the regime was not inconsistent with ef-

problems ahead, the viable implementation of the new framework in the context of large, multinational banking groups presently seems far from guaranteed, however,[42] which again could undermine efforts to do away with protective *ex post* ring-fencing in insolvency for the time being. In this regard, the recent international work on harmonised requirements for total loss absorbing capacity with a view to ensuring the feasibility of bail-ins even in large, internationally active groups could prove particularly helpful, in that they could help to ensure that all group companies be funded in a way that would reduce the impact of insolvency on local stakeholders and thereby reduce the incentives of host authorities to resort to ring-fencing.[43]

B. "Ex ante" Ring-Fencing as a Prudential Tool to Control Risk Allocation in Banking Groups

1. The concept in the light of US regulatory practice

Ring-fencing upon insolvency works effectively in the interest of host-country creditors of a branch of an insolvent bank only if the assets held by that branch are sufficient to meet the relevant claims. *Ex post* ring-fencing by host-country authorities will therefore be preceded frequently by efforts to force branches of foreign institutions to hold, and retain, assets deemed sufficient to meet the claims of the creditors of that branch, which effectively restricts the ability of such branches to upstream financial and other resources to their headquarters, or indeed to other group companies, abroad.[44] In the United States, for example, *ex ante* ring-

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forts for global coordination of bank resolution). The final rule ("Rule YY") is set out from pp. 17315, the requirement for foreign banking organizations holding U.S. assets of USD 50 bn or more to establish an intermediate holding company is prescribed by §§ 252.150 and 252.153.

[42] See, for further discussion, Jens-Hinrich Binder, "Resolution Tools", Ch. 3, in: *Bank Recovery and Resolution in Europe: The BRRD in Context* (Jens-Hinrich Binder and Dalvinder Singh, eds., forthcoming 2015).

[43] See Financial Stability Board, 'Adequacy of loss-absorbing capacity of global systemically important banks in resolution. Consultative Document', 10 November 2014, available at www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf; see also Financial Stability Board, 'Structural Banking Reforms. Cross-border consistencies and global financial stability implications. Report to G20 Leaders for the November 2014 Summit', 27 October 2014, available at www.financialstabilityboard.org/publications/r_141027.pdf, pp. 7-8.

[44] For an early definition of ring-fencing that reflects this approach, see Inwon Song, "Foreign Bank Supervision and Challenges to Emerging Market Supervisors," IMF Working Paper WP/04/82, available at https://www.imf.org/external/pubs/ft/wp/2004/wp0482.pdf, p. 19:

> "'Ring-fencing' involves isolating the bank from other companies in the group by taking several actions, for instance by: (i) prohibiting or placing severe limits on the financial exposure of the bank vis-à-vis other companies in the group; (ii) restricting the volume of funding the bank receives from companies in the group; and (iii) ensuring that directors and management of the bank can operate the bank independently of the group management."

For a comparison of host country practices in this regard, see Katia D'Hulster, "Ring-Fencing Cross-Border Banks: How is it Done and How Important is it?" (2014), available at http://ssrn.com/abstract=2384905. And see, discussing both *ex ante* and *ex post* ring-fencing, Basel Committee, "Report and Recommendations of the Cross-Border Bank Resolution Group", *supra* n. 8, p. 16.

fencing to that end has been expressly recognised in state regulation for foreign banks,[45] and reportedly has been practised on a regular basis in order to prepare the grounds for *ex post* ring-fencing if the relevant institution became insolvent at a later stage.[46] As discussed above,[47] the recent introduction of special prudential requirements and the need to create intermediate bank holding companies for the domestic operations of large foreign-owned banking organisations in the United States is only the latest exemplare for the express recognition of the concept in modern US regulation.

2. Ex-ante ring-fencing and the European framework for banking regulation

Within Europe, by contrast, the picture is more complicated. Under existing EU banking regulations, Member States are free to prohibit the provision of banking services through branches only with regard to institutions from non-EU third countries, and to request such interested institutions to carry out their activities through subsidiaries instead, which would then have to be licensed as a separate institution in accordance with the harmonised prudential framework.[48] There presently appears to be a wide-spread tendency among Member States to make use of this discretion, which may be attributable to the lack of express ring-fencing provisions in relation to third country branches in many EU jurisdictions.[49] Changes to existing group structures may also be enforced as a result of the evaluation of recovery plans or the assessment of the resolvability of institutions and groups under the BRRD.[50] With regard to EU branches and subsidiaries of EU banks, by contrast, the situation is different. Conceptually, *ex ante* ring-fencing vis-à-vis branches or subsidiaries of institutions domiciled in other Member States is hard to defend on the grounds of the Treaty Freedoms of Establishment and Free Movement of Capital (articles 49 and 63 TFEU, respectively). When applied to branches of EU credit institutions, it also runs counter to the guiding principle of European banking regulation, namely the free pursuit of banking business by credit institutions duly licensed in one

[45] E.g., N.Y. [Banking] Law § 202-b; Cal. Financial Code § 1810.

[46] See, again, *supra*, n. 17 and accompanying text.

[47] *Supra*, nn. 40 and 41 and accompanying text.

[48] Cf. Directive 2013/36/EU, *supra* n. 16, article 47. See, generally, Theissen, *supra* n. 16, p. 276; Tobias H. Tröger, “Effective Supervision of Transnational Financial Institutions”, 48 *Tex. Int’l L.J.* 177 (2013), pp. 202-7.

[49] Theissen, *ibid.*

[50] See BRRD, articles 6(6)(2)(c), 7(2)-(4) (on recovery plans) and articles 17(5)(g) and (h) and 18 (on powers to address or remove impediments to resolvability). For further discussion on these powers, see Jens-Hinrich Binder, Resolution Planning and Structural Bank Reform within the Banking Union, Working Paper (December 2014), available at http://ssrn.com/abstract=2540038.

Member State through branches operating in all other Member States ("European Passport").[51]

Consequently, the present Union law framework for prudential requirements does not provide for powers for host country authorities to require branches operating under a European Passport within their country to retain specific assets. In fact, article 17 of the new Capital Requirements Directive, or "CRD IV" (just as its predecessors) expressly prohibits the application of endowment capital charges to branches operating under the European Passport. Likewise, article 49(3) of the Directive expressly prohibits supervisory measures by host country authorities that would amount to a "discriminatory or restrictive treatment on the basis that an institution is authorised in another Member State". However, host country authorities reserve some information rights[52] and also retain the right to conduct independent assessment of the relevant credit institution's compliance with applicable EU regulations. If they conclude that the relevant institution is in breach of applicable law, however, they may not act independently but are required to collaborate with host country authorities in order to remedy the deficiencies.[53] Only in exceptional circumstances, and only as long as, and to the extent that, home country authorities do not react in order to resolve the problems themselves, host country authorities have the power to impose precautionary measures in order "to protect against financial instability that would seriously threaten the collective interests of depositors, investors and clients in the host Member State."[54]

Pending further cooperation with regard to liquidity ratios, host country authorities to date also retain the power to supervise the liquidity position of branches of EU institutions domiciled within their territory.[55] While this may not be used in a discriminative way merely on the grounds that the institution is located in another Member State,[56] it appears that such powers could nonetheless be used, for the time being, as a legal basis for a limited form of *ex ante* ring-fencing.[57] Under CRD IV, however, such powers have only been granted until the new harmonised framework on liquidity requirements will have been adopted pursuant to article 460 of the Capital Requirements Regulation (EU) no. 575/2013, or "CRR," by 1 January

[51] Directive 2013/36/EU, *supra* n. 16, articles 35-43; for further discussion, see *supra*, nn. 15 and 16 and accompanying text.

[52] Directive 2013/36/EU, *supra* n. 16, article 40.

[53] *Ibid.*, article 41.

[54] *Ibid.*, article 43.

[55] *Ibid.*, article 156(1).

[56] *Ibid.*, article 156(3).

[57] Cf. Theissen, *supra* n. 16, p. 591 (on the previous EU law framework).

2015, from which time the normal delineation of powers between home and host country authorities will apply also to this field.[58]

In sum, the EU framework for the prudential regulation of credit institutions leaves only limited space for the *ex ante* ring-fencing of assets in branches that are not domiciled in the home country. It is difficult to determine to what extent it has actually been practised by host country authorities, e.g., on the basis of the emergency powers for host countries under article 43 or the powers for liquidity supervision under article 156 of Directive 2013/36/EU, as there appears to be no empirical data on the application of such powers, and on host country policies to branches of foreign EU banks generally.[59]

3. Ring-fencing of subsidiaries and informal "subsidiarisation"

By comparison with host authorities' control of foreign-owned branches, national supervisory authorities generally enjoy a much higher degree of autonomy with regard to foreign-owned subsidiaries, which by definition are separate legal entities and thus require an individual banking licence to be issued by the competent ("host") authorities in the country of registration of the respective company. With regard to subsidiaries, "host" country authorities therefore have to make an independent assessment of the subsidiary's financial position and other prudential criteria anyhow, and are responsible for the on-going control of the subsidiary's business under their domestic regulatory framework. In principle, this also applies within the European Union, where the harmonised European framework provides for the consolidated application of capital (and in the future liquidity) requirements to the group as a whole, and where group supervisory responsibility is concentrated on the authorities responsible for the administration of the head institution of a group as lead supervisor.[60] In the absence of established rules on the treatment of group insolvencies, which could prevent the separate liquidation or reorganization of the subsidiary and force domestic authorities to coordinate their efforts with the authorities responsible for the parent and/or other group companies,[61] subsidiaries can be dealt with separately from the remainder of the group upon insolvency, which would give host country authorities full responsibility and control also at this stage.

[58] See Directive 2013/36/EU, *supra* n. 16, article 151(1).

[59] For further discussion, see Tröger, *supra* n. 48, p. 204.

[60] For details, see Directive 2013/36/EU, *supra* n. 16, Ch. 3, and Regulation (EU) No. 575/2013, *supra* n. 14, Ch. 2. See generally, Theissen, n. 16, pp. 248-58.

[61] On the status of global and European initiatives for the development of a legal framework for the international coordination of group insolvencies, see generally, e.g., Horst Eidenmüller and Tilmann Frobenius, "A New Approach to Regulating Group Insolvencies: 'Procedural Consolidation' in the Context of National and International Reform Proposals" (2013), available at http://ssrn.com/abstract=2258874.

Given their independent legal and regulatory status, the provision of banking services through subsidiaries could thus provide domestic stakeholders with a similar level of protection as would be achieved by *ex ante* and *ex post* ring-fencing of assets of foreign-owned branches. For reasons discussed further below,[62] however, this should not be misinterpreted as affording anything resembling full coverage against risks arising out of the subsidiaries' legal and/or commercial ties with the parent and/or other group companies. In fact, due to intra-group organisational and/or financial ties, even a solidly supervised subsidiary can victim to contagion spreading from problems in other group companies. Nonetheless, the comparative advantages of subsidiaries over branches from a host country perspective have not escaped the attention of academics and policymakers in recent years. Whether branches or subsidiaries are more attractive commercially, is certainly debatable, and may depend on a number of factors that differ from case to case.[63] Notwithstanding potential costs for institutions and groups in terms of reduced profitability, however, both international standards and policy-oriented academic analyses have advocated the forced transformation of branches into subsidiaries on the initiative of host country authorities as a possible way to contain the impact of failures on domestic stakeholders, and to expand domestic powers in particular with regard to entities whose activities are considered to be of significance for the stability of the domestic market as a whole.[64] In this light, the "subsidiarisation" of existing branches on the initiative of host country authorities thus can be qualified as a functional equivalent to both *ex ante* and *ex post* ring-fencing of branches. The recent move towards mandatory intermediate bank holding companies in the United States, discussed above,[65] provides yet another example in this respect.

In the context of European banking regulation, however, the Treaty Rights of Establishment and the Freedom of Movement of Capital certainly restrain host authorities' power to interfere with the organisational choices of banks and banking groups whose parent company is domiciled and duly licensed by another Member State. Just as its predecessor, the new framework for prudential supervision established by CRD IV and CRR does not provide a basis for the mandatory transformation of branches into subsidiaries on the initiative of either home or host countries. For branches considered by host countries as "significant" given their position in

[62] *Infra*, text accompanying nn. 87, 88.

[63] See generally Jonathan Fiechter et al., "Subsidiaries or Branches: Does One Size Fit All?", *IMF Staff Discussion Note*, 7 March 2011, available at www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf.

[64] E.g., Markus Brunnermeier et al., *The Fundamental Principles of Financial Regulation. Geneva Reports on the World Economy 11* (2009), pp. 28-9, 65. See also D'Hulster and Ötker-Robe, *supra* n. 4, pp. 9-14; Fiechter et al., *supra* n. 63, p. 16; Tröger, *supra* n. 48, pp. 198-9 (all discussing advantages to host countries in terms of more effective supervisory control, the protection against adverse external shocks, but also potential risks of greater fiscal exposure in the event of failure of a systemically important foreign-owned subsidiary when compared to the failure of foreign-owned branches). See also *infra*, n. 174 and accompanying text.

[65] *Supra*, nn. 40 and 41 and accompanying text.

the domestic market, a series of provisions in CRD IV[66] merely provide for increased cooperation between home and host countries, with a privileged access to information by the latter, but do not allow for any interference with the relevant institution's right to choose its own corporate structure and business model.

Neither can such power be derived from other legal instruments that have yet to enter into force. Whereas the BRRD expressly provides a mandate to require supervised institutions to remove obstacles to an effective resolution, which could also arise from complex corporate structures,[67] this power is reserved for competent home country authorities and may only be used with a view to improving the "resolvability" of institutions, not in order to protect stakeholders in host Member States by way of segregating and isolating the activities carried out and the assets held in these jurisdictions. Likewise, the recent Commission proposal for an EU regulation on matters of structural bank reform sets out a harmonised approach to the structural segregation of core and investment banking activities in sizeable, systemically relevant banks and financial institutions for preventive reasons,[68] but again will not provide host countries with a power to require the restructuring of local activities in the form of subsidiaries on their own initiative.

Especially in the light of these recently reformed regulatory powers to interfere with the corporate structure of banks and banking groups, the case for allowing additional, autonomous initiatives by Member States designed to accomplish the subsidiarisation of foreign-owned banking activities seems weak in relation to institutions domiciled in other EU Member States. Thus, the observation that "the main rule of the EU treaties and the CRD is and remains that the bank can choose the format in which it wants to access other markets (either through services, branches or subsidiaries)"[69] continues to apply also under the renewed legal framework established by CRD IV and CRR. While host country authorities could be tempted to nudge foreign banks into subsidiary structures rather than branches on an informal basis, such initiatives would conflict with the Treaty Right of Establishment and would therefore be difficult to defend legally.[70]

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[66] See CRD IV, articles 51, 114(1), 116(6), 117(1)(1)(a) and 158.

[67] BRRD, *supra* n. 36, article 17. The provision is embedded in the Directive's requirements on "recovery planning" by institutions and groups (articles 5-9) and "resolution planning" by resolution authorities (articles 10-14, see also article 15 which requires resolution authorities to carry out an assessment of each institution's resolvability). For further discussion, see Dalvinder Singh, "Crisis Prevention", Ch. 3, in: *Bank Recovery and Resolution in Europe: The BRRD in Context*, supra n. 42; Binder, *supra* n. 50.

[68] As to which, see *infra*, C. 2. c).

[69] Theissen, *supra* n. 15, p. 247.

[70] *Ibid.*

Similar considerations also apply to less intrusive forms of supervisory interference with intra-group financial relations. For example, in response to growing alertness as to the risks involved in cross-border failures of financial institutions and groups, some regulators appear to have turned to restricting upstream flows of capital in recent years, even if the transfer of liquid funds did not violate applicable capital regulations, including restrictions on intra-group loans. In Germany, for example, this reportedly happened in the case of upstream loans from *Hypovereinsbank AG*, a wholly owned subsidiary of Italian *Unicredito SA*. In this case, the EU Commission has initiated investigations against *BaFin*, the German authority responsible for the supervision of *Hypovereinsbank*, for an alleged infringement of the Treaty Right of Free Movement of Capital.[71] Even in the absence of explicit rules prohibiting such treatment in the existing legal framework for the regulation of foreign-owned subsidiaries whose parent company is domiciled in another EU Member State, its legitimacy would appear questionable in the light of the Treaty Freedoms for exactly the same reasons developed above with regard to mandatory "subsidiarisation." From an economic point of view, both types of regulatory action serve similar purposes and therefore must be evaluated against the same legal standard.

C. "Ring-Fencing" as a Tool for Structural Banking Reform

1. Activities-oriented ring-fencing of core banking functions: the UK approach

The most recent use of the term "ring-fencing", i.e., the mandatory segregation and isolation of specific business activities, has been coined in proposals released by the UK Independent Commission on Banking (the "Vickers Commission") in September 2011,[72] which were recently enacted in law by the Financial Services (Banking Reform) Act of 2013.[73] The objectives for the move towards a comprehensive structural reform of the UK banking system were defined as follows: to "reduce the probability and impact of systemic financial crises," to "maintain the efficient flow of credit to the real economy," and "to preserve the functioning of the payment system and guaranteed capital certainty and liquidity for small savers."[74]

Against this background, the Vickers Commission recommended the separation of specific "retail" banking activities, namely selected banking activities for individuals and small and

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[71] Cf., e.g., "EU-Kommission kritisiert BaFin", *Handelsblatt*, 3 January 2013, p. 32.

[72] See, for a brief analysis of the Report, Claire Chambers-Jones, "The Vickers Report", *Bus. L. Rev.* (2011), p. 280, and for in-depth discussion, John Armour, 'Structural Regulation of Banking', chapter █ of the present volume.

[73] See *supra*, *supra* n. 5 and accompanying text.

[74] Vickers Report, *supra* n. 5, p. 20; for a detailed analysis of these and other objectives see Armour, *supra* n. 72, at paras. █; see also Alan Bainbridge et al., 'The Banking Reform Act 2013', Compliance Officer Bulletin (2014), 1.

medium-sized enterprises, from other banking activities, and their transfer into a legally and economically separate subsidiary.[75] The subsidiary would be prohibited from pursuing other business, in particular wholesale and investment banking services, which might expose it to the risk of losses.[76] Moreover, the report recommended that all transactions between the ring-fenced entity and the remainder of the group be conducted on an arm's length basis, so as to protect the entity against contagion from risk affecting other parts of the group.[77] In particular, the ring-fenced bank was recommended to be organised in a way that would facilitate the effective isolation from the remainder of the group in both legal and organisational ways and without intra-group solvency support, so as to ensure the continuity of its activities even if other parts of the group became insolvent.[78]

The statutory framework for the implementation of the recommendations made by the Vickers Commission is now set out by Part 9B of the UK Financial Services and Markets Act 2000 ("FSMA 2000"), as introduced by the Financial Services (Banking Reform) Act 2013 and specified further by statutory instruments.[79] Instead of "retail" banking activities, as recommended by the Vickers Commission, the framework now provides for the isolation of "core" banking activities from other banking business. "Core services," which are to be singled out and to be conducted through "ring-fenced bodies", as defined by sections 142C(2) and 142A FSMA 2000, respectively, now include "(a) facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits; (b) facilities for withdrawing money or making payments from such account; [and] (c) overdraft facilities in connection with such an account." Specifically, the new framework applies to 'core deposits' as defined by the relevant statutory instrument.[80] Conceptually in line with the Vickers Report's recommendations, ring-fenced bodies will be prohibited from pursuing banking activities other than "core" activities and services, respectively, which has been specified further by delegated legislation.[81] These restrictions apply only to

[75] *Ibid.*, pp. 9-11, and, for detailed discussion, Part I Ch. 3, pp. 35-41.

[76] *Ibid.*, pp. 9-11 and, for detailed discussion, Part I Ch. 3, pp. 41-62.

[77] *Ibid.*, pp. 9-11 and, for detailed discussion, Part I Ch. 3, pp. 62-76.

[78] *Ibid.*, pp. 9-11, and, for detailed discussion, Part I Ch. 3, p. 67.

[79] See, in particular, The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014, S.I. 2014 No. 1960, and The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

[80] The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014, *supra* n. 79, paras 2(2), 9 and 10: accounts by individuals from EEA countries with less than GBP 250,000 or corporate persons with less than GBP 6.5 m annual turnover. For discussion of these criteria, see Armour, *supra* n. 72, para. █.

[81] See, for details, sections 142D-J FSMA 2000, as introduced by the Financial Services (Banking Reform) Act 2013 and The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order, *supra* n. 79. For a detailed discussion, see, e.g., Armour, *supra* n. 72, para. █; Alan Bainbridge et al., "The Banking Re-

large institutions, i.e., institutions with more than GPB 25 bn. of "core deposits".[82] As noted by John Armour, the UK approach is, in principle, purely entity-oriented in that it applies to ring-fenced bodies, which will be subject to restrictions on intra-group transactions pursuant to section 142H of the FMSA 2000, while the remainder of the group will be free to pursue the prohibited activities.[83]

Irrespective of its technical implications, which do not have to be explored any further for the purposes of the present paper, the concept underlying the reform is comparatively simple, especially when contrasted with the implementation of the US "Volcker Rule" and some aspects of the recent Commission proposal on structural banking reform in Europe which will be discussed below: Conceptually, ring-fencing in this respect is "entity based"[84] aims at protecting selected economic functions of banks that are deemed to be of particular importance to the economy from risks associated with other, less significant activities that used to be pursued by the same legal entity. By forcing banks to transfer these activities to separate legal entities and prohibiting these from pursuing more risky business, the reform is designed so as to limit that entity's risky activities and investments, and thereby to shield the entity against excessive risk taking.[85]

This approach has been criticised, *inter alia*, on the grounds of the resulting increase in transactional and operational costs and concentration risks that may follow from the restriction on diversification into markets other than the United Kingdom.[86] While these concerns relate to the potential economic costs of the new approach, the concept as such appears sufficiently clear cut so as to facilitate smooth implementation. Nonetheless, it yet remains to be seen whether the ring-fence can be established and upheld in a manner that ultimately succeeds in curbing the risk of intra-group contagion. It is worth noting, in this context, that the nature and dimension of such risk has been the subject of a considerable body of academic research on the risk profile of different types of organisational forms already prior to the global financial crisis.[87] Such research has at least highlighted some potential channels of contagion which

form Act 2013", *Compliance Officer Bulletin* (2014), 1; Alastair Hudson, "Banking regulation and the ring-fence", *Compliance Officer Bulletin* (2013), 1.

[82] The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014, *supra* n. 79, paras. 11 and 12.

[83] See Armour, *supra* n. 72, para. .

[84] Cf. Armour, ibid.

[85] Cf. Schwarcz, *supra* n. 1, p. 79.

[86] Cf. Charles A. E. Goodhart, "The Vickers Report: an assessment", *Law and Fin. Markets L. Rev.* (2012), 32; Armour, *supra* n. 72, para. ; see also Laurence J. Kotlikoff, 'The Vickers Commission's failure', VoxEU (26 October 2012), available at www.voxeu.org/article/vickers-commission-s-failure.

[87] See, for reviews of the legal and economic literature in this respect, Leonardo Gambacorta and Adrian van Rixtel, "Structural bank regulation initiatives: approaches and implications", *BIS Working Papers No.* 412 (April 2013), pp. 8-9, and, from a legal perspective, Panagiotis K. Staikouras, "Universal Banks, Universal Crises?

may be difficult to address by any form of structural reform short of the outright prohibition to pursue commercial and investment banking activities from within the same group of companies. Irrespective of existing *legal* barriers between the different group companies, irrespective of separate funding arrangements, and irrespective of the prohibition of intra-group transactions other than on an arm's length basis (which all may be difficult enough to prescribe and enforce), a separate legal entity within a group may still be depending on its reputational links with the remainder of the group. Assuming, for example, that the ring-fenced entity operates under the same or similar brand names and logos and marketing channels as other firms of the group, it may be difficult to isolate it regardless of separate funding arrangements because of reputational losses following financial problems in other parts of the firm or group.[88] These concerns have, of course, been addressed by the Vickers Report, but, on balance, were not considered as sufficiently strong as to justify an even stricter separation of business activities.[89]

It is certainly too early at the present stage to conclude with a comprehensive analysis of the more technical problems associated with ring-fencing along the lines recommended by the Vickers Commission and adopted by the reform Act of 2013. Likewise, the potential implications for both the ring-fenced entities and the remainder of the relevant groups in terms of long-term profitability, which in turn will directly affect the long-term sustainability of the reformed banking system as a whole, can hardly be evaluated on the basis of available evidence. In an impact assessment published alongside the draft Bill, the UK Treasury estimated the costs associated with the implementation of the new approach for the regulated industry to be in the area between GPB 2 and 5 bn. p.a. in direct costs, which would be followed by an expected reduction of the long-run GDP level of between 0.04% and 0.1% (equivalent to an average annual GDP cost of between GPB 0.4 bn and 1.1 bn p.a.).[90] Given the dimension of the reform and its impact on existing firms and groups of firms, and given, further, the complex trade-offs between implications for funding and profitability, such estimations obviously amount to little more than informed guesses. Within this paper, they certainly cannot be verified or falsified in substance, but the very existence of such uncertainties casts doubt on the underlying policy objectives.

Disentangling Myths from Realities in Quest of a New Regulatory and Supervisory Landscape", (2011) 11 *JCLS*, 139, pp. 152-6.

[88] *Ibid*., p. 155.

[89] Vickers Report, *supra* n. 5, pp. 63-4.

[90] HM Treasury, Department for Business Innovation and Skills, "Banking reform: A new structure for stability and growth", CM 8545 (February 2013), Annex A.1, p. 31, available at www.official-documents.gov.uk/document/cm85/8545/8545.pdf.

2. Ring-fencing of certain investment banking activities: USA and Continental Europe

a) USA: § 619 Dodd-Frank Act

As part of the comprehensive legislative response to perceived lessons learnt from the financial meltdown between 2007 and 2008, § 619 of the Dodd-Frank Act of 2010[91] essentially takes up a proposal for the segregation of retail and certain investment banking activities that had been formulated by former Federal Reserve Chairman Paul Volcker before.[92] The so-called "Volcker Rule", which has been implemented through secondary legislation agreed by various regulatory authorities in early 2014,[93] specifically aims at reducing contagion risk arising out of proprietary trading and banks' exposure to hedge funds or private equity funds.[94] In this respect, it takes up some features of the even more restrictive institutional separation between financial institutions involved in commercial banking and others engaged in investment banking and securities trading which had been in force until the US Banking Act of 1933 (known as the "Glass-Steagall Act")[95] was repealed by the 1999 Gramm-Leach-Bliley Act.[96] In general terms and subject to qualifications and exemptions, the Volcker Rule as adopted by Dodd-Frank prohibits any "banking entity" from engaging in proprietary trad-

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[91] *Supra* n. 40.

[92] See www.nytimes.com/2010/01/31/opinion/31volcker.html/?pagewanted=all; and see *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies before the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 2 (February 2, 2010) (testimony of the Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board). This concept was elaborated already by a G-30 committee under the chairmanship of Paul Volcker as early as January 2009, see Group of Thirty, Working Group on Financial Reform, *Financial Reform: A Framework for Financial Stability*, p. 28 (2009), available at http://www.group30.org/rpt_03.shtml. For a brief discussion of this background, see Julie A.D. Manasfi, "Systemic Risk and Dodd-Frank's Volcker Rule", 4 *Wm. & Mary Bus. L. Rev.* 181 (2013), pp. 196-7.

[93] See "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule" (hereafter: "Final Rule"), Federal Register Vol. 79 No. 21, 31 January 2014, pp. 5535-6076. The final version of the rule has been prepared on the basis of a report released by the Financial Stability Oversight Council [FSOC] on 18 January 2011, see FSOC, "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds", available at www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[94] See 12 U.S.C. § 1851(h)(4) (prohibition of proprietary trading) and § 1851(a)(1)(B) (prohibition on acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund). And see Final Rule, *supra* n. 93, Subpart B – "Proprietary Trading Restrictions". For a brief summary of the rule, see Patrick Doyle et al., "New 'Volcker Rule' to Impose Significant Restrictions on Banking Entities, Other Significant Financial Service Companies", 127 *Banking L.J.* 686 (2010); see also, for an extensive analysis, Charles K. Whitehead, "The Volcker Rule and Evolving Financial Markets", 1 *Harv. Bus. L. Rev.* 39 (2011).

[95] Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, 48 Stat. 162 (1933).

[96] Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act), Pub. L. 106–102, 113 Stat. 1338 (1999). On the historical links between the Glass-Steagall and Dodd-Frank legislation, see, e.g., Manasfi, *supra* n. 92, pp. 207-8; Charles A. Piasio, "It's complicated: Why the Volcker Rule is Unworkable", *43 Seton Hall L. Rev.* 737 (2013), pp. 741-4.

ing and from maintaining affiliations with private equity funds and hedge funds.[97] The term is defined so as to include FDIC-insured deposit taking institutions and their affiliates.[98] Unlike the UK approach, the Volcker Rule thus takes a group perspective.[99]

Throughout the preparatory works and the academic discussion of the Volcker Rule, the prohibition of proprietary trading has attracted particular attention, as a possible instrument to reduce prevailing incentives for banks to maximise their trading activities in the expection of profits that, if successful, would exceed traditional sources of income (e.g., fees or interest), and to reduce the corresponding direct exposure to the full economic risk of loss associated with such transactions.[100] In order to adequately capture those risks, proprietary trading has been defined rather comprehensively.[101] The range of application of the Volcker Rule thus defined has been found problematic from the start, inasmuch as it evidently includes not just "bright line" proprietary trading but also activities considered to be neither inherently risky nor otherwise harmful from a prudential point of view, including, *inter alia*, the acquisition or sale of securities or related instruments in the context of market-making activities on behalf of clients. For that reason, the Volcker Rule, by way of exemptions from the general rule, expressly designates a number of "permitted activities,"[102] including activities related to market-making.[103]

The scope of such exemptions has been criticised for a number of reasons, including alleged capture of policy-makers by interest groups from the regulated industries.[104] One of the most problematic aspects, however, has turned out to be the exact delineation of transactions that

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[97] See 12 U.S.C. § 1851(a).

[98] 12 U.S.C. § 1851(h)(1).

[99] Armour, *supra* n. 72, para. █.

[100] See generally, e.g., Onnig H. Dombalagian, "Proprietary Trading: Of Scourges, Scapegoats, and Scofflaws", 81 *U. Cin. L. Rev.* 387 (2012), pp. 391-8 (discussing various concerns both from a firm-oriented and a systemic perspective); Manasfi, *supra* n. 93, pp. 195-7 (analysing the rationale of the Volcker Rule against this background); Piasio, *supra* n. 96, pp. 746-53 (same).

[101] 12 U.S.C. § 1851(h)(4), defining the term as including

> "engaging as a principal for the trading account of the [entity] in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate [authority] may, by rule […] determine."

A trading account, in this context, is defined by 12 U.S.C. § 1851(h)(6) as

> "any account used for acquiring or taking positions in [relevant securities and instruments] 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), and any such other accounts as the [authority] may, by rule […] determine."

[102] See generally, 12 U.S.C. § 1851(d) and, for further discussion, Dombalagian, *supra* n. 100, pp. 401-2; FSOC, n. 93, at 18-25.

[103] 12 U.S.C. § 1851(d)(1)(B).

[104] See generally, Alison K. Gary, "Creating a Future Econimic Crisis: Political Failure and the Loopholes of the Volcker Rule", 90 *Or. L. Rev.* 1339 (2012).

have to be qualified as "proprietary trading" proper from exempted "permitted activities". By their very nature, at least some of the activities referred to in the general definition quoted above have to be qualified as "polyfunctional" in the sense that, depending largely on the bank's motives in each particular case, the same type of purchase or sale or related transaction can serve *either* (a) exclusively the relevant bank's interest, (b) exclusively the interest of a client on behalf of whom the bank engages in market-making transaction, *or* (c) both the interest of the bank and the client, e.g., when market-making transactions are entered into and executed in a way that generates profits in addition to the fee paid by the client. Thus, a given type of transaction as such may not conclusively support the determination whether or not a specific sale or purchase has to be treated as proprietary trading (prohibited), or rather as market-making (permitted).[105] These inherent difficulties have led the regulatory authorities to allow the development of quantitative metrics by the regulated institutions, which have to be designed so as to measure, in particular, the relative size and risk of market-making activities in comparison to proprietary trading proper. On the basis of these metrics, to be reported regularly by the industry in accordance with criteria to be defined by the competent regulatory authorities, the authorities are then required to carry out their own assessment for the purposes of the application of the Volcker Rule.[106]

Compared with the different forms of ring-fencing examined thus far, the concept of a mandatory segregation of certain types of investment banking activities implemented by the Volcker Rule stands out as far more complicated and, therefore, considerably more difficult to calibrate. Unlike the more traditional forms of *ex ante* and *ex post* ring fencing of domestic assets, but also in contrast to the modern UK-style ring-fence of a few selected activities, the separation of a broader range of activities from banks' business portfolios requires a careful definition of the relevant criteria that delineate prohibited from permissible activities. In this regard, polyfunctionality of certain types of transactions that are characteristically executed *both* in the context of proprietary trading proper *and* as part of legitimate market-making may pose insurmountable technical difficulties both for the legislative design and the enforcement of the new regime. Ultimately, this could have a negative bearing on the effectiveness of the entire concept.[107] These technical difficulties to differentiate between transactions are also reflective of a lack of empirical data on the relevance of proprietary trading in US banks and other fi-

[105] Cf., for further discussion, FSOC, *supra* n. 93, pp. 17-25; Chow and Surti, *supra* n. 7, pp. 20-1; Piasio, *supra* n. 96, pp. 761-6.

[106] See Final Rule, supra n. 93, §____.4(b) and explanatory notes, p. 5544; FSOC, supra n. 93, pp. 5, 31-2, 36-43; see also (for a discussion of merits and shortcomings of this approach) Chow and Surti, supra n. 7, pp. 20-1.

[107] See, for a more detailed analysis and review of the policy discussion in this respect, Piasio, n. 96 (advocating a more flexible, principles-based approach to calibration as an alternative to the prevailing metrics-based concept).

nancial institutions, which in turn has fuelled criticism of the very concept of ring-fencing proprietary trading activities in general.[108]

In conclusion, the success of the Volcker Rule as a regulatory tool to protect certain banking functions from the risk associated with more speculative activities appears to be even less certain than the prospects for effective ring-fencing of "core" banking activities in the United Kingdom. Both concepts are certainly related and can indeed be classified as functional substitutes, as both essentially aim at the protection of systemically important banking functions, thereby reducing the need for costly, taxpayer-funded bail-outs in the event of a crisis.[109] Just as in the UK, it remains to be seen whether or not the rule will have a positive impact in terms of greater sustainability of the business models of the relevant institutions. Given the lack of reliable data on the systemic implications of proprietary trading, however, the Volcker Rule rests on an even weaker conceptual basis. In this case, the uncertainties start already at the design level, with a highly complex combination of broadly defined legal categories and technical specifications in the form of metrics developed jointly by banks and regulators, whose reliability as a basis for a sound assessment of risk and for a clear-cut application of the rule is yet to be tested.

b) European Union

On the European Continent, the debate on the separation of banking functions has been triggered by recommendations of a panel of experts appointed in 2009 by the European Commission, which were promulgated in October 2013.[110] The panel, known as the "Liikanen Commission" after its chairman, Bank of Finland Governor Erkki Liikanen, examined in detail structural developments in the European banking markets in the run-up to the global financial crisis, as well as shortcomings in the regulatory framework in this context.[111] Comparing their findings, *inter alia*, with the approaches adopted by the Volcker Rule in the United States and recommended by the Vickers Commission in the United Kingdom,[112] the group advocated the structural separation of certain banking activities from deposit-taking, including, in particular, proprietary trading and the extension of credit to hedge funds, structured investment vehicles, and private equity funds, and the mandatory transfer of such activities to a separate "trading

[108] *Ibid.*, pp. 746-50; see also Manasfi, *supra* n. 92, pp. 208-11; but see, supporting the policy objectives, Dombalagian, n. 95, p. 388.

[109] See also Schwarcz, *supra* n. 1, pp. 78-81 (discussing both as emanations of the same principle).

[110] High-Level Expert Group on Reforming the Structure of the EU Banking Sector, "Final Report" (2012), available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf ("Liikanen Report").

[111] *Ibid.*, pp. 88-91.

[112] *Ibid.*, pp. 83-6.

entity" within the respective group. Both measures were to be made subject to quantitative thresholds, intended to focus the application to systemically important institutions, with smaller institutions to be exempted.[113] The recommendations were based on a broad analysis of large European banks' business activities in the run-up to the global financial crisis, with a focus on changes in the size and structure of banks' assets.[114] Among other findings, this revealed a significant increase in trading activities prior to the crisis.[115] The report also reviewed differences in post-crisis firm structures, business and funding models,[116] highlighting, *inter alia*, developments with regard to the balance-sheet position of "assets held for trading" and derivatives positions over time.[117]

The recommendations formulated by the Liikanen Report have been taken up, in part, by a Commission proposal for a Regulation "on structural measures improving the resilience of EU credit institutions," released on 29 January 2014,[118] on which political negotiations are still underway. Specifically, the proposal provides for the prohibition of proprietary trading[119] and specific transactions vis-à-vis certain types of investment funds, including hedge funds,[120] for credit institutions and group companies. This prohibition, as well as other restrictions envisaged by the proposal, shall apply exclusively to institutions that are either qualified as global systemically important institutions under article 131 of Directive 2013/36/EU[121], or to institutions which exceed specific quantitative thresholds defined on the basis of the Liikanen Report.[122] Under the proposed Regulation, market-making activities are differentiated from

[113] *Ibid.*, pp. 101-3.

[114] *Ibid.*, pp. 11-9.

[115] *Ibid.*, p. 15.

[116] *Ibid.*, pp. 33-57.

[117] *Ibid.*, pp. 44-5. Note that these findings do not reveal a consistent trend across the sample, but point to different developments in many banks.

[118] Commission, Proposal for a Regulation of the European Parliament and the Council on structural measures improving the resilience of EU credit institutions, COM(2014) 43 final. For an introduction (in German), see Matthias Lehmann and Johannes Rehahn, 'Trennbanken nach Brüsseler Art: Der Kommissionsvorschlag vor dem Hintergrund nationaler Modelle', *WM Wertpapiermitteilungen – Zeitschrift für Wirtschafts- und Bankrecht* 68 (2014), 1793.

[119] *Ibid.*, article 6(1)(a).

[120] *Ibid.*, article 6(1)(b), pursuant to which a relevant institution shall not:

> "with its own capital or borrowed money and for the sole purpose of making a profit for own account: (i) acquire or retain units or shares of AIFs as defined by Article 4(1)(a) of Directive 2011/61/EU; (ii) invest in derivatives, certificates, indices or any other financial instrument the performance of which is linked to shares or units of AIFs; (iii) hold any units or shares in an entity that engages in proprietary trading or acquires units or shares in AIFs."

Note that this does not include the extension of guarantees and similar instruments in relation to the funding of such vehicles. This falls short of the restrictions laid down in a similar provision in § 3(2) sentence 2 no. 2 of the German Banking Act *[Kreditwesengesetz]*, on which see further below text accompanying nn. 141-145.

[121] Commission proposal, *supra* n. 118, article 3(1)(a); for Directive 2013/36/EU, see *supra* n. 16.

[122] See *ibid.*, article 3(1)(b), referring to

"proprietary trading."[123] Along with other "trading activities",[124] however, market-making activities will be subject to review by competent authorities. Using a rather complex set of metrics,[125] the authorities may then require the relevant institutions to separate these activities from core banking functions as well, and to transfer them to a separate entity within the group, which itself will be suject to a set of qualitative criteria designed so as to prevent intra-group contagion.[126] Strikingly, the methodology on which relevant trading activities shall be calculated is not defined by the proposed Regulation itself. Instead, the proposal suggests that they be specified by way of technical regulatory standards developed by the European Bank-

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> "any of the following entities that for a period of three consecutive years has total assets amounting at least to EUR 30 billion and has trading activities amounting at least to EUR 70 billion or 10 per cent of its total assets: (i) any credit institution established in the Union which is neither a parent undertaking nor a subsidiary, including all its branches irrespective of where they are located; (ii) an EU parent, including all branches and subsidiaries irrespective of where they are located, where one of the group entities is a credit institution established in the Union; (iii) EU branches of credit institutions established in third countries."

[123] *Ibid.*, p. 8:

> "It is difficult to define proprietary trading and distinguish it from market-making. According to Article 5(4), which defines proprietary trading narrowly, desks', units', divisions' or individual traders' activities specifically dedicated to taking positions for making a profit for own account, without any connection to client activity or hedging the entity's risk, would be prohibited."

See also similar considerations expressed *ibid.*, preamble, recital 16, and the proposed technical definition for market-making in article 5 no. 12, whereby "market making" is defined as

> "a financial institution's commitment to provide market liquidity on a regular and on-going basis, by posting two-way quotes with regard to a certain financial instrument, or as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade, but in both cases without being exposed to material market risk."

By contrast, "proprietary trading" is defined by article 5 no. 4 as

> "using own capital or borrowed money to take positions in any type of transaction to purchase, sell or otherwise acquire or dispose of any financial instrument or commodities for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity or for the purpose of hedging the entity's risk as result of actual or anticipated client activity, through the use of desks, units, divisions or individual traders specifically dedicated to such position taking and profit making, including through dedicated web-based proprietary trading platforms."

[124] As defined *ibid.*, article 8(1).

[125] *Ibid.*, article 9(2):

> "When performing the assessment referred to in paragraph 1, the competent authority shall use the following metrics: (a) the relative size of trading assets, as measured by trading assets divided by total assets; (b) the leverage of trading assets as measured by trading assets divided by core Tier 1 capital; (c) the relative importance of counterparty credit risk, as measured by the fair value of derivatives divided by total trading assets; (d) the relative complexity of trading derivatives, as measured by level 2 and 3 trading derivatives assets divided by trading derivatives and by trading assets; (e) the relative profitability of trading income, as measured by trading income divided by total net income; (f) the relative importance of market risk, as measured by computing the difference between trading assets and liabilities in absolute value and dividing it by the simple average between trading assets and trading liabilities; (g) the interconnectedness, as measured by the methodology referred to in Article 131(18) of Directive 2013/36/EU; (h) credit and liquidity risk arising from commitments and guarantees provided by the core credit institution."

[126] For details, see *ibid.*, articles 10-21.

ing Authority,[127] which is questionable given the relevance for the definition of the scope of application of the entire Regulation.

As has been rightly observed, the concept effectively amounts to "ring-fencing to limit firms – in this case, deposit-taking institutions – from engaging in risky activities and making risky investments, similar to the goals of the Volcker Rule and the Vickers Report."[128] Conceptually, it is much closer to the Volcker rule. Just like the US model (as adopted by the Dodd-Frank Act), the proposed Regulation aims at the segregation of risky activities, in particular, proprietary trading, at the group level rather than protecting specific "core" functions by isolating these from the remaining portfolio. It is also clearly based on the assumption that "proprietary trading" and "market-making" are sufficiently distinguishable so as to permit effective implementation and enforcement of the regime in practice. As discussed above, this may prove rather optimistic given the necessity to rely exclusively on *subjective* criteria.[129] Again, just as the Volcker rule in the context of the US market, the development of workable criteria in this respect, which under the Commission proposal would fall largely to technical regulatory standards that shall be drafted by the European Banking Authority and submitted to the Commission,[130] will be complicated further by the absence of reliable empirical data on the relative importance of proprietary trading and market-making activities of relevant institutions in Europe. This is acknowledged explicitly by the Commission proposal itself, which is based on purely anecdotal evidence in this respect.[131]

Significantly, the concept is structurally incompatible with the recent UK reform. This has, in fact, led the Commission to provide for the express derogation from all provisions on the separation of trading activities under Chapter III of the proposed Regulation, which will be granted,

> "[a]t the request of a Member State (…) to a credit institution taking deposits from individuals and SMEs that are subject to national primary legislation adopted before 29

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[127] *Ibid.*, article 23.

[128] Schwarcz, *supra* n. 1, p. 81.

[129] See the wording of the definition of "proprietary trading" as set out by article 5 no. 4 of the Commission proposal, cited *infra*, n. 123 (requiring that relevant transactions be entered into "for the *sole purpose* of making a profit for own account" [emphasis added]).

[130] See *ibid.*, article 23.

[131] *Ibid.*, p. 7:

> "While consistent data at Union level with regard to specific banking activity is scarce, available evidence suggests that proprietary trading represents a limited part of banks' balance sheets. […] However, the same evidence also highlights that such trading was significant prior to the crisis and, in the absence of regulatory intervention, there is no guarantee that it may not increase again in the future."

> January 2014 when the national legislation complies with the following [qualitative criteria].“[132]

While neither the proposed wording nor the explanations expressly refer to the United Kingdom, it is obvious both from the catalogue of qualitative criteria set out in article 21(1) and from the reference to 29 January 2014 as a deadline, that the provision is designed so as to facilitate the carve-out of UK banks from the core of the Regulation. If ultimately adopted, this would inevitably trigger regulatory competition between the United Kingdom on the one hand and the rest of Europe on the other. With the political negotiations in a very early stage, however, it is far from certain if this will become reality. Considerable opposition from other Member States, including France and Germany, on the grounds of an alleged distortion of competition, suggest that this may not be acceptable.

Such concerns are at least *prima facie* supported by obvious differences in the economic consequences associated with the respective approaches. These would indeed trigger significantly different implications on existing group structures and business models, which in turn could trigger significant differences in terms of implementation costs, funding models and, ultimately, the profitability of relevant institutions or groups. Should this scenario turn out to be true in the medium and long term, the resulting distortions would be hardly reconcilable with the need to ensure a level playing field for all market participants operating across the European Union, an objective which is enshrined in the Treaty provisions on the internal market and expressly recognised by the Commission Proposal itself.[133] Whether that will be the case is impossible to predict at the present stage, though, which again is attributable to the absence of reliable empirical data on the relevance of proprietary trading, market-making and the trade-off between different group structures, business models and profitability.

c) Autonomous structural banking reform in Belgium, France and Germany

Should the Regulation be eventually adopted, its implementation across Europe will not be made easier by the fact that a number of Continental European jurisdictions have already implemented autonomous versions of structural reforms in the meantime. Unlike the UK model, these are based broadly on the recommendations of the Liikanen commission, but nonetheless differ from the Commission proposal in a number of respects.

Belgium

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[132] Commission proposal, *supra* n. 118, article 21(1).

[133] *Ibid.*, article 1(d) (stressing the objective “to contribute to undistorted conditions of competition for all credit institutions within the internal market“).

In Belgium, the developments leading to the adoption of statutory provisions on the separation of certain banking activities started with a consultation process in the course of 2012, in which the Belgian central bank was commissioned by the government to develop recommendations for a structural banking reform within the country. Based on a comparative of events leading up to the global financial crisis, as well as of individual insolvencies in this context,[134] the central bank published its final report and recommendations in July 2013.[135] This process finally led to the adoption of certain provisions on the separation of deposit-taking and related activities from proprietary trading as part of the reformed Banking Law in 2014, which will enter into force on 1 January 2015. Under the new regime, subject to certain quantitative thresholds, activities prohibited for credit institutions and their subsidiaries will have to be transferred to a legally separate entity outside the scope of consolidation of the credit institution.[136]

France

In France, a reform project aiming at the structural reform of domestic credit institutions was initiated also in the course of 2012, and registered formally as a legislative project in December 2012.[137] The proposals were finally enacted in July 2013,[138] with the transfer of specific trading activities to separate entities within the group to be completed by 1 July 2015.[139] In principle just as under the new Belgian regime, prohibited trading activities, subject to quantitative thresholds to be specified by way of delegated legislation, will have to be transferred to separate trading entities within the same group of companies.[140]

Germany

[134] See Banque Nationale de Belgique, "Rapport intérimaire: Réformes bancaires structurelles en Belgique" (June 2012), available at www.bnb.be/doc/ts/Publications/NBBreport/2012/StructureleHervormingen_Fr.pdf.

[135] Banque Nationale de Belgique, "Réformes bancaires structurelles en Belgique: rapport final" (July 2013), available at www.bnb.be/doc/ts/publications/NBBReport/2013/StructuralBankingReformsFR.pdf.

[136] Loi relative au statut et au contrôle des établissements de crédit, 25 April 2014, Moniteur Belge Ed. 2, 7 June 2014, p. 36794, articles 117 (definitions), 119 (general prohibition), 120-125 (qualifications and exemptions), 126-127 (transfer to other entities).

[137] See Assemblée nationale, No. 566, "Projet de Loi de séparation et de régulation des activités bancaires, enregistré à la Présidence de l'Assemblée nationale le 19 décembre 2012". The legislative file, accompanied by a detailed impact assessment, is available via www.assemblee-nationale.fr/14/dossiers/separation_regulation_activites_bancaires.asp.

[138] Loi no. 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires, Journal Officiel de la République Française no. 0173 du 27 juillet 2013, p. 12530. For a short introduction, see Edouard Fernandez-Bollo, 'Structural reform and supervision of the banking sector in France', *OECD Journal: Financial Market Trends* (2013), available at http://dx.doi.org/10.1787/fmt-2013-5k41z8t3mrhg.

[139] *Ibid.*, articles 2 and 5.

[140] Code monétaire et financier, articles L511-47 et seq., as introduced by Loi no. 2013-672 (*supra*, n. 138), article 2.

In Germany, legislation providing for the separation of commercial and investment banking activities was introduced as a government bill in February 2012[141] and enacted in August 2013.[142] Under the new framework, credit institutions operating above specific quantitative thresholds are prohibited from engaging in proprietary trading (except with regard to, *inter alia*, transactions qualifying as market making or hedging transactions) and funding, through equity positions or by way of loans or guarantees, hedge funds and other alternative investment funds.[143] Below these thresholds, the supervisory authority retains the power to impose similar restrictions.[144] Prohibited transactions may instead be carried out through a legally and economically separate trading entity within the same group.[145]

Common features and differences

Comparing the Belgian, French and German reform proposals, a number of common features can be identified:

First, all three initiatives clearly reflect the Liikanen proposals and anticipate the concept of segregation of a specified range of higher-risk transactions that could become mandatory across Europe by virtue of the proposed Regulation.[146] Their focus is entity-oriented in principle, but prohibited activities may only be pursued out of group entities subject to specific requirements intended to insulate the remainder of the group from the relevant business risk. In this regard, they are clearly motivated by the political desire to preserve as many features of a universal banking system as possible, and thus reflect a broad consensus as to the comparative advantages of universal over narrow banking in Continental Europe.[147]

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[141] Bundesregierung, "Entwurf eines Gesetzes zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen", Bundesrats-Drucksache 94/13 of 8 February 2013.

[142] Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen, 7 August 2013, Bundesgesetzblatt Part I, p. 3090. For discussion, see, e.g., Tim Oliver Brandi and Konrad Gieseler, 'Entwurf des Trennbankengesetzes', *Der Betrieb* (2013), 741, 744-746; Sven Schelo and Andreas Steck, 'Das Trennbankengesetz: Prävention durch Bankentestamente und Risikoabschirmung', *ZBB Zeitschrift für Bankrecht und Bankbetrieb* (2013), 227, 236-244; Florian Möslein, 'Grundsatz- und Anwendungsfragen zur Spartentrennung nach dem sog. Trennbankengesetz', *BKR Zeitschrift für Bank- und Kapitalmarktrecht* (2013), 397.

[143] Kreditwesengesetz [Banking Act], § 3(2) as amended.

[144] *Ibid.*, § 3(4).

[145] *Ibid.*, §§ 3(4), 25f.

[146] Cf., for Belgium, Banque Nationale de Belgique, *supra* n. 135, at pp. 1-2, 7-8; for France, Assemblée nationale, *supra* n. 137, pp. 10-2; for Germany, government bill, *supra* n. 141, p. 2.

[147] See, pointedly, the French bill, Assemblée nationale, *supra* n. 137, p. 8 (arguing that the crisis as such did not undermine confidence in the merits of universal banking). And see the in-depth discussion of the implications of structural reform on existing business models based on the universal banking concept in Banque Nationale de Belgique, *supra* n. 135, pp. 11-2.

Secondly, all three reforms are, as a result, largely compatible with the concept underlying the Commission proposal, but a number of technical differences nonetheless exist. Whether such institutions could benefit from a carve-out under article 21 of the Commission proposal[148] is at least questionable given the present wording of that provision. This would depend on a detailed analysis of both the definition of prohibited activities and the technical requirements for the regulation of relevant trading entities under the applicable national law, which is beyond the scope of the present article. If they do not qualify in this respect, however, credit institutions which will become subject to one of the autonomous national regimes in the course of 2014 and 2015 could have to restructure some of their operations again once the proposed EU Regulation comes into force. This could expose such institutions to significant competitive disadvantages vis-à-vis their peers in other Member States which had not implemented structural reforms ahead of the enactment of the Regulation.

In particular, the three reform initiatives differ from the Commission proposal with regard to the delineation of proprietary trading and market-making activities. Just as the Commission proposal, all three reform initiatives acknowledge the need to facilitate the on-going provision of market-making by credit institutions as beneficial in macro-economic terms, and all three exempt market-making from the general prohibition. However, under the Belgian, French and German frameworks, the prohibition of proprietary trading is formulated in such terms as essentially qualify market-making, at least in part, as a sub-category to proprietary trading.[149] Notwithstanding the general exemption, the competent authorities in all three jurisdictions are then empowered also to prohibit the pursuit of market-making activities, if these are considered to be too significant given their relative importance within the relevant institution's overall portfolio.[150] While the Commission proposal, as discussed above,[151] is based on a seem-

[148] As to which see *supra*, text accompanying n. 132.

[149] Cf., for Belgium, Loi relative au statut et au contrôle des établissements de crédit, *supra* n. 136, article 121 § 1:

> "(…), l'interdiction prévue à l'article 119 [on proprietary trading] ne s'applique pas aux opérations sur instruments financiers qui font partie des activités suivantes (…): 2. les activités de tenue de marché (…)."

For France, cf. Code monétaire et financier, article L. 511-47 (as amended by Loi no. 2013-672, *supra* n. 138):

> "I. (…) il est interdit aux établissements de crédit, compagnies financières et compagnies financières holding mixtes (…) d'effectuer autrement que par l'intermediaire de filiales dédiées à ces activités les operations suivantes: 1. Les activités de négociation sur instruments financiers faisant intervenir leur compte propre, *à l'exception des activités relatives:* (…) d) *à la tenue de marché*." (emphasis added)

And see, for Germany, Kreditwesengesetz, supra n. 143, § 3(2)(2):

> "Nach Maßgabe von Satz 1 verbotene Geschäfte sind (…) 2. der Eigenhandel iSd § 1 Abs. 1a Satz 2 Nr. 4 Buchst. d *mit Ausnahme der Market-Making-Tätigkeiten* (…)." (emphasis added).

[150] See, for details, Loi relative au statut et au contrôle des établissements de crédit [Belgium], *supra* n. 136, article 123 (quantitative thresholds to be determined in delegated legislation); Code monétaire et financier as amended by Loi no. 2013-672 [France], *supra* n. 138, article L. 511-47 al. V; Kreditwesengesetz [Germany], supra n. 143, § 3(4).

ingly clear-cut definition of both categories which may be difficult to implement and enforce in practice, the alternative developed for the Belgian, French and German frameworks appears to be more flexible. While less rigourous conceptually at first sight, this could facilitate an evolutionary calibration of the general prohibition over time, which could be refined with growing understanding of the relevant portfolios on the basis of information that will be made available to the competent authorities in the course of implementation.

Thirdly, while all autonomous initiatives were associated with the implementation of preventive resolution planning requirements ahead of the BRRD,[152] they fail to take into account that the mandatory restructuring of existing groups and business models ideally should address both the containment of commercial risks associated with certain investment banking activities *and* problems of resolvability associated with opaque firm or group structures. To date, both objectives – enhanced resilience against trading risk on the one hand and improved resolvability on the other – have only insufficiently been coordinated and harmonised. Notably the French and the German legislative projects addressed resolution planning as a separate objective in addition to the preventive ring-fencing of certain types of investment banking activities, with little if any connection between the two aspects.[153] Both aspects were addressed in a more integrated way in the Belgian central bank's preparatory study,[154] but even the Belgian legislation fails to fully integrate the two aspects. In sum, none of the three initiatives have adopted a coordinated approach that would reconcile the containment of risks arising out of specific trading activities with the prevention of risks associated with complex or otherwise opaque group structures, whose removal is the key objective of preventive resolution planning prescribed by the BRRD.

This may also be attributable to the *fourth* feature common to all three initiatives, namely, again, the absence of reliable empirical evidence that could provide the basis for a sound analysis of costs and benefits of the individual projects. With the exception of the preparatory study presented by the Belgian central bank, which presents a more detailed breakdown of the relevant banks' balance sheets,[155] the evidential basis for the reform proposals appears to be

[151] *Supra*, n. 122 and accompanying text.

[152] As to which see *supra*, text accompanying n. 67. This context is clearly reflected in both the preparatory legislative work in all three jurisdictions, see, for Belgium, Banque Nationale de Belgique, *supra* n. 135, pp. 8, 13-6; for France, see Assemblée nationale, *supra* n. 137, 19-23; for Germany, government bill, *supra* n. 142, pp. 1-3.

[153] *Ibid.*

[154] Banque Nationale de Belgique, *ibid.*

[155] Banque Nationale de Belgique, interim report, *supra* n. 134, pp. 37-41.

weak.[156] Some impact studies also suggest specific price tags in terms of implementation costs and on-going costs.[157] However, given the far-reaching implications on existing group structures and ensuing potential implications on individual groups' and firms' profitability and, ultimately, financial stability as a whole, calculations that focus exclusively on a narrow range of microeconomic costs, e.g. implementation costs measured by the cost of setting up new trading entities within existing groups, arguably understate the impact.

D. COMPARISON AND CONSEQUENCES

At first sight, jurisdiction-oriented and activities-oriented concepts of ring-fencing have little in common: as little, indeed, as to cast doubt on the rationale for the denomination by the same term. Discussing all of them under the same heading *prima facie* could be criticised as confusing rather than convincing. In this light, given the obvious differences between concepts for the separation of assets along jurisdictional borders in insolvency on the one hand and the functional, economic and legal segregation of business activities for prudential reasons on the other, it is understandable that the discussion of "modern" forms of ring-fencing, aimed at the segregation of business activities, barely refers to the earlier forms, i.e. the forced *ex ante* pooling of assets and the *ex post* separation of insolvency liquidation along jurisdictional borders. In fact, with the academic debate concentrating increasingly on the various options for structural banking reform, and with growing international convergence on tools for the forced restructuring and resolution of banks and banking groups, traditional, jurisdiction-oriented rather than acitivity-oriented forms of ring-fencing, with few exceptions,[158] appear to be all but forgotten in the modern debate on structural banking reform.

However, the case for re-inclusion of such traditional emanations into the ongoing debate on regulatory reforms after the global financial crisis is stronger than would appear at first sight. There are, in fact, more features common to all forms of ring-fencing examined above besides merely the use as instruments to "reallocate and reduce risk more optimally, such as by protecting the firm's assets and operations and minimizing its internal and affiliate risk",[159] and

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[156] Neither the French nor the German proposals (*supra*, nn. 137 and 142, respectively) disclose relevant empirical data.

[157] See, e.g., the German legislative proposal, *supra* n. 141, p. 6 (quantifying costs for the creation of new trading entities in the amount of some 19.1 mio. Euro and unspecified on-going costs in the amount of 28.7 Euro); for the UK proposals, see *supra*, text accompanying n. 90. The French reform bill expressly declares estimations of costs to be impossible for the time being, see Assemblée nationale, *supra* n. 137, p. 17.

[158] But see, for a broader perspective, again Schwarcz, *supra* n. 1. See also UK Independent Commission on Banking, Interim Report, *supra* n. 5, p. 80 (discussing the move towards mandatory subsidiarisation as functional alternative to activities-oriented ring-fencing).

[159] Schwarcz, supra n. 1, p. 82 (footnote omitted).

besides their qualification as a "subset of economic regulation."[160] To be sure, in all different emanations, ring-fencing is employed in order to contain risks: risks associated with the economic implications of cross-border bank failures in the case of the more traditional forms of *ex ante* and *ex post* ring-fencing along territorial lines, and risks associated with specific types of investment banking activities, broadly defined as "proprietary trading," in the case of the more modern forms of comprehensive structural reforms of the banking systems of the United States and the European Union.

In addition, notwithstanding significant differences between the older forms of jurisdiction-oriented ring-fencing and modern activities-oriented models, all different concepts are closely related in functional terms, which is highlighted by a comparison of the traditional forms with the approach adopted in the United Kingdom: In both cases, the focus is on the protection of depositors' assets,[161] which are to be shielded, in the first case, against risk arising out of foreign-administered insolvency proceedings and, in the second case, against risks associated with specific forms of investment banking activities undertaken by their bank. In both cases, the risks that are addressed can be ultimately traced back to the relevant bank's own performance. Moreover, despite significant conceptual differences, all forms of ring-fencing seek to accomplish this objective through regulatory infringements of the relevant institutions' freedom of choice of corporate structure and business models. As a consequence, all forms of ring-fencing also need to address trade-offs between business organisation and profitability, and thus have to be evaluated against a common measure.

From an analytical point of view, the identical terminology therefore cannot be dismissed as purely accidental but is justified by functional similarities that indeed call for a broader conceptual approach and comprehensive analysis.[162] All different emanations of the underlying concept, the segregation of bundles of business relationships along territorial borders as well as the segregation of specific types of activities along business lines, reflect regulatory concerns about the complexity of modern, cross-border banking groups and their possible repercussions on financial stability in the relevant markets. Against this backdrop, the discussion on ring-fencing generally ought to bear in mind potentially conflicting national interests with respect to multinational groups – an issue which has been addressed by the literature on the

[160] *Ibid.*, p. 83.

[161] Cf. also Schwarcz, supra n. 1, p. 88 (analysing both forms as instruments to protect the interest of depositors).

[162] See also Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services, U.S. House of Representatives, Washington DC, 5 February 2014, available at http://www.bis.org/review/r140205b.pdf (discussing the similarity between the more traditional forms of separate treatment of branches of foreign banks and the modern concepts for the separation of business activities).

older forms of *ex ante* and *ex post* ring-fencing along territorial lines[163] but has not yet fully been acknowledged by the recent reform discussion. As a welcome step into the right direction, however, the Financial Stability Board, in a report on "Structural Banking Reforms", addressed to the November 2014 G 20 summit, for the first time expressly recognises the need for greater consistency in this respect and calls for future work towards this objective.[164]

In this light, "ring-fencing", for the purposes of the present paper, can be defined as a generic concept that involves the segregation of assets, liabilities, and/or business activities against specific risks, with a view to protecting markets and counterparties either directly or indirectly. From this functional perspective, the differences in scope reflect different levels of complexity in the design of the respective model rather than fundamental conceptual discrepancies. More specifically, the different models are reflective of a continuum of complexity in terms of (a) the underlying assessment of the risks that are to be addressed, (b) the degree of technical sophistication in design and, finally, (c) the (only partly foreseeable) implications and repercussions for the relevant banking systems as a whole.

Any analysis of ring-fencing thus ought to take into account potential trade-offs between complexity (of any of the categories thus specified) on the one hand and both the effectiveness of the respective regulatory strategy and the long-term implications for the industry and financial stability on the other hand. In this context, conceptual simplicity can facilitate the assessment of potential consequences, as it may be easier to analyse a concept that rests on a small number of assumptions and preconditions than a complex one, with numerous, potentially interdependent, requirements. However, technical simplicity does not necessarily correspond with reduced complexity in terms of long-term economic outcomes. For example, as has been discussed above, ring-fencing of "core" banking activities in the way recommended by the Vickers Commission and adopted by Parliament in the United Kingdom is less complex in terms of technical design than its counterparts in the United States of America and on the European continent. Nonetheless, in view of its drastic implications on existing market structures, the impact on long-term profitability of the UK banking sector as a whole could ultimately equal or even exceed the long-term implications of the more complex reforms adopted elsewhere.[165] On the other hand, a higher degree of sophistication as such does by no means guarantee a more precise calibration of long-term implications. In fact, the commercial implications asso-

[163] See *supra*, sections II. A. and B.

[164] Financial Stability Board, 'Structural Banking Reforms. Cross-border consistencies and global financial stability implications. Report to G20 Leaders for the November 2014 Summit', 27 October 2014, available at www.financialstabilityboard.org/publications/r_141027.pdf.

[165] See sources cited *supra*, n. 86. See also Chow and Surti, *supra* n. 7, pp. 27-30 (discussing the complex policy considerations to be considered in the context of the ring-fencing of "core" banking functions).

ciated with the more nuanced approaches to structural reform adopted in the United States and Continental Europe may, in the long run, turn out to be similarly far-reaching as the ones associated with the UK model, e.g. with regard to incentives for banks to transfer certain types of banking activities into the less regulated shadow banking sector, to which the ring-fenced banks may continue to be exposed through credit risk.[166] As has been argued with respect to the US Volcker Rule, but could well apply in general, this could include the provision of market-making services which, as a result of the close relation to prohibited activity of proprietary trading, could potentially become less profitable to the extent "polyfunctional" activities in the sense mentioned above will no longer be admissible. If this came true, the implications would probably not fall on the banking sector, but be felt as a burden on corporate finance more generally.[167] On the basis of available evidence, these different scenarios can neither be verified nor dismissed, but their very existence as object of concerns is certainly revealing of underlying weaknesses in terms of policy design.

As a matter of fact, the effective implementation of ring-fencing strategies by (national or supranational) regulatory authorities, like any other form of regulatory interference with markets by way of economic regulation,[168] can work effectively only if the regulator has a clear-cut understanding of (a) the risks to be addressed (i.e., the objectives to be pursued) and (b) the (unintended) side-effects that could be triggered (even involuntarily) by the proposed regulation. In this light, both the *ex ante* and *ex post* ring-fencing of assets located in domestic branches (or subsidiaries) of foreign-owned banks can be characterised not just as simple and, therefore, easy to implement, but also as comparatively straightforward in terms of the assessment of the costs involved. Past precedents, especially in the context of insolvencies of foreign banks dealt with under US American banking legislation, suggest that the key objective, i.e., the protection of local creditors from losses in connection with foreign-administered

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[166] See, e.g., Roel J. Theissen, *Are EU Banks Safe?* (2013), pp. 170-5 (reaching a similar conclusion); Whitehead, *supra* n. 94, at p. 46 (same).

[167] See Douglas J. Elliott and Christian Rauch, "Lessons from the Implementation of the Volcker Rule for Banking Structural Reform in the European Union", SAFE Policy Center White Paper Series No. 13 (2014), available at http://safe-frankfurt.de/uploads/media/Elliott_Rauch_Volcker_Rule_Lessons.pdf, pp. 6-7, arguing that:

> "(…) banks are believed likely to retreat from market making activities. (…) they will be unable to reap profits through speculative positions as part of the market making business. [This] can make an otherwise attractive business unprofitable, causing banks to give it up or drastically reduce their activities therein. This will lead to lower market liquidity, causing higher transaction costs, mispricing and higher risk premia which result in higher costs of capital for corporations. Market volatility will most likely increase as well."

See also, reaching similar conclusions, Darrell Duffie, "Market Making Under the Proposed Volcker Rule", Rock Center for Corporate Governance at Stanford University Working Paper No. 106 (2012), available at http://ssrn.com/abstract=1990472.

[168] On the need of a sound information basis as a precondition for effective regulation, see generally (in the context of corporate law) Jens-Hinrich Binder, *Regulierungsinstrumente und Regulierungsstrategien im Kapitalgesellschaftsrecht* (2012) (in German), pp. 290-3.

insolvency proceedings abroad, can be accomplished effectively, albeit at the price of disruptive effects on these proceedings. These may in turn come with repercussions on systemic stability, which may not be confined exclusively to the home markets of the relevant institution but affect other relevant markets too.[169]

To a lesser extent, similar considerations also apply to the *ex ante* ring-fencing of systemically important "core" banking functions along the lines recommended by the Vickers Commission. Unlike the more complex approach to ring-fencing adopted in the United States and by incoming legislation on the European Continent, the identification of those activities that are considered to be worthy of special protection is rather straightforward, in that it does not require the legislator or regulator to make prognoses as to the risk associated with other banking activities. By contrast, if a structural reform aims at a *positive* prohibition of certain types of activities that are considered to be risky, and especially if such prohibition is calibrated by way of references to quantitative thresholds, the effectiveness of the entire concept clearly rests on a precise assessment of the relevant risks which, given the apparent lack of empirical information mentioned above, may not realistically be feasible at least on the basis of available empirical evidence. In this respect, as has been mentioned before, the empirical findings that have been cited as supporting the more recent reform initiatives in both the United States and Europe are incomplete and do not fully appear to bear out the assumption that the transaction costs involved in sector-wide restructurings are actually merited by the expected gains in terms of enhanced resilience at the institution, group and system-wide levels. While there are ways to deal with the ensuing uncertainties in the design of regulatory responses,[170] such technical solutions can improve the practical manageability of the respective models and facilitate more consistent enforcement, but they do not remove the uncertainty with regard to the economic rationale and policy foundations as such.

III. Rationale, shortcomings and open questions: a menu of policy considerations

A. "Ex post" Ring-Fencing

To sum up the analysis, ring-fencing of assets along geographical and jurisdictional borders on an *ex post* basis presents the simplest case. As has been indicated above,[171] the separation

[169] See, for further discussion, *supra*, Section II. A.

[170] Contrast, again, the approach adopted by Continental European jurisdictions with regard to the delineation of market-making from proprietary trading (discussed *supra*, text accompanying n. 149) with the concept provided by the Commission proposal in this respect (*supra*, text accompanying n. 122).

[171] *Supra*, section II. A.

of foreign-owned branches or subsidiaries from insolvency proceedings initiated and administered from the firm's, or parent company's, home jurisdiction, can be qualified as a legitimate and indeed useful tool for host country authorities in settings where a reliable framework for the coordination of international insolvency procedures for credit institutions does not exist. Again as discussed before, the benefits in terms of effective protection for local constituents are as clearly established as the potentially detrimental repercussions on systemic stability which, in the case of branches of large institutions, ought to be considered also by host jurisdictions, as they could potentially backfire in the form of regional or indeed world-wide contagious effects. Within Europe, *ex post* ring-fencing is, as a rule, feasible only with regard to branches of Non-EU third countries and, pending harmonisation of the legal frameworks for group insolvencies, also for subsidiaries of EU banking or financial groups. With these restrictions in mind, it should be considered, in appropriate circumstances, as a "second best" (compared with the ideal of reliable, full coordination of home and host country measures), but nonetheless potentially viable policy option.[172]

B. "EX ANTE" RING-FENCING

With regard to the various forms of *ex ante* ring-fencing, the assessment is considerably more complicated. In this regard, the two basic models examined above,[173] i.e., ring-fencing of assets along geographical and jurisdictional lines on the one hand and ring-fencing of business activities on the other, clearly have to be differentiated.

For similar reasons to the ones developed above for *ex post* ring-fencing along jurisdictional borders, the imposition of a requirement on foreign-owned branches or subsidiaries to hold and retain specified amounts of assets can respond to legitimate concerns about the legal and commercial position of such local constituents in insolvency proceedings initiated and administered by foreign (home country) authorities. It is therefore hardly surprising that international standard-setting bodies have expressly encouraged *ex ante* ring-fencing in this sense,[174] although other papers released by the same actors – somewhat inconsistently – have expressed

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[172] For further discussion, see *supra*, text accompanying n. 33.

[173] *Supra*, section II. B.

[174] E.g., Basel Committee on Banking Supervision/Joint Forum on Financial Conglomerates, "The Supervision of Financial Conglomerates" (1999), available at www.bis.org/publ/bcbs47.pdf, p. 36; Basel Committee on Banking Supervision, "Supervisory Guidance on Dealing with Weak Banks", Report of the Task Force on Dealing with Weak Banks (2002), available at www.bis.org/publ/bcbs88.pdf, pp. 38-40, 51; Basel Committee on Banking Supervision, "Parallel-owned Banking Structures" (2003), available at www.bis.org/publ/bcbs94.pdf, pp. 4-6; but see, reflecting conflicting positions among ist members and presenting a more balanced assessment, Basel Committee on Banking Supervision, "Report and Recommendations of the Cross-Border Bank Resolution Group", *supra* n. 8, at pp. 5, 18-9, 30.

more reserved views with regard to the ring-fencing of local branches *ex post.*[175] In fact, as indicated above,[176] *ex ante* and *ex post* ring-fencing will often operate virtually hand in hand in the relevant settings, inasmuch as the preventive shielding of assets located within the reach of host authorities *ex ante* will facilitate the effective application of *ex post* ring-fencing once the relevant branch (or subsidiary) has reached the stage of insolvency.

As mentioned before, however, these advantages of *ex ante* ring-fencing ought to be assessed in light of evident drawbacks. *Ex post* ring-fencing violates the principle of *pari-passu* treatment of creditors in insolvency and could, if not anticipated by affected stakeholders in the relevant jurisdictions, wreak havoc to the orderly, coordinated unwinding of the operations of a multi-national banking business. Similarly, *ex ante* ring-fencing comes with potential costs in terms of reduced intra-group funding and ensuing reductions in the overall profitability of the firm or group.[177]

For jurisdictions differing in terms of regulatory policies and effectiveness of supervision, *ex ante* ring-fencing of capital and liquidity may thus continue to be an option. For the Eurozone, by contrast, the advent of the Banking Union, with the transfer of supervisory powers to the Single Supervisory Mechanism to the European Central Bank,[178] may mark the end of it, as the ECB will strive to apply and enforce a truly integrated, supra-national approach to the allocation of resources within banks and banking groups.[179] This may facilitate a more efficient use of the financial resources within the respective firms and groups,[180] but it clearly also removes a rather effective regulatory tool that, if used wisely, has the potential to contain the impact of insolvency in cases where neither the roots nor the administration of the crisis can be controlled by host country authorities. All in all, jurisdictional ex ante ring-fencing of foreign-owned banking operations may ultimately be superseded by more cooperative approaches if and to the extent that the adverse implications of insolvencies on host countries in

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[175] See *supra*, text accompanying n. 21.

[176] See again *supra,* text accompanying n. 44.

[177] See also (analysing the economic implications of jurisdiction-orientied ex ante ring-fencing) Eugenio Cerutti et al., 'Bankers Without Borders? Implications of Ring-Fencing for European Cross- Border Banks', IMF Working Paper WP/10/247 (2010), available at www.imf.org/external/pubs/ft/wp/2010/wp10247.pdf.

[178] See, generally, Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287 p. 63.

[179] *Cf.* speech by Mario Draghi, President of the European Central Bank, at the conference for the 20th anniversary of the establishment of the European Monetary Institute, Brussels, 12 February 2014, available at http://www.bis.org/review/r140213a.htm.

[180] *Cf. ibid.:* "Another benefit of the SSM – and perhaps a more important one – will be the lack of 'hidden barriers' to cross-border activity linked to national preferences. With a European supervisor, borders will not matter. Issues such as protecting national champions or supervisory ring-fencing of liquidity will not be relevant. This means that banks will be in a better position to achieve the economies of scale that were promised by the single financial market – and that they also need to be competitive at the global level."

cross-border groups are ultimately overcome. While it is too early to predict success in this regard, the recent progress in the development of globally agreed standards for total loss absorbing capacity in banks and banking groups[181] may bring all stakeholders closer to a solution in this regard.

By contrast, the case for business-oriented *ex ante* ring-fencing, i.e. the segregation of "core" banking functions from a specified range of investment banking activities, is considerably less clear-cut for the time being. Given the weak empirical basis, a reliable assessment of expected benefits and costs associated with the structural banking reforms that have been initiated in the United States, the United Kingdom, some Continental European Member States and at the EU level does not appear to be feasible at the present stage. To be sure, the findings of the Liikanen Report have revealed strikingly large proportions of "total assets held for trading" in relation to the amount of total assets for systemically relevant European banks.[182] This highlights a potential source of risk that could have the capacity to undermine the stability of the relevant institution and thus to jeopardise banking functions whose on-going provision are vital in macro-economic terms. To quantify this risk, however, and thus to estimate the expected benefits of activities-oriented structural reform would require additional analyses of the respective firm and group structures and business models, all of which influence the possible channels of intra-firm or intra-group contagion between commercial and investment banking activities. Moreover, as explained above,[183] the absence of sufficiently granular empirical evidence also hampers the technical design of ring-fencing regulations, in particular with regard to the delineation of prohibited proprietary trading from exempted market-making transactions.

C. TO RING-FENCE OR NOT, AND HOW? THE AGENDA AS OF MID 2014

Starting from these considerations, it is hardly possible, at the present point in time, to present a consistent assessment of the different reform initiatives, let alone policy recommendations that could assist the improvement of existing and the design of future structural reform projects. First and foremost, the findings reached above call for further research. More extensive and more granular data would be necessary to evaluate, in a meaningful way, the merits of the different concepts, and to discuss possible alternatives in terms of both regulatory objectives and technical solutions. As the various regulatory initiatives towards structural banking re-

[181] See *supra*, n. 43 and accompanying text.

[182] See, again, Liikanen report, *supra* n. 110, p. 44 and, for further discussion, *supra*, text accompanying nn. 114-117. And see Chow and Surti, *supra* n. 7, pp. 14-6 (discussing the empirical evidence from a comparative US/EU perspective).

[183] *Supra*, section I. D.

form examined above have been initiated without proper preparation in this respect,[184] there is an urgent need to remedy this deficiency by accelerating interdisciplinary analysis of a number of key aspects identified throughout the present paper.

This should, in particular, include the following:[185] (a) research into the structure of banks' trading activities, with a view to an improved understanding both of their relative size and the composition of relevant portfolios, which would facilitate a more precise calibration of the prohibition of specific types of activities and corresponding exemptions; (b) research into the sources of intra-firm and intra-group contagion, taking into account existing differences in corporate structures and business models, as well as existing legal and regulatory restraints on intra-group funding arrangements; (c) research into the merits and deficiencies of different forms of intra-group "insulation" against contagion (e.g., restrictions on funding arrangements, corporate governance-oriented restrictions on the exercise of control by parent companies) in relation to risk arising out of reputational links between group companies[186], and finally (d) research into the immediate and long-term costs of the different forms of structural reform available in terms of funding and reduced medium- and long-term profitability as a result from reduced diversification. If at all, the complex trade-offs that are likely to exist between those different determinants can only be explored, and quantified, on the basis of complex empirical research into the relevant institutions' balance sheets and off-balance sheet trading activities, which would depend on information that presently does not appear to be available with regard to any of the jurisdictions that have moved towards fundamental structural reforms of their banking systems. To be sure, given present restraints on available data, such research amounts to no less than a Herculean task, and, given the sensitive nature of the relevant information, in all likelihood will be possible only through joint efforts of national central banks. Absent such a foundation, however, a meaningful analysis of costs and benefits associated with the existing reform initiatives is not possible.

Irrespective of the prevailing uncertainty in terms of both policy objectives and technical design of regulatory frameworks, the findings developed in the present paper suggest that greater attention should be devoted, in this context, to the potential of jurisdiction-oriented ring-fencing as an alternative that would avoid the complexities inevitably associated with activities-oriented structural reform. Jurisdiction-oriented ring-fencing certainly has been demonstrated to conflict both with existing trends towards further coordination of supervisory

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[184] For a similar conclusion, see Florian Möslein, "Die Trennung von Wertpapier- und sonstigem Bankgeschäft: Trennbankensystem, ring-fencing und Volcker-Rule als Mittel zur Eindämmung systemischer Gefahren für das Finanzsystem", ORDO Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft 64 (2013), 349, at p. 369.,

[185] For a partly similar list of unresolved issues, see Gambacorta and van Rixtel, *supra* n. 87, pp. 4-5.

[186] As to which, see *supra*, text accompanying n. 88.

powers and, indeed, the Treaty Right of Establishment and the Freedom of Movement of Capital.[187] However, the analysis of traditional jurisdiction-oriented approaches both *ex ante* and *ex post* insolvency nonetheless reveals the potential of mandatory "regionalisation" of multi-national operations as a means to simplify group structures, which could facilitate an improved burden-sharing between home and host jurisdictions and, in turn, contain the impact of insolvencies on regional and indeed global financial stability.

In this light, the notion that smaller, independent, regionalised entities could be supervised and, ultimately, resolved more effectively than fully integrated multi-national groups should not be dismissed lightly in the on-going debate on structural bank reform. Despite growing international convergence in terms of substantive national legislation and procedural coordination of national resolution measures in recent years, the complexities associated with the resolution of large multi-national financial groups continue to be daunting,[188] given prevailing conflicts of economic interests between home and host countries as well as insufficient agreement on technical issues at least outside the European Union. At the least, such apparent advantages can be interpreted as advocating the re-inclusion of the more traditional forms of ring-fencing in the present debate.[189] It has been noted above that the existing reform initiatives both at the Member State and the EU level have thus far failed to dedicate sufficient attention to the coordination of activities-based structural reform with the move towards mandatory restructuring of firms and groups in the context of preventive recovery and resolution planning.[190] In the on-going debate on the proposed EU Regulation, both aspects should be addressed in a coordinated, integrated approach.[191]

Just as with activities-oriented ring-fencing, however, the possible advantages of increased regionalisation must be balanced against drawbacks in terms of long-term costs on the regulated industry and ensuing implications for long-term stability. As has been observed with regard to the mandatory subsidiarisation on the initiative of host-country authorities, regionalisation will come with costs in this respect.[192] These findings reinforce the need for further

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[187] *Supra*, section II. B. 2.

[188] See again *supra*, text accompanying n. 33.

[189] For a similar conclusion, see Schwarcz, *supra* n. 1, p. 96 (advocating the use of ring-fencing as an instrument to foster "modularity", i.e., the reduction of complexity in terms of group structures and business models, in the public interest).

[190] See *supra*, section II. D. While the Vickers Commission has reflected on these issues (see Independent Commission on Banking, Interim Report, *supra* n. 5, at p. 80), the considerations presented in this regard hardly reflect the relation to structural impediments to the "resolvability" of credit institutions.

[191] For similar considerations, cf. D'Hulster and Ötker-Robe, *supra* n. 4, pp. 10-3 (noting possible lines of future research in this regard).

[192] For further discussion, see Fiechter et al., *supra* n. 63, p. 16; Tröger, *supra* n. 48, pp. 178-80, 197-9 (discussing trade-offs between the organizational structure of firms and groups and profitability); cf. also Staikouras, *supra* n. 87, at pp. 156-61 (same).

interdisciplinary research that should include insights from corporate finance theory, corporate (group) law, insolvency law and conflicts of laws issues, all of which have a bearing on the risk profile associated with individual group structures, business models and funding arrangements both for the on-going prudential supervision and the resolution of multi-national banking groups.

IV. Conclusions

Starting from a historical comparison of the different concepts which have come to be referred to by the term over the years, the present article has developed a generic definition of ring-fencing as a regulatory strategy that involves the segregation of assets, liabilities, and/or business activities against specific risks, with a view to protecting markets and counterparties either directly or indirectly. Against this backdrop, it argues that differences between the various models exist with regard to their respective complexity rather than the underlying conceptual foundations. In this respect, the more recent developments examined in the present paper, unlike the earlier forms of ring-fencing, certainly cannot claim to be based on sound analyses of costs and benefits, and the benefits that are to be expected from their implementation are, at the present stage, far from clear. This is not to say that structural banking reform based on a segregation of "core" banking functions and certain investment banking activities, deemed to be both risky and socially less beneficial, could not be justified upon a more intensive analysis of the facts, which has not been presented so far. Given the significant costs associated with the implementation of the present initiatives and given the potential implications for the long-term profitability of the relevant markets, however, not just the banking industry itself may be forgiven to find this rather alarming.