House of Lords
House of Commons

Parliamentary Commission on Banking Standards

Proprietary trading

Third Report of Session 2012–13

HL Paper 138

HC 1034

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Report, together with formal minutes

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Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards is appointed by both Houses of Parliament to consider and report on professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process, lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy and to make recommendations for legislative and other action.

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Footnotes

In the footnotes of this Report, references indicated by 'Q' and followed by a question number refer to oral evidence taken by the Commission. Transcripts of this oral evidence and oral evidence taken by the Commission's panels are available at http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/publications/.

Contents

1 Introduction

1. The Parliamentary Commission on Banking Standards was established to examine the crisis of culture and standards in banking which has been exposed in recent times. The Commission was also asked to examine the Government's draft legislative proposals to bring about structural change in the UK banking sector to secure a greater degree of organisational separation between retail banking and investment banking. We discharged this last requirement in our First Report published on 21 December,[1] and in our more recent follow-up Report on the same subject.[2] We intend to report fully on the issues of culture and standards in our final Report later this Spring.

2. In the course of our consideration of the Government's structural proposals, we received evidence, most forcefully from Paul Volcker, the former Chairman of the US Federal Reserve, about the risks that could be posed to attempts to improve the culture and standards of banks through banks being able to undertake "proprietary trading"—a term whose meaning is explored in the next chapter. We noted in our First Report that there was:

> evidence to suggest that proprietary trading, which under the current proposals could still take place within the non-ring-fenced part of banking groups, is an activity which is incompatible with maintaining the required integrity of customer-facing banking and which could have harmful cultural effects if permitted to continue.[3]

We indicated our intention to take further evidence in the New Year on this matter.[4]

3. In preparing this Report, we have benefited from written evidence from major UK banks, from the Financial Services Authority (FSA) and from Finance Watch, a Europe-wide pressure group. We have also drawn upon oral evidence taken as part of our wider continuing work on banking culture and standards, most notably that from Sir John Vickers, who chaired the Independent Commission on Banking (ICB), from Martin Taylor and Bill Winters, who were members of the ICB, from individual banks, from Michael Cohrs of the Financial Policy Committee, from Lord Turner of Ecchinswell, the Chairman of the FSA, and from the Rt. Hon. George Osborne MP, the Chancellor of the Exchequer. We are most grateful to all those who assisted us in the course of work on this matter.

1 Parliamentary Commission on Banking Standards, First Report of Session 2012-13, *First Report*, HC 848/ HL 98 (hereafter cited as First Report)

2 Parliamentary Commission on Banking Standards, Second Report of Session 2012-13, *Banking reform: towards the right structure*, HC 1012/ HL 126 (hereafter cited as Second Report)

3 First Report, para 95

4 *Ibid*., para 96

2 What is proprietary trading?

4. The term "proprietary trading" when applied to a bank could in theory refer to any trading activity which results in a proprietary position for that bank—in other words, where price movements in the relevant market affect the bank's bottom line. However, such a definition would be so broad as to be effectively meaningless. As HSBC pointed out:

> Banks act as principal in virtually all transactions and therefore all market price movements accrue to the stated capital position of the bank either through the profit and loss account or directly to reserves in defined circumstances.[5]

5. Some witnesses proposed a more restrictive understanding of proprietary trading in order to focus on the activities of greatest concern. Lloyds said:

> We would define proprietary trading as the risking of a bank's own capital by taking positions in financial instruments in order to make gains from market movements, where such activities are speculative or run as a specific business with the sole aim of the bank making a profit for itself.[6]

RBS suggested that the defining characteristic of what they termed "pure" proprietary trading was that it was unrelated to any customer activity:

> If the bank is using its capital for its own account to generate profits (and risking taking losses) from illiquid inventory, disconnected from customer activity, then that is "pure" proprietary trading.[7]

6. This form of proprietary trading is the clearest expression of so-called "casino" banking, where traders are speculating on markets using the bank's capital and borrowed money, for no purpose other than to make a profit and without any connection to trading on behalf of customers. Prior to the financial crisis, many global banks explicitly engaged in this form of proprietary trading, setting up dedicated units or internal hedge funds. One of the best known examples was Goldman Sachs' "Principal Strategies" group, which was reported as accounting for 10 per cent of the bank's revenue before being shut down in response to the prospective Volcker rule.[8] UBS put significant capital into an internal hedge fund called "Dillon Reed" in 2005 in an attempt to stop star proprietary traders defecting to external funds.[9] Morgan Stanley wrote to shareholders in 2005 saying "we are employing more of our own equity capital to work in principal investing".[10] Citigroup shut its "Equity Principal Strategies" business which made proprietary trades only in 2012.[11]

5 Ev w12

6 Ev w17

7 Ev w20

8 "Goldman Sachs Said to Shut Principal Strategies Unit", *Bloomberg,* 4 September 2010, www.bloomberg.com

9 "UBS's Investment Bank Chief Costas to run Hedge Fund (Update10)", *Bloomberg,* 30 June 2005, www.bloomberg.com

10 "Letter to Shareholders", *Morgan Stanley,* 1 February 2006, www.morganstanley.com

11 "Citigroup Exits Proprietary Trading, Says Most of Unit's Workers to Leave", *Bloomberg,* 27 January 2012, www.bloomberg.com

7. However, even at the height of the boom, when banks were expanding their proprietary trading, many banks made only limited public disclosure about their proprietary trading activity, instead including it within reports about total trading revenues. It is therefore difficult accurately to gauge the scale of such trading. The trend towards dedicated proprietary trading units appeared to have been more a feature of US banks than UK-headquartered banks. Most UK banks did not mention proprietary trading in their public reports, and Bob Diamond, the then Chief Executive of Barclays of Barclays, claimed in 2010 that Barclays "closed down our proprietary trading in 1998".[12] RBS's 2007 report simply noted that

> The primary focus of the Group's trading activities is client facilitation [...] The Group also undertakes [...] proprietary activity—taking positions in financial instruments as principal in order to take advantage of anticipated market conditions."

8. Some banks suggested in evidence that it was dedicated proprietary trading units which should be the focus of attention. Lloyds said that pure proprietary trading "would typically be an activity that banking groups would undertake through a dedicated unit, segregated from client-facing business areas and often with segregated capital, limits and remuneration policies".[13] HSBC echoed this point,[14] while Barclays sought to distinguish proprietary trading conducted by stand-alone desks from two other forms of "beneficial" trading—namely market-making and risk-hedging.[15]

9. It is not the case that even "pure" proprietary trades can only arise if there is a stand-alone desk devoted to the activity. Parts of the bank which actively trade for other reasons, such as the market-making or risk-hedging activities mentioned by Barclays, could in theory use such activity as cover to engage in market speculation in pursuit of higher returns. For example, as HSBC and Standard Chartered pointed out, a market maker might legitimately choose to take a long position in an asset either in anticipation of client demand to allow the order to be fulfilled quickly, or to facilitate a quick sale by a client of an illiquid asset.[16] Expectations about the direction of the market price would quite reasonably factor into such a trading strategy. However, if traders used these opportunities to take large positions on anticipated market movements without any imminent expectation of unwinding the trade, this could be regarded as "pure" proprietary trading. Similarly, the treasury function of a bank will need to engage in trades, for example to manage excess liquidity or hedge the risk from selling fixed-rate mortgages while funding with floating rate borrowing. However, over time the treasury functions in some banks became more aggressive traders, with strategies that could be seen as resembling proprietary trading. As Lord Turner told us:

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12 "Barclays' Bob Diamond says casino critics have 'no basis in reality'", *The Telegraph,* 11 September 2010, www.telegraph.co.uk

13 Ev w17

14 Ev w12

15 Ev w1

16 Ev w12; Ev w25

> those treasuries had developed into huge profit centres in themselves, which were not merely managing the natural consequences of the balance sheets, naturally arising from customer activity, but doing a set of activity in themselves.[17]

10. **There is no commonly-accepted definition of proprietary trading. Most activity undertaken by banks results in some form of proprietary position. In principle, the type of trading which causes the greatest concern is where the bank is using its own funds, raised from shareholders, depositors and creditors, to speculate on markets, without any connection to customer activity. This has been the main focus of our consideration. Some banks, particularly US investment banks, historically had units dedicated to such activity. However, an examination of proprietary trading which only considered such units would be inadequate, because speculative activity can also take place alongside customer-related trading.**

11. The difficulty of moving beyond this theoretical definition to being able to differentiate in practice between what has been termed "pure" proprietary trading and the other kinds of trading activity is considered in more detail later in this Report. As will be seen, there is a wide range of activities which may from the outside look like proprietary trading, but which banks could attempt to justify as being related to customer business or hedging. Equally, proprietary trading for the benefit of the bank can be, and frequently has been, contrary to the interests of its customers.

17 Q 1007

3 Concerns about proprietary trading by banks

Prudential concerns

12. Proposals in other countries to separate proprietary trading from banking have been motivated in part by concerns about the prudential risks which proprietary trading poses to the rest of the bank. In advocating adoption of the Volcker rule in 2010, President Obama said:

> These kinds of trading operations can create enormous and costly risks, endangering the entire bank if things go wrong. We simply cannot accept a system in which hedge funds or private equity firms inside banks can place huge, risky bets.[18]

Paul Volcker, in an article at the same time that President Obama endorsed the rule bearing his name, wrote that "adding further layers of risk to the inherent risks of essential commercial bank functions doesn't make sense, not when those risks arise from more speculative activities far better suited for other areas of the financial markets".[19]

13. Announcing a French proposal along similar lines in late 2012, Finance Minister Pierre Moscovici said:

> In effect the crisis showed the very serious risks posed by financial market trading which banks carry out on their own account and for their own profit, putting at risk the deposits of their clients.[20]

German Finance Minister Wolfgang Schäuble announced similar proposals in February 2013, saying "separating risky activities from retail banking will increase the solvency of an institution and contribute to the stabilisation of financial markets".[21]

14. HSBC listed three main areas where proprietary trading could give rise to prudential risks:

> (a) the ability of banks and supervisors to properly understand and thereby calibrate the risks which are being taken in this area, in particular tail risks, and so apply the correct capital treatment so that banks have sufficient resources to absorb losses if these occur;

> (b) the risk that unexpected losses in proprietary trading may diminish capital resources and curtail the ability of a bank to provide sustainable support to the

18 "Remarks by the President on Financial Reform", *The White House,* 21 January 2010, www.whitehouse.gov

19 "How to Reform Our Financial System", *The New York Times,* 30 January 2010, www.nytimes.com

20 "Séparation et régulation des activitiés bancaires", *Portail du Gouvernement,* 19 December 2012, www.gouvernement.fr

21 German Finance Ministry announcement accompanying approval of draft bank separation law, 6 February 2013 http://www.bundesfinanzministerium.de

> real economy – with the potential consequence that some form of intervention is required to restore such lending, thereby creating a moral hazard; and
>
> (c) the risk that an unexpected loss is of such magnitude or nature that unsecured creditors restrict or withdraw funding until they have clarified and understood the cause of the loss, once again thereby causing credit capacity to be curtailed.[22]

15. However, as RBS pointed out, "the prudential risks inherent in any 'own account' positions are independent of the intent of the trade (whether proprietary or client-driven)".[23] In other words, the risk to the bank from a trading position—such as being long £10m in a particular market position—is the same whether that position results from client-related activity or a desire to speculate. Barclays also suggested that prudential risks from proprietary trading were no different from other trading risks and should be manageable using the same set of controls.[24]

16. The FSA noted that while both non-client-related proprietary trading and client-related trading can give rise to similar risks on individual trades, the key difference is in breadth and scope of how these risks are likely to build up:

> When undertaking proprietary trading [...] additional risks will be taken in order to try and profit from a wide range of market movements. Whilst this activity can be extremely lucrative it also means that a much wider scope and breadth of risks can impact a bank's capital base. Ultimately, as with any risk, if losses are large enough this could lead to a bank's insolvency.[25]

17. Proprietary trading was the cause of some losses during the crisis. UBS reported that its internal hedge fund Dillon Read Capital Management accounted for $3bn of losses before being closed and reintegrated into the investment bank in late 2007.[26] It is difficult confidently to attribute many other losses to proprietary trading, in large part because most banks did not report such activity separately. Also, for many of the large trading losses which were incurred—particularly by the large US investment banks—it is not clear to what extent these related to client activity. For example, many banks lost significant amounts on collateralised debt obligations (CDOs)—structured securities created by packaging together mortgages or bonds and slicing them up into different risk tranches. Many banks held these in trading portfolios and they certainly did involve proprietary risk. However, one reason why the US investment banks held CDOs was that they were a by-product of structuring CDOs for clients, because sometimes parts of the securitisation would need to be "warehoused" before being sold on.[27]

18. A number of smaller European banks also suffered losses on such assets, not because they were involved in the origination, but because they had bought them from the US investment banks. They had been drawn into this activity because the highly-rated CDOs

22 Ev w12

23 Ev w20

24 Ev w1

25 Ev w8

26 Shareholder Report on UBS's writedowns, April 2008

27 "How Wing Chau Helped Neo Default in Merrill CDOs Under SEC View", *Bloomberg,* 10 May 2010, www.bloomberg.com

offered much better yields than other AAA assets such as government bonds, but were just as acceptable to regulators as liquidity management tools. Having enjoyed the higher yield, some banks devoted more and more of their balance sheet to investing in such assets as opposed to their regular business of extending domestic credit.[28] While this business model proved flawed, it is again hard to say how much of it could be regarded as "pure" proprietary trading, given that it had its origins in liquidity management.

19. More recently, in 2012 JPMorgan suffered nearly $6bn in trading losses in the synthetic credit portfolio of its Chief Investment Office (the so-called "London Whale" trades). JPMorgan's special report on the losses claimed that this portfolio was "intended generally to offset some of the credit risk" that the firm faced, and that the losses were the result of "flawed trading strategies, lapses in oversight, deficiencies in risk management, and other shortcomings".[29] However, the scale and nature of the positions which gave rise to the losses seem hard to explain except through there being a considerable degree of speculative proprietary trading. A Bloomberg article prior to the losses noted "One public sign that the chief investment office does more than hedge: Its trading risk is on par with that of JPMorgan's investment bank". The article also cited JPMorgan sources saying that the unit responsible for the losses had shifted its strategy after 2005 away from simply managing risk towards generating profit.[30]

20. No evidence the Commission has received viewed proprietary trading as the primary cause of any failures during the crisis. Standard Chartered stated:

> we do not believe that proprietary trading was a significant contributory factor in the financial crisis. If we look at those banks that failed during the crisis their failures were broadly driven by a range of simple failures such as highly leveraged structured credit, ineffective liquidity or risk management and/or poor corporate governance.[31]

21. The possible impact of proprietary trading on the resolvability of banks also did not feature much in evidence. RBS noted that "the resolvability of a bank and overall systemic risk would of course be materially affected by the presence of uncontrolled trading and inventory within a banking group".[32] Individual trading positions are treated the same way in resolution whether they result from client activity or speculation, so the presence of proprietary trading could affect the quantity of positions needing to be resolved, but not their nature. This is in contrast to the intended effect of the ring-fence, which, by separating all investment banking from core banking, is intended to simplify resolution of the retail entity.

22. **Proprietary trading gives rise to prudential risks. Concerns about the prudential risks from proprietary trading have been cited, not least by Paul Volcker himself, as one of the justifications for legislation to prohibit banks engaging in certain forms of proprietary trading in the USA. They are also the principal justification for proposed**

28 "IKB's experience is the thin end of the wedge", *Financial Times*, 19 April 2010, www.ft.com

29 Report of JPMorgan Chase & Co. Management Task Force Regarding 2012 CIO Losses, January 2012

30 "JPMorgan Said to transform Treasury to Prop Trading", *Bloomberg,* 13 April 2012, www.bloomberg.com

31 Ev w25

32 Ev w20

legislation to require partial separation for banking entities engaged in certain forms of proprietary trading in Germany and France. The Commission has concluded that the prudential risks associated with banks engaging in proprietary trading are not necessarily different in kind from those associated with a range of other banking activities, many of which made a greater contribution to the recent financial crisis. However, having greater exposure to markets than is necessary for client servicing increases the potential for risks that may not be fully understood until the next crisis.

Cultural concerns

23. Paul Volcker said that his desire to restrict proprietary trading was not primarily driven by prudential risk, but by the cultural effects of allowing such activity within banks:

> I get a little irritated by people saying, "Why are you worried about proprietary trading? That didn't cause all the bankruptcies or failures." It certainly contributed to some of them, as they say, but that is not the point. It is the cultural damage that it does.[33]

He also argued that the cultural effects did in fact play a significant part in encouraging the wider excesses that led to the crisis:

> I think, in part, that is where banks got in trouble, as that kind of activity became attractive—dare I say dominant—in some institutions. It employed a different form of compensation—heavily incentivised, very high levels of compensation—that inevitably affected the rest of the organisation.[34]

> [...] people who criticise the so-called Volcker rule might say, "Sure, there were speculative excesses, but that was not the heart of the banking crisis." In fact, a lot of things were the heart of the banking crisis but, just in terms of losses at the banks, it was excessive lending on home mortgages—a traditional business of banks. It went wild. Why did that go wild? I would argue that the compensation practices that crept in, and the very large compensation in the trading parts of banks, infected the culture of the institutions generally, so the lending offices dreamt things up—how to make a lot of money in the short run and get a big bonus.[35]

Michael Cohrs, a member of the Financial Policy Committee and a former investment banker, echoed this concern, saying that proprietary trading had wider cultural effects which were incompatible with banks being focused on client service:

> if a bank is allowed to do proprietary trading, or proprietary investments, you will not have a culture that you like, because de facto, you are then competing with the client, and it is a heck of a lot easier to do proprietary work than it is to do client service. The best and the brightest within the institution will gravitate to the proprietary activity and we will end up where we have ended up, which is with bankers who sometimes do not understand right from wrong, or at least a pool of

33 Q 70

34 Q 56

35 Q 61

> them. I think that Volcker was on to something [...] this concept that proprietary activity exists within a client-serving organisation is false.[36]

24. Bill Winters suggested that the cultural differences between traders and other areas of banks did stem from compensation approaches:

> if you have people sitting on a trading floor who are paid a percentage of their profit—recognising that they are given a lot of capital to deal with so the profits can be very large, which means that their bonuses could be very large—that just is not consistent with good customer service or traditional banking with the guy sitting next door. So this person over here is paid £60,000 and this person over here might make £6 million if he happens to roll seven at the right time and in the right sequence.[37]

He also considered that such differences could cause problems in the non-trading parts of a bank, based on his experience with the merger of JPMorgan and Chase. He argued that "the two cultures do not need to be incompatible in a single organisation, but it is very difficult to manage".[38]

25. However, Barclays argued that proprietary trading was unlikely to have a broader effect on remuneration and culture across the firm as a whole:

> The risk of any proprietary trading influencing broader remuneration practices, culture and standards depends entirely on the specific scale and nature of the proprietary trading, especially in relation to other activities undertaken by the relevant firm. We would posit, based on our experience, that any proprietary trading (even broadly defined) would have to be unusually large in order to have any discernible influence on any of these.[39]

26. Paul Volcker said that, as well as the effect on remuneration, he was also concerned about the conflicts of interest that arose when banks engaged in proprietary trading:

> When you are conducting on the one hand a straight-up trading operation, where you deal with the customer in an impersonal way and do not have a continuing responsibility, and on the other hand you are lending that customer money or not lending them money—whatever you are doing—you get conflicts, or you get conflicts with your investment management business. How can you run an investment management business completely insulated from the trading book you are running on a speculative basis? I guess that my biggest concern is not actually the risks; it is the damage that it does to the culture of the whole institution.[40]

The FSA noted that "where a bank decides to engage in proprietary trading there is a potential for increased principal-agent conflicts with its clients":

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36 Oral evidence taken before the Parliamentary Commission on Banking Standards Panel on Regulatory Approach on 11 December 2012, HC (2012-13) 821-i, Q 25

37 Q 3681

38 Q 3682

39 Ev w1

40 Q 62

> This is because the bank stops being a mere provider of banking/financial services to its clients and becomes a potential competitor. This means that the bank's incentives may become less aligned with its clients. This conflict becomes more pronounced when the proprietary trading operations of any given bank are more material to the bank's profitability than its client operations.
>
> Where a bank conducts proprietary trading the handling of client information is a particularly sensitive issue. For example, client order flow information has to be shielded from the bank's proprietary trading desks, as the bank could make improper profits off the information to the detriment of its clients. This can be challenging to do if, for example, the proprietary trading desks are located in close proximity to the client trading desks on the trading floor.[41]

27. HSBC also acknowledged the risk of conflicts of interest arising from proprietary trading:

> the most obvious example in the recent crisis was where some firms were positioning for a collapse of the US housing market while continuing to service and promote client demand for exposure to that market. Although firms have clear 'chinese walls' – internal separation – to reduce potential conflicts of interest, there will inevitably be instances when a bank will profit from a proprietary transaction positioned on the other side of client facing activity.
>
> There is no reason why the current rules should be viewed as inadequate in principle, yet it is clear from recent experience there is little confidence that in practice they are being adequately monitored and enforced. In reality, no matter how strong the conduct rules are, there will always be concerns over their application particularly where a proprietary trading function is seen to benefit at the expense of clients.[42]

Finance Watch referred to research from Germany into banks which both managed assets for clients and undertook proprietary trading, which indicated that:

> - Banks systematically push stocks from their proprietary portfolio into their retail customers' portfolios.
>
> - Those stocks systematically underperform compared to both other stocks in banks' proprietary portfolio and other stocks in households' portfolios.
>
> - Customers' portfolio performance at banks with prop trading is significantly worse than at those without.[43]

28. However, some witnesses pointed out that principal-agent conflicts were not simply confined to proprietary trading. Martin Taylor warned:

> I do not want us to ban proprietary trading and imagine that the problem of bank-client, agency-principal conflict has been solved. However you frame this, banks

41 Ev w8

42 Ev w12

43 Ev w3

> are, in their own way, highly leveraged, highly expert organisations that are trying to make money out of the financial flows in the economy, and most of those financial flows come from their clients. There is sometimes a tiny flavour of proprietary trading being wicked because there is not a client involved - whereas client-related flows are thought to be virtuous because they help the client. Banks have always made far more money out of client flows than out of any naked proprietary trading desks. I think that banks can still get into trouble by abusing their leverage and their market-making position[44]

He went on to cite the example of Libor manipulation, suggesting that the traders at the heart of the scandal were not engaged in proprietary trading but rather in managing trades that had arisen due to client activity:

> I do not know [...] the extent to which the misbehaviour in the LIBOR scandal was the result of people trying to get proprietary trading permissions right, à la Volcker, or whether it was simply the endless struggle that these very big organisations have to keep their derivative back books in order, which have probably arisen in the first place from satisfying customer demands of one kind or another.[45]

Stephen Hester, Chief Executive of RBS, said that he understood the individuals involved in Libor manipulation to be market makers rather than proprietary traders:

> I think that the LIBOR setters are a form of market maker, if I could put it like that [...]the derivatives traders were making markets in derivatives from which, again, there is end customer usage.[46]

29. The Chancellor of the Exchequer argued that cultural problems are neither "restricted to proprietary trading, [nor] particularly inflamed by proprietary trading".[47] Bill Winters also rejected the assertion that proprietary trading was to blame for the wider cultural failings in banks:

> I don't see proprietary trading, from a cultural perspective, as any more damaging, egregious or likely to create the wrong sort of culture in a bank than any other banking activity. We have seen plenty of instances of misbehaviour. Almost certainly we have seen many more instances of misbehaviour outside of proprietary trading than inside.[48]

RBS similarly suggested factors other than proprietary trading were more likely to be to blame for cultural failings in banks:

> We recognise the risk that the presence of "pure" proprietary trading could give rise to cultural issues and consequent misconduct. However, we do not agree that own account trading connected to actual or anticipated customer activities per se

44 Q 2942 [as corrected by witness]

45 Q 2918

46 Q 4173

47 Q 4330

48 Q 3681

> creates a negative influence on a bank's culture. Issues such as Libor manipulation or swap mis-selling are more likely to stem from a poor, revenue driven, culture in which incentives are not aligned with the creation of long term value for clients and prudent risk management.[49]

30. **This Commission was set up to address the problems of culture and standards in banking. While there is clearly a big difference between the cultures of retail and investment banking, both exist to make a profit for shareholders by providing services to customers. In principle, the carrying on of proprietary trading by banks can be thought to embody a different culture, because in such a case the bank's aim is to make a profit without providing services to customers. In recent years, there have been too many examples of banks having benefited themselves at the expense of customers across a range of activities. The wider reforms relating to banking standards that we are considering are concerned with returning customers to the heart of banking. To the extent that the presence of proprietary trading within a bank affects its wider culture, this could put at risk efforts to place customers at the heart of banking.**

31. **The argument that the trading function within banks, in particular the proprietary trading function, could have harmful cultural effects has been convincingly made. The Commission is concerned that the conflict of interest which can arise from a bank attempting both to serve customers and trade its own position cannot be easily managed, and can be corrosive of trust in banking no matter what level of safeguards are put in place supposedly to separate these activities. The Commission is also concerned that the presence of proprietary trading within a bank, with its potential to generate high short-term rewards for individual traders, could have a damaging effect on remuneration expectations and culture throughout the rest of the firm.**

Social utility and the implicit guarantee

32. Proprietary trading is not unique in the risks it poses. Many banking activities carry risks—indeed risk is in some ways at the heart of banking. However, most banking activities can be seen to have a corresponding social utility, for example in providing credit, facilitating transactions or performing maturity transformation. Referring to the risks posed by proprietary trading, Paul Volcker asked "where is the corresponding or the offsetting public benefit?"[50] Bill Winters pointed out, "there is no particular societal value to proprietary trading, beyond a relatively small amount that is necessary for efficient, functioning markets".[51]

33. It has been argued that proprietary traders provide important market liquidity, and one of the criticisms of the Volcker rule has been that it could reduce liquidity.[52] However, there may be merit in differentiating between what has been termed "pure" proprietary trading and market-making. In the former, assuming it is capable of being tightly defined and identified, traders would be using banks' capital and borrowing to speculate on markets as they choose. While this may add to liquidity at the margin, there are other non-

49 Ev w20

50 Q 70

51 Q 3683

52 Oliver Wyman, The Volcker Rule: Implications for market liquidity, February 2012

bank market participants who trade in the same way—for example hedge funds. If such trading is a profitable use of capital, these other participants might be expected to help fill any void left by banks. The liquidity provided by this form of trading is plentiful in good times, but can dry up quickly in times of market stress. In contrast, in banks' role as market-makers where they openly quote buy and sell prices, they play a more important role in enhancing market liquidity; in a designated market-maker role they are also required to do so in both good times and bad.[53] While it is possible for institutions other than banks to take on a similar role to market-makers, banks do have a natural advantage in acting as market makers because of the high capital requirements associated with it, the fact that banks have a variety of other relationships with the clients who want to make trades, and the fact that acting as a market-maker for a security is often a natural follow-on activity for whichever banks underwrote its issuance.[54]

34. Even after the introduction of a ring-fence and other reforms, it is possible that systemic banks may benefit from an implicit Government guarantee. Lloyds Banking Group warned that this could make it cheaper for banks to fund proprietary trading—effectively using a taxpayer subsidy:

> to the extent that the presence of insured deposits alongside "true" proprietary trading results in proprietary trading activities not facing a cost of capital and funding that appropriately reflects the risk of these activities, then this could result in a mis-allocation of capital and funding towards these risky activities.[55]

Bill Winters said:

> that lack of alignment between the ultimate back-stop—the taxpayer—and the employees or shareholders is not limited to proprietary trading. It is any risk decision that the bank takes—it is mortgage lending, consumer lending, corporate lending, trade finance, market-making trading and underwriting of public securities. I just wouldn't make the distinction, although proprietary trading is clearly the most pure version of the selfish activity.[56]

35. **Although proprietary trading which goes beyond market making can generate social utility by contributing to market liquidity, the case has not been made for banks, rather than organisations such as hedge funds, to fulfil this role. The Commission's First Report emphasised the importance of reducing the perception of an implicit guarantee to banks and the subsidy to which this gives rise. While any subsidy is undesirable, it is particularly objectionable that the Government should subsidise and carry the risk for activities where the benefits might accrue to bank employees and shareholders, much of which would have little or no social utility, and which may pose a threat to banking culture.**

53 Written evidence from Andy Haldane to the Panel on Regulatory Approach, 8 February 2013, http://www.parliament.uk/bankingstandards

54 Katrina Ellis, Roni Michaely & Maureen O'Hara, "When the Underwriter Is the Market Maker: An Examination of Trading in the IPO Aftermarket", *Journal of Finance, American Finance Association*, vol. 55(3) (2000)

55 Ev w17

56 Q 3683

4 Proprietary trading by banks today

Extent

36. Most UK banks told us that they do not now engage in pure proprietary trading, or that this is only a very small activity with most of their trading activity being driven by client needs:

- "Standard Chartered has a client-focused business and has no dedicated proprietary trading desks";[57]
- Lloyds Banking Group "does not have a segregated proprietary trading unit";[58]
- HSBC "do not undertake proprietary trading activities";[59]
- Stephen Hester said that "we tried to remake RBS not so that every activity has no element of proprietary—I think that that is impossible—but so that the guiding rationale and dominant principle is serving customers".[60]

Barclays did not comment explicitly on their current activities, but said that they supported "a prohibition on proprietary trading desks that are established by a bank for the specific purpose of trading for the firm's own account".[61]

37. It is notable that several banks focused on the fact that they did not operate dedicated proprietary trading desks. As discussed earlier, it is also possible for banks to conduct proprietary trading within teams primarily trading for other reasons. Given that many banks historically have not been open about the extent and nature of their proprietary trading activity, it is therefore difficult to judge to what extent such activity is truly absent from the UK banking system.

38. One reason why banks may not presently be engaging in proprietary trading is that it is likely to represent a poor use of capital in the current economic climate. Bill Winters explained why he hoped and expected this would persist:

> when banks looked at how profitable proprietary trading really was and properly factored in the cost of funds [...] they saw it was not profitable, because banks cannot compete with hedge funds that are unconstrained by the regulatory and political pressures that we are all correctly introducing for banks. That is not to say that there are no good traders in banks—of course there are good traders—but even in the pre-crisis days, the best traders tended to drift out of banks and into non-banks, because that was the more natural place for proprietary trading to take place.

57 Ev w25

58 Ev w17

59 Ev w12

60 Q 4174

61 Ev w1

> The proprietary trading that became very large inside banks almost always involved the funding cost benefit that was coming from the transfer from taxpayers to the banks. The decision that most banks took to shut most of their proprietary trading was purely an economic one, and it is unlikely to be changed with the passage of time, as long as we do not allow Government subsidy to slip back in. Of course, it has not been completely excised yet, but the objective is to remove that subsidy completely. Once we have done that, most proprietary trading will naturally reside outside a bank.[62]

RBS also noted that "Tighter capital and liquidity rules, together with prudential controls as proposed by both Basel III and the ICB recommendations for PLAC will have the effect of restricting the appetite of any bank for own account trading".[63]

39. **Many of the leading UK banks have told us in evidence that they do not currently engage in proprietary trading, and a number of them agree that proprietary trading is not a suitable activity in which customer-oriented banks should engage. However, such reassurances alone cannot provide a guarantee against the re-emergence of proprietary trading over time, as public attention on banks' activities fades, economic circumstances change and another generation of bank leaders less scarred by recent events emerges.**

Controls

40. Some banks argued that any prudential and conduct risks from allowing proprietary trading to take place within banks could be adequately controlled and should not be of significant concern. RBS said:

> we do not believe that own account trading activity conducted in connection with customer activities within a financial group (but outside a ring-fenced bank) poses risks to that ring-fenced bank (or the financial system) that cannot be properly controlled (or that are disproportionate) by having effective internal controls, as overseen and supervised through regulatory powers.[64]

Lloyds contended that potential conflicts of interest from proprietary trading should be effectively controlled through existing conduct rules which require banks

> to take reasonable steps to identify conflicts of interest, to maintain a record of the kinds of activity and service which give rise to potential conflicts of interest and to put in place arrangements to prevent of manage these conflicts. These arrangements may include physical separation of conflicted business areas, controls on information sharing and other organisational and administrative arrangements. [The FSA's handbook] specifically identifies proprietary trading as one of a number of areas which require special attention in the context of a firm's conflict of interest policy.[65]

62 Q 3686

63 Ev w20

64 Ev w20

65 Ev w17

41. The FSA explained how they manage "the risk of detriment to clients arising from firms' proprietary trading activities":

> First, across all client categories (including eligible counterparties), the FSA requires special attention to be given by firms to their senior management arrangements and systems and controls where they undertake proprietary trading in addition to providing services to clients. We expect firms which carry out proprietary trading to ensure that they take all reasonable steps to identify, manage, and where necessary, disclose any conflicts of interest that arise from their activities. The organisational and administrative measures we expect firms to put in place to manage the conflicts should be proportionate to the size and organisation of the firm and the nature, scale and complexity of its business.
>
> Secondly, we recognise that some clients need to be afforded higher regulatory protection than others depending on their knowledge, skills and expertise and the FSA's rules reflect this through placing a number of more onerous requirements on the conduct of the firm when providing services to retail and professional clients. For example, best execution duties, the requirement not to misuse information they have on clients' pending orders, and the requirement to provide appropriate information to clients outlining the key risks of any service provided. We do however recognise that some proprietary trading activities are undertaken in pursuit of legitimate business, for example, market making or risk management purposes. Therefore an exemption to the rules is available in certain circumstances.[66]

The FSA also noted how the FCA's new approach would enhance its scrutiny on potential conduct risks in wholesale markets and suggested that "areas which have not been a focus for the FSA in the recent past will be looked at more closely".[67]

42. **Existing supervisory measures address some of the risks—particularly prudential—arising from proprietary trading within banks. Reforms to capital requirements since the financial crisis have made proprietary trading a less attractive activity for UK banks. Greater attention to risk management and control frameworks both within firms and from the supervisor should help to limit the extent of prudential risk.**

43. **Rules already exist to address potential conflicts of interest between banks and customers. However, these measures as currently applied do not at all adequately address the risks to culture and standards which have been identified.**

44. **Supervisors already have broad, discretionary powers which they could use to discourage or prevent proprietary trading. These include imposing additional capital requirements and the ability to require firms to reform or cease activities which cause concern. However, it is not clear that supervisors would currently be willing to use such powers specifically to restrict proprietary trading, except where it poses a clear prudential risk. Since supervisors do not appear to view proprietary trading as a significant threat on these grounds, it is also unlikely that they currently seek actively to identify where a bank is undertaking such activity.**

66 Ev w8

67 *Ibid.*

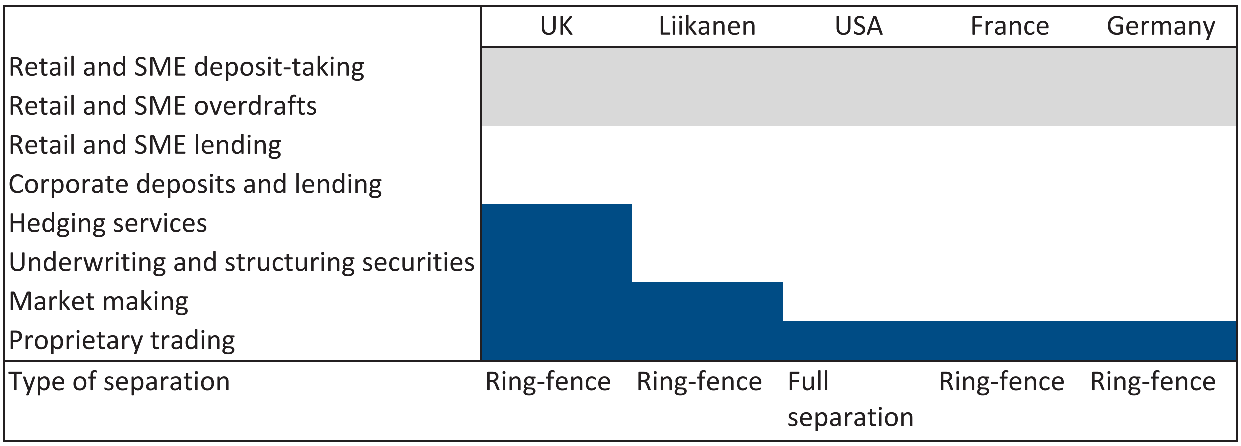
Reforms currently in progress

45. Structural reform proposals in the US, France and Germany have focused on separating proprietary trading from the main business of banks, either through a prohibition in the case of the US Volcker rule, or by requiring a separate subsidiary to carry out proprietary trading in the case of the French and German proposals. The Volcker rule was passed as part of the Dodd-Frank Act in 2010, with a target implementation date of July 2012, but as of February 2013 regulators were still working on the detailed rules to underpin it. In the meantime, Comptroller of the Currency Thomas Curry wrote in July 2012 that:

> many of the largest national banks [...] have shut down, or are in the process of winding down, exposures in trading books that appear most clearly to fall within the statutory definition of proprietary trading, specifically those desks which do not face clients and do not have a purpose other than speculating on markets.[68]

The French and German proposals are more recent and have not yet been passed into law.

46. In the UK, the Government has proposed legislation to implement a ring-fence, originating from the report of the ICB, and following on from draft legislation which we considered in our First Report. The UK approach takes a broader view of the investment-banking activities which should be separated, also including market-making and underwriting. Finally, the High-level Expert Group on structural bank reforms established by the European Commission and chaired by Erkki Liikanen also made structural reform proposals which are under consideration by the European Commission; their scope would fall between the UK and other approaches. The table below provides a necessarily simplified comparison of the broad principles of the five current versions of structural separation. Grey and dark-blue activities must be conducted in separate entities. White activities can be conducted in either:



47. The ICB considered whether separating proprietary trading alone would solve the problems it had identified with the present structure of banking in the UK, and concluded

68 Letter from Thomas Curry to Rep. Carolyn Maloney, July 2012, http://maloney.house.gov/sites/maloney.house.gov

that it was preferable to separate a wider range of investment banking activities from retail banking.[69] As Martin Taylor pointed out:

> We obviously looked at the Volcker rule, because it was pre-existent. [...] We did not see that it would solve the problem we were trying to solve. [...] A Volcker rule is of course a lot less radical from the banks' point of view than a ring-fence.[70]

48. The proposed ring-fence will address some of the concerns specific to proprietary trading discussed in the previous section. First, by proposing to create a degree of organisational separation between proprietary trading and retail banking—the functions most important to the real economy—the danger of prudential and cultural contagion between the two can be reduced. Second, by permitting different resolution strategies for each entity, ring-fencing— combined with other measures such as resolution plans and bail-in—should reduce the perception of an implicit guarantee for the investment bank. This should result in the investment bank's funding costs more accurately reflecting the risks it runs, limiting their ability to increase leverage and making proprietary trading more costly for banks to undertake. Lloyds Banking Group told us:

> Ring fencing should be sufficient to remove risks that any proprietary trading within the remainder of the group poses to a bank's retail and commercial operations. Ring fencing would eliminate any potential mis-allocation of capital and funding which could result from banks which conduct proprietary trading having access to the insured deposits at a retail and commercial bank. Furthermore, ring fencing ensures that if problems emerge in relation to any proprietary trading activity, this will not impact the continuity of the bank's retail and commercial operations.[71]

Bill Winters emphasised the ICB's focus on addressing the implicit guarantee:

> culture or the migration or the perversion of the culture no doubt had a lot to do with the incentives that were in place along the way. I think the incentives in turn really came both endogenously and exogenously. Endogenously, they came as much as anything from the fact that Governments were implicitly allowing banks to operate with tremendous advantages relative to any other participating capital markets. That was the transfer of value from taxpayers to banks and from banks to bankers, not just proprietary traders but clearly they were part of the beneficiary. What we can see in retrospect was grotesque and completely inappropriate and highly damaging. That is a clear observation. Certainly through the ICB's work we have tried very hard to remove that transfer from the taxpayer to shareholders or to the bank.[72]

49. However, although implementation of a robust ring-fence is an important priority, this measure alone does not fully address the concerns relating to proprietary trading. Proprietary trading will still be able to take place within the non-ring-fenced bank, leaving two main potential areas of concern which we consider further below: first, that the ring-

69 Independent Commission on Banking, Final Report, September 2011, p 45

70 Q 390

71 Ev w17

72 Q 3681

fence may prove less than completely impermeable despite this Commission's recommendations for strengthening it; second, that, even if the ring-fence is impermeable, problems may remain from allowing proprietary trading to take place alongside other important wholesale activities in the non-ring-fenced banks.

50. The FSA listed three channels of possible concern from proprietary trading taking place within a group containing a ring-fenced bank:

> Firstly, if the ring-fence does not prove to be fully effective then there could be contagion from the non-ring fenced bank to the ring-fence entity threatening the provision of core banking services.
>
> Secondly, it would be inappropriate if the cost of funding of the proprietary trading business in a group with a ring-fenced bank would be lower than a standalone wholesale bank solely because of the presence of the ring-fenced bank in the former group. Whether this will be the case depends on how the legislation and rules pertaining to the height of the ring-fence develop and the markets view on whether this removes the potential for any government support from the non-ring fenced bank.
>
> Thirdly, depending on the height of the ring-fence, proprietary trading may directly impact on retail clients either through losses threatening the provision of core services or through the group putting its interests ahead of those of its clients in an improper way, such as the miss-selling of financial products.

Finance Watch also noted the remaining possibility of contagion:

> As the PCBS's First Report notes, ring-fences are fallible [...] Given a leaky, badly maintained or weak ring-fence, there is a danger that losses from proprietary trading could cause problems for ring-fenced entities. Resolution tools, no matter how well designed, can only deal with so much. Therefore, there remains a danger that State intervention at taxpayers' expense will be required and that "perceived implicit guarantees" will remain.[73]

51. HSBC noted how the UK ring-fence leaves important wholesale bank activities potentially vulnerable to risks from proprietary trading:

> By combining proprietary trading activity with other markets activity, neither the UK nor the Liikanen proposals address the risks that contagion from proprietary trading could disrupt other important markets activities which support customers [...] these markets activities are also systemically important. They are considered to be Critical Economic Functions by the FSA for resolution purposes and, in the case of market-making, the creation of a deep and liquid trading market is essential to the financing of the real economy through securitised funding.[74]

Douglas Flint, Chairman of HSBC, echoed this point in oral evidence:

73 Ev w3

74 Ev w12

> I also believe that the non-ring-fenced bank is systemically important. Therefore, if you believe that one of the risks to the non-ring-fenced bank is proprietary trading, you should not want it there, because the non-ring-fenced bank is going to be systemically important to the payments systems, to large corporates, to credit creation[75]

52. The FSA acknowledged the potential systemic importance of non-ring-fenced banks, citing potential effects similar to those experienced when Lehman Brothers failed:

> It is important to note that even standalone wholesale banks can indirectly threaten the provision of financial services. For example, the failure of a large wholesale bank may cause the wholesale funding market to temporarily dry up leaving retail banks unable to access wholesale market funding.[76]

53. Barclays argued that if proprietary trading was felt to be an issue, there was no reason to confine any response to just those groups containing a ring-fenced bank:

> we see no distinction in terms of the risks to financial stability between a proprietary trading entity that sits within a group containing a non-ring-fenced bank, and one on its own, especially if ring-fencing has been completed. So no particular benefit would be gained from applying such a prohibition only to a non-ring fenced bank within a group containing a ring-fenced bank.[77]

HSBC expressed a similar view:

> In terms of standards of conduct, it is difficult to see a material difference between proprietary trading conducted in a group which contains a ring-fenced bank (which will necessarily be in a separate subsidiary from the ring-fenced activities) and through a stand-alone wholesale bank. Again we note the US and proposed French solution is simply to prohibit proprietary trading absolutely in banks of any shape.[78]

54. The present structure of the UK banking system is such that most large UK-headquartered banks with the capacity to engage in proprietary trading will probably be part of a group containing a ring-fenced bank once the legislation before Parliament comes into effect, with the likely exception of Standard Chartered under a de minimis exemption which we have previously examined.[79] As an international financial centre, the UK also hosts a number of foreign investment banks. The failure of Lehman Brothers showed how these can pose a prudential threat to UK interests, while the JPMorgan "Whale" trader, the UBS Libor scandal and the UBS rogue-trader scandal all had an impact on the trust and reputation of the City of London despite originating in foreign-owned banks. If the USA, France and Germany do implement intended restrictions on proprietary trading by their banks, this would cover a significant portion of the foreign investment banks operating in the UK.

75 Q 3869

76 Ev w8

77 Ev w1

78 Ev w12

79 First Report; Second Report

55. **Implementation of a robust ring-fence in the UK, strengthened by measures to give effect to the recommendations in the Commission's First Report, will create a degree of organisational separation between those parts of some banks which might in future carry out proprietary trading and the core banking services provided by those banks. By seeking to confine the benefits of the implicit guarantee to retail banking, with a view to its eventual elimination, the ring-fence should also further raise the cost for a non-ring-fenced bank in funding risky trading activity, including proprietary trading.**

56. **However, no measures proposed under legislation currently before Parliament would directly restrict the ability of non-ring-fenced banks to engage in proprietary trading. The possibility of contagion between a non-ring-fenced bank and a ring-fenced bank will not be eliminated. A ring-fence is not the same as full structural separation, and potential channels of contagion will remain a cause for concern. In addition, the risks and conduct of investment banks—including those which are not part of a group containing a ring-fenced bank—remain grounds for public concern, because such firms may still be of systemic importance and could contain critical economic functions.**

57. **The Commission believes that, while current and planned reforms will mitigate the risks (although not the full extent of the cultural threat) from proprietary trading within certain banks, these do not go far enough. Further measures to address proprietary trading within the banking sector, including outright prohibition, could therefore be desirable in principle, provided they can be implemented in a proportionate and effective way.**

5 Controlling proprietary trading by banks: the issues

The definitional issues

58. Many witnesses agreed that, in principle, it would be a good thing if banks did not engage in pure proprietary trading. Andy Haldane, Executive Director of Financial Stability at the Bank of England, said:

> In principle, there ought to be a sharp distinction between directional bets made on one's own account and the provision of liquidity services to customers and clients. Any commingling of those two sounds as if is in some ways best avoided.[80]

Douglas Flint said "There is a case for not having proprietary trading properly defined within regulated entities or groups".[81]

59. Most witnesses who agreed with this principle made clear, however, that any action to put it into practice would have to overcome the significant challenge of defining proprietary trading clearly and distinguishing it from other forms of trading activity which should be allowed to continue. Sir John Vickers said "I am not against the principle of Volcker; it is the difficulty of implementation".[82] Stuart Gulliver, Group Chief Executive of HSBC, said "as long as we can distinguish proprietary risk, which is principal risk, from proprietary trading, then, yes, it should sit in a hedge fund".[83]

60. Stephen Hester told us:

> In RBS, we tried to eliminate the bits of the previously sprawling organisation that were truly distant from customer rationale. In that sense, if the Volcker rule was capable of easy definition, I would absolutely think that it is a terrific rule for a banking industry that I believe should be centred around customers.[84]

The FSA noted:

> Enforcing total separation of proprietary trading alongside or instead of ring-fencing could provide a stronger barrier against global market contagion to core financial services, but the difficulty is in designing a proprietary trading prohibition that works in practice.[85]

61. The main difficulty that most witnesses warned of was in trying to distinguish pure proprietary trading from market-making. Paul Sharma of the FSA warned that "a number of people have tried and are trying [to define market-making versus proprietary trading]. It

80 Oral evidence taken before the Parliamentary Commission on Banking Standards Panel on Regulatory Approach on 21 January 2013, HC (2012-13) 821-ii, Q 178

81 Q 3685

82 Q 2595

83 Q 3866

84 Q 4173

85 Ev w8

is not clear that they will be able to succeed [...] we do know for certain that it is extraordinarily difficult”.[86] Asked whether he thought a definition was going to be found, Stephen Hester noted that “in the United States, they are finding it very challenging”.[87] The US legislation and supporting documentation, albeit reflecting the US legalistic culture, already runs to 298 pages, and the debate about implementation is still continuing despite the intended July 2012 deadline.[88] Martin Wheatley said “I do not think it is possible to do it in a way that would not be gamed by the banks”.[89] Martin Taylor explained the nature of the challenge:

> Banks are in the business of taking proprietary risk; that is the problem. The distinction is made between the proprietary risk taken because a trader comes in in the morning and decides to put a position on, and the proprietary risk that arises because a client rings up and says, "I’d like you to structure this derivative for me" [...] One may be more socially useful than the other, but in the end the bank has the same risk position.[90]

62. Andy Haldane warned:

> we have moved to a market-making model which is radically different from that which we had 10 or 20 years ago and which conflates the act of making markets with the act of making money on a proprietary basis. I see no realistic prospect of rolling that back very quickly, which leads us to the problem that it is very difficult in practice to differentiate these two sets of activities.[91]

RBS made a similar point, noting how “there is no bright line that can be drawn to differentiate between the two types of activities”.[92] Finance Watch explained why market-making and proprietary trading were so intimately intertwined:

> Market-making necessarily involves taking a view on how prices are going to move, and necessarily involves holding an inventory. These are also the two essential elements of prop trading. All market-making (as opposed to broking) involves an element of prop trading. To make markets involves standing ready to buy and sell, and communicating to others in the market the prices at which you are willing to do so. Deciding on those prices requires deciding how happy, or not, you are to have the instrument in question on your book and adjusting your bid and ask prices accordingly.[93]

63. HSBC gave some practical examples of how market-making can lead to proprietary positions:

86 Oral evidence taken before the Parliamentary Commission on Banking Standards Panel on Tax, Audit and Accounting on 24 January 2013, HC (2012-13) 881-iv, Q 279

87 Q 4175

88 “Volcker Rule, Once Simple, Now Boggles”, *New York Times*, 1 October 2011, www.nytimes.com

89 Q 4473

90 Q 2914

91 Oral evidence taken before the Parliamentary Commission on Banking Standards Panel on Regulatory Approach on 21 January 2013, HC (2012-13) 821-ii, Q 178

92 Ev w20

93 Ev w3

> if there is a pattern of investment managers moving into Japanese equities, a foreign exchange desk is likely to hold a long Yen position in anticipation of the demand for settlement currency, in exactly the same way as retailers adjust their summer stock depending on projected weather patterns; the difference is the bank is marking its open currency (stock) position to market daily as opposed to the retailer marking down unsold stock in the end of season sale. The point being highlighted is that banks routinely have positions held as principal from which they may gain or lose but a practitioner would regard only a very limited and bespoke portion of these as 'proprietary trading'.[94]

Standard Chartered also explained how serving client needs could result in them taking on market positions which look from the outside like proprietary trading:

> Often a market maker will need to run a risk after trading with clients, either due to illiquidity or mismatch between the client product and available interbank hedges. These issues are particularly true in the emerging markets in which Standard Chartered operates because the markets may not be sufficiently liquid. So a market maker is forced to become an active risk taker in order to facilitate quoting clients. The alternative is that a client must wait until matching buyers or sellers have been found, dramatically reducing liquidity.
>
> For instance, if a mutual fund was looking to liquidate a position in an emerging market bond to meet some redemptions then they would require us to offer them a firm price to take the bonds immediately. In turn, we may not be able to find a buyer immediately at a reasonable price so we would purchase the bonds on our own account and subsequently seek to sell the position which would require us to take market risk until the bonds have been all sold.
>
> As another example, if we are helping a client hedge the risk it faces from a large iron ore order it may take several days to undertake the trades that are necessary to reduce the risk we take on as a result of this trade, and we may still not be able to eliminate the risk entirely. These subsequent trades will be necessary for us to meet the needs of our clients but they will not be as a direct result of an order from these clients.[95]

Professor Darrell Duffie set out his concerns in a paper he wrote in 2012 that implementation of the Volcker rule would have undesirable effects on market-making, namely that:

> investors would experience higher market execution costs and delays. Prices would be more volatile in the face of supply and demand shocks. This loss of market liquidity would also entail a loss of price discovery and higher costs of financing for homeowners, municipalities, and businesses.[96]

94 Ev w12

95 Ev w25

96 Darrell Duffie, "Market Making Under the Proposed Volcker Rule", *Rock center for Corporate Governance,* Working Paper Series No. 106 (2012), p 2

64. Some witnesses considered that a workable definition of proprietary trading could be achieved. Asked whether the US authorities were going to solve the definitional problems, Douglas Flint replied “Yes” and Stuart Gulliver said “I think we can get 90 per cent of the way”.[97] Bill Winters thought that the US authorities had made significant progress towards defining proprietary trading:

> The bankers to whom I have spoken about this have said that they think it is a pretty fulsome attempt to capture the idea that you want to preclude purely discretionary, for-profit proprietary risk taking and separate that from risk taking that is incidental to the provision of liquidity in the capital markets.[98]

65. Paul Volcker explained that his preferred approach would not be to monitor every single transaction for compliance, but rather require banks to have appropriate policies in place to prevent proprietary trading, and use a series of metrics to check their effectiveness:

> It is a fool’s errand to look at every transaction and say, “That’s proprietary” or “That’s a customer trade” or “That’s a market-making trade”. But you can tell over time [...] what you are going to do, which they will do in the United States, is to have so-called metrics. They will have maybe too many but they will have seven or eight metrics that they will look at. Volatility would be very important. Your ordinary customer trading operation is not going to have a lot of volatility. The aging of the inventory, the size of the inventory, the hedging of the inventory: there are certain things you can look at that are going to give you pretty clear evidence as to whether as a regular matter, proprietary trading is going on and the guys are market-making. It does not mean that you catch every transaction. You don’t have to catch every transaction. I think that can be effective. I have had a lot of traders tell me that.[99]

66. Lord Turner agreed that an approach based on metrics would be more viable than a transaction-based approach, and added that the FSA had even attempted a one-off exercise along these lines in the past:

> If you look at the frequency distribution of daily profits and you find that every now and then there are some whacking great losses and whacking great profits and there is not much of this regular flow in the middle, it is highly likely that as a post facto indicator, that tells you that they are more of a proprietary trader. Indeed, I will not name names, but we did that exercise four years ago, and you could compare different banks, and it clearly lined up with what we knew about their philosophy as to whether or not they were trying to make money out of prop trading.[100]

HSBC and Lloyds Banking Group also both considered how proprietary trading could be controlled in this way, suggesting examples of the kind of metrics that were referred to by Paul Volcker.[101]

97 Q 3867

98 Q 3684

99 Q 68

100 Q 4473

101 Ev w12; Ev w17

67. However, Bill Winters warned that, although such approach could be effective, it would still involve considerable complexity:

> A series of those sorts of measures could be put in place, and by the time that is converted into a set of rules of what you are allowed to do and what you cannot do, each of the measures needs a number or some sort of algorithm attached to it, and that needs to be implemented and monitored. It is very complicated—bordering on impossible—but that is not a good reason not to try if you have decided, from a policy perspective, that banks will not do this particular thing. That is the process that you would have to go through.[102]

RBS also noted the danger of an approach involving complex metrics:

> The US regulators preparing the detailed regulations for the Volcker Rule have struggled with the problem of definition for two years. The current draft implicitly recognises the difficulty of identifying what is "pure" proprietary trading and relies on complex analysis of 17 different indirect metrics they have determined might be indicators of proprietary trading [...] We believe that monitoring and tracking such indicators will be expensive both for institutions involved and for the regulators. [...] There is a danger that the implementation and subsequent monitoring of highly complex rules across multiple metrics could serve more to distract from ensuring that "pure" proprietary trading is prevented (or controlled depending on the institution) and that all own account trading is otherwise conducted in an appropriately controlled way.[103]

The enforcement issues

68. Sir John Vickers voiced his concern that such complexity could consume regulatory attention and distract from more important tasks such as policing of the ring-fence.

> If one had ring-fencing and Volcker, there would then be two boundaries to police and the Volcker rule—as its rather slow progress towards implementation in the United States is showing—draws the line in a very, almost excruciatingly, difficult place. There is a risk that if one added the Volcker rule, a large portion of regulatory capacity, energy, distraction, aggravation would be forced to be directed on that very difficult set of issues, and regulatory capacity is finite.[104]

Mark Carney shared this concern when he recently gave evidence to the House of Commons Treasury Committee:

> I do not think you should overlay a Volcker Rule on top of the Vickers recommendations. I think the ring fence model is a superior model to the Volcker Rule, and I will not make this a long answer but I would be very concerned. It is extremely difficult to draw the line between market-making and proprietary trading. The first cut of the US authority [...] shows how difficult that is and it would unnecessarily, amongst many other things, divert the supervisor's attention

102 Q 3684

103 Ev w20

104 Q 2579

from amongst other things, not just prudential responsibilities, but fulfilling that responsibility on ensuring that the ring fence is respected.[105]

Finance Watch also warned about this risk:

> In our view, the benefits of eliminating a small amount of dedicated proprietary trading are likely to be outweighed by the strong likelihood that gaps elsewhere in the ring-fence would be systemically exploited. The complexity of defining and enforcing such a ban could undermine the overall robustness of the ring-fenced approach.[106]

69. Bill Winters noted that dealing with the complexity would be particularly resource-intensive:

> it is layering complexity on complexity. I can imagine a lot of human beings needing to try to figure this out. All else being equal, I think I would rather have either fewer human beings, who were better trained, or those human beings focused on whatever the most compelling problem of the day was. It may be proprietary trading, in which case that is what they should focus on. I think it is more likely to be the things that have caused recurring banking crises through time[107]

70. Some witnesses also warned that such a subjective approach to defining proprietary trading could be difficult to enforce. Sir Mervyn King said:

> I know that [Paul Volcker] said to you that a good banker can tell the difference between market-making and proprietary trading. That is true, but that is not the issue. The question is whether the regulator or a court can tell the difference between the two and whether it is possible to pull the wool over the eyes of the regulator or to confuse the issue legally even if the banker can understand exactly what the nature of the transaction is. It's can you prove it?[108]

Sir John Vickers echoed this point that regulators need objective rather than subjective measures in order to be able to defend their actions against challenge.

> Part of Volcker, as it is being implemented in the US requires, in a sense, an investigation of the intent and purpose of the building of a position: is it for resale within a 60 day period, and so on? That for me brought to mind Queen Elizabeth I on opening windows into men's souls-I think it's just a very difficult business to get into[109] [...]
>
> For the law to work, it is the regulator who needs to be able to know, and the regulator will be subject to a framework of accountability in which it will need to be able to demonstrate the facts, and so on. The senior bankers knowing is not

105 Oral evidence taken before the Treasury Committee on 7 February 2013, HC (2012-13) 944, Q 136

106 Ev w3

107 Q 3693

108 Q 1149

109 Q 2580

> itself sufficient. To repeat a point that was made earlier, this Commission has seen a number of senior bankers who were, it appears, less knowledgeable about what was going on in their institutions than the remark by Paul Volcker [...] suggests.[110]

71. The FSA also raised concerns about whether it is possible to design a definition which is both enforceable and straightforward for banks to follow:

> There are two ways of addressing this issue. The first way is through very prescriptive rule-making combined with intensive supervision. The second way is through a purpose based restriction. There are problems with both of these approaches which is part of the reason why the ICB and Liikanen both avoided trying to distinguish between proprietary trading and market-making.
>
> A prescriptive approach is resource intensive to supervise and banks, if they are so inclined, will eventually find a way around the rules. A purpose based approach will not provide clarity to banks or their clients about what is permitted. It also does not provide supervisors with a clear consistent framework for exercising their judgement, particularly as derivative trading is a highly complex area where 'risk management hedges' can quickly become sizable proprietary losses due to poor modelling of risk.
>
> A combination of these approaches is currently being considered in the US and it may be a number of years before we can be sure that such a prohibition is possible to enforce in a meaningful way.[111]

Other issues relating to a prohibition

72. Sir John Vickers warned that pushing proprietary trading out of banks might simply move the problem to somewhere else:

> if proprietary trading is divorced from banking, it will move elsewhere and there is no guarantee that elsewhere will be a place where one need not worry about cultural and other issues. Indeed, it may move to a less well-regulated place, which could rebound adversely for the things that one cares about.[112]

Professor Darrell Duffie also raised this concern in relation to implementation of the Volcker rule in a paper written in 2012, suggesting that:

> The financial industry would eventually adjust through a significant migration of market-making to the outside of the regulated bank sector. This would have unpredictable and potentially important adverse consequences for financial stability.[113]

On the other hand, there may be cultural and even prudential advantages in confining hedge fund activities to hedge funds.

110 Q 2591

111 Ev w8

112 Q 2580

113 Darrell Duffie, “Market Making Under the Proposed Volcker Rule”, *Rock center for Corporate Governance,* Working Paper Series No. 106 (2012), p 2

73. HSBC noted that attempting to introduce a prohibition could delay implementation of the ring-fence:

> We are concerned that adding at this stage in the process a prohibition on proprietary trading in groups containing a ring fence bank could lengthen the implementation timetable for the current ring-fencing proposals because of definitional challenges.[114]

74. Ken Costa raised a concern that banning proprietary trading could drive talented individuals out of UK investment banks, harming their global competitiveness. He suggested, given wider reforms aiming to remove the possibility of an implicit guarantee from investment banks, we should be more willing to allow this activity to continue under proper controls:

> to remove it completely would, in my view, take the proprietary traders out of what is now going to be the investment bank but without the very best talent, which was what investment banks drew on, and into the hedge funds, new private equity funds and other places in the market.[115]

75. The FSA noted that there could be obstacles under EU law to measures aiming to prevent a group which contains proprietary trading activity from being the owner of a ring-fenced bank:

> The exercise of the regulator's powers to prohibit groups containing a ring-fenced bank from engaging in proprietary trading is likely to be constrained by provisions of EU law which limit the grounds on which a competent authority may object to a proposal to acquire a qualifying holding in banks. These provisions were introduced by the Acquisitions Directive [2007/44/EC] which amended the BCD to provide that a competent authority may oppose a proposed acquisition of a bank only if there are reasonable grounds for doing so on the basis of specified criteria. [116]

This is the same obstacle as for a move to require full separation which we discussed in our First Report.[117] One of our conclusions then was that, ahead of the commencement of provisions relating to electrification, the Government should take the opportunity of the delay to implementation that we proposed to “secure amendments to European legislation to ensure that the provisions relating to full structural separation are compatible with European law”.[118]

Conclusions

76. **We have received extensive evidence from banks, and particularly from regulators and independent experts, about the practical difficulties of establishing a definition of proprietary trading which meets the standard necessary to support effective**

114 Ev w12

115 Q 2737

116 Ev w8

117 First Report, para 89

118 First Report, para 166

enforcement. An individual proprietary trade may outwardly appear to be similar or identical to trades arising from client activity such as market-making, with the main difference relating to the intent behind the trade.

77. **Attempting to categorise individual trades as proprietary or non-proprietary is likely to be particularly challenging. Attempting to use a broad definition would risk capturing activities which all would accept perform a useful economic and social function, such as serving clients, supporting markets or mitigating risk; in such cases supervisors could be faced with a burdensome task of having to assess firms' justifications for exemption on a case-by-case basis. However, using a narrow definition, or setting out category exemptions up-front, risks making it too easy for creative traders or firms who wish to continue speculating to evade the rules by re-classifying or disguising their activity. Another argument advanced by several witnesses was that attempting to prohibit proprietary trading in the UK would risk distracting attention from implementation of the ring-fence.**

78. **An alternative way of enforcing prohibition, as currently being developed by US authorities, would be to use a range of metrics to monitor and track patterns of trading activity in order to identify where it appeared to have the characteristics of proprietary trading. Although this would not identify which individual trades are proprietary or client-related, such metrics could be able to signal which banks are engaged in proprietary trading, highlighting risks to the regulator. While this new approach appears more promising than attempting to categorise individual trades, it remains unproven, relatively complex and resource-intensive.**

6 The way forward

The priority for action

79. While a number of witnesses acknowledged the case in principle against proprietary trading by banks, most recommended against taking early action to attempt a prohibition. Many of them questioned the benefits that would result, or warned of the scale of the definitional challenge. Sir John Vickers stressed that he saw few benefits from adding such a measure to the existing ring-fence plans:

> I believe that ring-fencing gains not all, but many, of the merits that the Volcker proposal seeks to achieve. Seeking to add Volcker from the outset would add cost and complexity, and could add to uncertainty in undesirable ways.[119]

Bill Winters said:

> I do not reach the same conclusions as Paul Volcker does, that proprietary trading should be an area of particular focus. I certainly don't agree that the Volcker rule, which was not primarily a cultural tool, but was primarily a financial stability tool, is the most effective way to achieve the objectives that he, quite correctly, set out.[120] [...] I think the extraordinary focus on proprietary trading is not without relevance, but is misplaced in terms of prioritisations.[121]

The FSA said:

> In our view, the ICB took a sensible approach to addressing the issues that can be caused by proprietary trading and a properly designed ring-fence can deliver an appropriate degree of insulation of core banking services while conflicts of interest can be addressed through systems and controls and conduct rules. It is not clear that the addition of a Volcker rule on top of a strengthened ring-fence, will bring further benefits in terms of resolvability. It also seems likely that legislating and then implementing both structural changes in tandem would prove very complex.[122]

The Chancellor of the Exchequer argued:

> I do not think it is necessary. We have good reforms now to the structure of our banking industry, and I do not think that we need to supplement them; we need to implement them. I would say that that should be the priority. Engaging in a whole new set of reforms, which would take a long time to legislate for and to implement, not least because there are implementation issues as the Americans are finding out, would distract attention from the primary task in hand, which is to get the reforms that are agreed through and implemented.[123]

119 Q 2592

120 Q 3681

121 Q 3691

122 Ev w8

123 Q 4331

80. Martin Taylor took a somewhat different view:

> I don't think a prop trading ban is necessary. [...] I don't think it's a bad idea. I just don't think it will make a huge amount of difference; I certainly don't think that it will make a big difference to financial stability. [...] If I favour it, I favour it very modestly. If I were a member of this Commission and other members were very strongly in favour of it, I would not try to stop it. It does not seem to me a mistake-certainly not a bad mistake-but it is not something that I would be proposing.[124]

81. Some other witnesses were more favourable to action, but they nevertheless made clear that they did not believe this to be a high priority. Asked whether the UK should have a Volcker Rule, Douglas Flint responded "I do not see any reason why one could not".[125] However, HSBC's written evidence stated:

> As an effective ring-fence should protect the retail activities, having gone down the ring-fence route, it is difficult to see what additional practical benefits would arise from a total prohibition on proprietary trading, unless there are now concerns about the systemic importance of the wholesale activities to be contained in the non ring-fenced bank. Any conclusion that this is the case would logically re-open a discussion about the positioning of the ring-fence so that all economically-critical activities, whether wholesale or retail, could be protected from proprietary trading.

Asked whether a prohibition on proprietary trading would be in the public interest, Sir David Walker, Chairman of Barclays, responded favourably:

> I would not, on the face of it, see a problem with that, because the market-making activity and the proprietary trading activities that we would defend are designed to promote, in the interest of our clients, their ability to undertake flow business with us to hedge whatever exposure they want to hedge on in reasonable terms, which would not be available to them if they were not a market maker in the market. If we agree on that proposition, as I believe we do, from your conversation, I don't have a difficulty with the proposition you make.[126]

However, Barclays' written evidence suggested that this support was conditional on a prohibition being limited only to stand-alone proprietary trading desks:

> Our position was, and still is, supportive of a prohibition, providing that the definition of proprietary trading is suitably narrow and concise. More specifically, we support a prohibition on proprietary trading desks that are established by a bank for the specific purpose of trading for the firm's own account. These desks tend to be set-up with segregated capital and with separate teams of people whose compensation structure mirrors those of hedge fund managers, rather than other traders within the bank, and have minimal or no interaction with client business. These "stand-alone" proprietary traders typically sit apart from traders who serve

124 Q 2897, Q 2900, Q 2912

125 Q 3868

126 Q 3660

clients as a part of steps taken to address the potential for conflicts of interest. A wider definition could bring considerable limitations.[127]

82. Martin Taylor commented on this type of conditional support:

> Many of the banks—Barclays among them—have, I believe, said publicly that they do not do that kind of thing anymore. That certainly gels and chimes with Barclays' support for the idea of a prohibition. What I think the banks are talking about is that they are abandoning specific proprietary desks, or internal hedge funds, where you have people coming in every morning and, irrespective of what the bank's position is elsewhere or what the customer flows are, simply saying, "We like the yen; let's buy the six-month position and go hard on it."
>
> It is very easy to tell the banks not to do that and it is easy to police it. What is not easy to police, of course, is the banks building up positions that are expressive of a proprietary view by the way in which they build their trading books.[128]

83. In view of the fact that one of the main objections to a prohibition related to the uncertainty about whether a workable definition of proprietary trading could be found, a number of witnesses suggested delaying any decision in the UK until the efforts of other countries that are proceeding with a proprietary trading ban can be properly evaluated. Andy Haldane said:

> I would like to take time to see how the US experience pans out with their Volcker rule. Down the line, if we have a review of Vickers in four or five years' time, as you proposed in your earlier report, we might see whether imposing the Volcker rule on top is a practical proposition.[129]

Referring to our proposals for periodic independent reviews of the effectiveness of the ring-fence and the case for full structural separation, Sir John Vickers suggested that "This might be a good topic for the first of ... [these] reviews [...] because I believe that these are really very difficult and vexing questions".[130] Lloyds Banking Group said:

> it is reasonable (as suggested by the PCBS) to conduct reviews into the effectiveness of the legislation after a suitable period of time has elapsed, and of the relevant banking groups internal controls and compliance, risk management and conflicts of interests systems. If these reviews find that the ring fencing reforms are not meeting the objectives of the legislation or that the internal measures put in place by the groups are not sufficient to identify and restrict risk, then it would be at that stage that further measures could be designed to address any shortcomings identified.[131]

HSBC recommended that any future consideration of proprietary trading should be considered alongside other elements of the design of the ring-fence:

127 Ev w1

128 Q 2890

129 Oral evidence taken before the Parliamentary Commission on Banking Standards Panel on Regulatory Approach on 21 January 2013, HC (2012-13) 821-ii, Q 178

130 Q 2588

131 Ev w17

> given that the ring-fence is intended to prevent contagion from non-core activities, any requirement for a prospective review to consider the possible case for a prohibition of proprietary trading should be part and parcel of a more general review of the effectiveness of ring-fencing, the appropriateness of the location of the ring fence, and the sustainability of critical business activities and infrastructure across both the ring-fenced and non ring-fenced banks.[132]

84. Bill Winters set out the arguments between acting now against proprietary trading and waiting:

> The argument for now would be that there's enough uncertainty surrounding the operation of UK banks today that it's better to get the bad news out now than to have a longer period of uncertainty, with the prospect of bad news down the road. Clarity is a good thing; it's a good objective. British banks need to be able to have access to capital markets to properly capitalise themselves and to serve their customers. Clarity is good, and that would argue for now.
>
> But since I don't think that the Volcker rule is a particularly helpful tool for our economy and for the regulator to impose, I would suggest we wait, because we may change our mind. Whatever we think today, we may have a different view a year, two years or five years from now, especially having benefited from whatever experience the Americans have. I think the Europeans will have a similar experience as they try to introduce the Liikanen proposals. [...][133]

He concluded by saying "on balance, and recognising my bias against the Volcker rule as a practical matter, I'll say waiting is better."[134] However, Martin Taylor pointed out another argument for not waiting, namely that "if you are going to do it, the time to do it is when the banks say that they are not doing it anyway."[135]

85. Some witnesses discussed the possibility of legislating now to give regulators a reserve power to bring in a Volcker rule, should current controls prove inadequate to contain proprietary trading over time. Sir John Vickers said:

> In the long term, I would be open minded. One simply does not know how these things will develop. If enshrining a reserve power in statute at the outset catered for those future contingencies, there might be an uncertainty point that needed to be weighed in the balance. To use the word you quoted from my paper, that would seem a perfectly "coherent" thing to do. One could then imagine a family of reserve powers: the full split reserve power, the sibling reserve power and a Volcker reserve power.[136]

Lloyds Banking Group warned against attempting to design powers now that would only be used in response to uncertain future problems, since this would give rise "to the risk that

132 Ev w12

133 Q 3696

134 Q 3697

135 Q 2910

136 Q 2582

regulators' tools are ill-suited to their needs."[137] Bill Winters warned that it could be difficult to use such a reserve power:

> The idea that the regulator has that reserve power could in some scenarios be helpful, but it would be very difficult to actually implement it. I suspect that the regulator has many more tools at its disposal to encourage or force banks to behave in a way that is different from how they are behaving without having that particular reserve power.[138]

RBS argued that a reserve power could be justified in relation to an individual out-of-control bank, but not the sector as a whole:

> We have no objection in principle to the regulator holding a reserve power to impose a restriction on the nature or scale of proprietary trading of any individual bank. However, as discussed above, we do not consider that an outright prohibition on proprietary trading is likely to deliver benefits in any way proportionate to its costs. Therefore, we see no advantage in creating either a mandate for regular review of the need for such a prohibition or reserve powers to implement a blanket ban.[139]

86. **In the previous chapter we noted the challenges associated with defining those types of proprietary trading that are undesirable. We also noted the concerns expressed about the possible distraction that an attempt to prohibit such undesirable activities now might represent to other regulatory priorities. One or both of these arguments have led many, including Sir John Vickers, Mark Carney and the FSA, to oppose the introduction of a ban on proprietary trading in the UK now.**

87. **The issues we have identified have not prevented proposals from being developed in other jurisdictions. The progress—or otherwise—of the USA, and, to a lesser extent, France and Germany, in establishing a definition of proprietary trading and enforcing their measures should become apparent over time. This will provide valuable evidence to enable a better assessment of the feasibility and likely effectiveness of similar action in the UK, although the different banking and legal traditions and regulatory approach in each country mean that experiences will not be fully transferable.**

88. **The UK ring-fence, in its electrified form, is intended to protect core banking services by separating all investment banking activity, including proprietary trading, in contrast to other jurisdictions which are proceeding with structural reforms focused solely on proprietary trading. Given the present uncertainty about the feasibility and burden of prohibiting proprietary trading within banks, the Commission believes that it would not be appropriate to attempt immediate prohibition using the legislation currently before Parliament.**

137 Ev w17

138 Q 3691

139 Ev w20

Our recommendations

89. Some witnesses said that similar outcomes to prohibition could be achieved through greater use of supervisory powers, but at a lower cost. Martin Taylor suggested that if action was needed, such an approach would be preferable to complex new legislation:

> I think that if you want to do this, the way to frame it is to ban the outright proprietary desks and to say that you expect the risk positions that arise in the course of normal market-making to be kept within reasonable bounds, and let the banks understand that, if they don't observe that, the regulators are likely to hit them with more capital on their trading book. Do that in a relatively informal way. It seems to me that under the new arrangements that are coming in for bank regulation in this country, there is some chance of making that kind of thing work, without resorting to an enormously complicated piece of legislation.[140]
>
> [...] If the supervisor lets it be known that the intention is that the banks should not take on proprietary risk positions, that the position should arise from customers flows and be hedged to keep the total value of risk at a reasonable level, and that it is necessary to report to the supervisors when it goes above that level and explain why, maybe you are beginning to get a sensible regime.[141]

90. Martin Taylor further explained that one way to put this into practice would be through using capital requirements to discourage proprietary trading:

> the way for the regulator to do that would be to calibrate the capital against the degree of market risk being run, and let the bankers know that if they increased their market risk appetite rapidly, their capital would go up even more rapidly, so it would become, at the margin, less and less profitable to them. I understand that in the new macro-prudential world, that kind of idea is on the table, and I certainly would not be hostile to it.[142]

HSBC explained how the supervisor already has discretionary powers to vary capital which could be used in this way:

> We believe that if the supervisor has concerns about the risks involved in any proprietary trading operations, it has the ability and authority already effectively to prohibit these activities in an individual bank if so required. At the simplest level, this could be achieved by increasing the capital requirements under the bank's Individual Capital Guidance (Basel Pillar 2) on the basis of protection against prudential risks, to levels which would effectively make the targeted proprietary trading activities non-viable.[143]

91. Standard Chartered also referred to these supervisory powers to apply capital charges or amend permissions.[144] The FSA's Pillar 2 Assessment Framework document sets out

140 Q 2890

141 Q 2917

142 Q 2945

143 Ev w12

144 Ev w25

that the regulator may make capital adjustments up or down “to reflect underlying weaknesses or strengths in governance, oversight, risk management and controls”.[145] Because banks currently claim that they do not engage in proprietary trading, if the supervisor were to discover evidence of such activity it would potentially imply a control or governance failure, thereby providing grounds for the FSA to make a capital adjustment under Pillar 2. It is unclear whether the legal position would allow such action to be justified on cultural rather than strictly prudential grounds, particularly in light of any EU-level restrictions on the use of capital add-ons which may emerge from the new Capital Requirement Directive.

92. HSBC pointed out that supervisors have discretionary powers to prevent activities which are deemed to pose risks beyond the capacity of the firm to manage them:

> Additionally, supervisors have wide powers to constrain activities based upon their assessment of the capabilities and capacity of individual firms to control and manage the underlying risks.[146]

RBS noted that although the FSA has considerable existing powers which could be used to control proprietary trading, there could be a case for bolstering these:

> It is possible that the current powers may take some time to exercise and therefore the introduction of an additional overarching power that allows the FSA to act immediately to require own account trading activities of a bank that is not being well managed to be reduced or suspended at short notice (whilst maintaining effective management of risk and avoiding unintended systemic consequences) may be additive to the overall powers of the regulators.[147]

93. As we noted in our First Report, the regulator has powers to vary or cancel a firm’s permission to carry on regulated business under section 45 of FSMA. This power can, however, only be exercised subject to a number of limits and safeguards to which we referred in that Report, including a requirement that it be in pursuit of regulatory objectives and that any restriction must be proportionate to the objective the regulator is seeking to achieve.[148] The FSA told us that, while they had existing powers which could be used to prohibit proprietary trading, primary legislation could strengthen their ability to use these:

> Firms' permissions could potentially be restricted to prohibit such trading. That could be done under present regulatory authority, but it would be highly preferable that if such restrictions were to be imposed across a class of firms (i.e. all RFBs) for reasons designed to promote structural separation that primary legislation specifically authorise the regulator to impose such restrictions across such a class. This would be to reduce litigation risk.
>
> The Banking Consolidation Directive (BCD) is silent on the question whether such restrictions on firms that would otherwise qualify to undertake such activities

145 Financial Services Authority, *Our Pillar 2 assessment framework,* May 2007, p 3

146 Ev w12

147 Ev w20

148 First Report, paras 159 - 160

is consistent with it. The FSA's General Counsel Division has taken the view that because the ICB's proposals go beyond matters within the BCD, it would not be impermissible for such constraints to be imposed. However, this view has not been tested and is open to argument. Primary legislation that specifically authorises the regulator to impose such restrictions is therefore desirable also to anticipate and blunt such a criticism. [149]

94. In our Second Report we recommended that in addition to the regulator having the power to “electrify” the ring-fence and force full separation between a ring-fenced and non-ring-fenced bank, there should also be a specific power to require a bank to divest itself of a specified division or set of activities, and that such a power should be able to be exercised to secure protection for the cultural position of ring-fenced activities. If the Government were to adopt this recommendation in the legislation before Parliament, it should help to overcome the potential obstacle to supervisory action described in the FSA’s evidence.

95. RBS described how a more general application of existing powers to trading-book risks would be preferable to something focused specifically on proprietary trading:

> We believe the better approach is to impose general principles requiring own account trading activity to be connected to customer activity, with specific requirements (as already exist) for capital, market and risk limits and controls to be in place, supported by robust compliance, monitoring and surveillance activities and with a strong emphasis on the correct culture and risk appetite. If at any time the regulators are not satisfied that a bank is managing its own account trading activities prudently the regulator can then invoke a standing power to restrict that activity, use existing powers to vary the bank’s permissions or otherwise impose additional capital requirements.[150]

96. Standard Chartered also suggested that the concerns about proprietary trading would be better dealt with through a more general change to how supervisors monitor and control risks in banks:

> Rather than spend time defining proprietary trading and splitting it out from risk taking associated with market-making, regulators ought to monitor the overall risk profile of banks. This approach is likely to lead to a more fruitful discussion on the approaches being taken by banks rather than a tick box approach to compliance with rules. It is the sustainability of a bank’s business model with which regulators ought to concern themselves. Regulators should measure how a bank is allocating its overall risk envelope. Is it for facilitating client business or is it undertaking standalone proprietary trading? Furthermore is the risk envelope appropriate given its client flows and revenue streams? This is really only a task that can be undertaken through effective supervision and not blunt rules.[151]

97. **The main UK-headquartered banks have told us that they do not engage in proprietary trading at the present time and do not wish to do so. We recommend that**

149 Ev w8

150 Ev w20

151 Ev w25

the PRA, with immediate effect, ensure that their regular scrutiny of banks monitors this assertion and holds banks to it. In particular, the PRA should play close attention to trading units which have characteristics such as large open or arbitrage positions and volatile revenue flows. Were a bank unable to demonstrate satisfactorily that certain trading activities relate to their core business of serving customers, this would be an indication of proprietary trading or of a more general prudential weakness in the bank. In such cases, the PRA should use its existing tools such as capital add-ons or variations of permission to bear down on such activity and incentivise the firm to exercise tighter control. As part of their commitment to enhanced disclosure, banks should be required to agree with the PRA a published statement of risk exposures in their trading book and of control issues in their trading operations raised by the PRA during the last year. Parliament will expect the PRA to report on these statements. It is possible that the PRA may not be able to justify use of existing tools in this way under its current mandate. We therefore further recommend that the Government consult the regulators on whether the current legislation needs amendment to give regulators the authority to carry out activities in pursuit of these regulatory aims.

98. **We further recommend that the current legislation require the regulators to carry out, within three years of the Act being passed, a report to include:**

i) **analysis of the monitoring and corrective actions conducted in accordance with the recommendations in paragraph 97;**

ii) **an assessment of any impediments encountered to such actions;**

iii) **the impact, by then, of the moves towards ring-fencing on banks' trading activities;**

iv) **lessons about the feasibility of defining and prohibiting proprietary trading within banks, based on the experience of other countries, in particular the USA, attempting to do this; and**

v) **a full assessment of the case for and against a ban on proprietary trading.**

99. **We would expect this report to be presented to the Treasury and to Parliament and to serve as the basis of full and independent review of the case for action in relation to proprietary trading by banks. We recommend that legislation be introduced to provide for such a review and to provide assurances about its independence, including a role for the House of Commons Treasury Committee in the appointment of the persons to carry out the review.**

Conclusions and recommendations

What is proprietary trading?

1. There is no commonly-accepted definition of proprietary trading. Most activity undertaken by banks results in some form of proprietary position. In principle, the type of trading which causes the greatest concern is where the bank is using its own funds, raised from shareholders, depositors and creditors, to speculate on markets, without any connection to customer activity. This has been the main focus of our consideration. Some banks, particularly US investment banks, historically had units dedicated to such activity. However, an examination of proprietary trading which only considered such units would be inadequate, because speculative activity can also take place alongside customer-related trading. (Paragraph 10)

Prudential concerns

2. Proprietary trading gives rise to prudential risks. Concerns about the prudential risks from proprietary trading have been cited, not least by Paul Volcker himself, as one of the justifications for legislation to prohibit banks engaging in certain forms of proprietary trading in the USA. They are also the principal justification for proposed legislation to require partial separation for banking entities engaged in certain forms of proprietary trading in Germany and France. The Commission has concluded that the prudential risks associated with banks engaging in proprietary trading are not necessarily different in kind from those associated with a range of other banking activities, many of which made a greater contribution to the recent financial crisis. However, having greater exposure to markets than is necessary for client servicing increases the potential for risks that may not be fully understood until the next crisis. (Paragraph 22)

Cultural concerns

3. This Commission was set up to address the problems of culture and standards in banking. While there is clearly a big difference between the cultures of retail and investment banking, both exist to make a profit for shareholders by providing services to customers. In principle, the carrying on of proprietary trading by banks can be thought to embody a different culture, because in such a case the bank's aim is to make a profit without providing services to customers. In recent years, there have been too many examples of banks having benefited themselves at the expense of customers across a range of activities. The wider reforms relating to banking standards that we are considering are concerned with returning customers to the heart of banking. To the extent that the presence of proprietary trading within a bank affects its wider culture, this could put at risk efforts to place customers at the heart of banking. (Paragraph 30)

4. The argument that the trading function within banks, in particular the proprietary trading function, could have harmful cultural effects has been convincingly made. The Commission is concerned that the conflict of interest which can arise from a

bank attempting both to serve customers and trade its own position cannot be easily managed, and can be corrosive of trust in banking no matter what level of safeguards are put in place supposedly to separate these activities. The Commission is also concerned that the presence of proprietary trading within a bank, with its potential to generate high short-term rewards for individual traders, could have a damaging effect on remuneration expectations and culture throughout the rest of the firm. (Paragraph 31)

Social utility and the implicit guarantee

5. Although proprietary trading which goes beyond market making can generate social utility by contributing to market liquidity, the case has not been made for banks, rather than organisations such as hedge funds, to fulfil this role. The Commission's First Report emphasised the importance of reducing the perception of an implicit guarantee to banks and the subsidy to which this gives rise. While any subsidy is undesirable, it is particularly objectionable that the Government should subsidise and carry the risk for activities where the benefits might accrue to bank employees and shareholders, much of which would have little or no social utility, and which may pose a threat to banking culture. (Paragraph 35)

Extent

6. Many of the leading UK banks have told us in evidence that they do not currently engage in proprietary trading, and a number of them agree that proprietary trading is not a suitable activity in which customer-oriented banks should engage. However, such reassurances alone cannot provide a guarantee against the re-emergence of proprietary trading over time, as public attention on banks' activities fades, economic circumstances change and another generation of bank leaders less scarred by recent events emerges. (Paragraph 39)

Controls

7. Existing supervisory measures address some of the risks—particularly prudential—arising from proprietary trading within banks. Reforms to capital requirements since the financial crisis have made proprietary trading a less attractive activity for UK banks. Greater attention to risk management and control frameworks both within firms and from the supervisor should help to limit the extent of prudential risk. (Paragraph 42)

8. Rules already exist to address potential conflicts of interest between banks and customers. However, these measures as currently applied do not at all adequately address the risks to culture and standards which have been identified. (Paragraph 43)

9. Supervisors already have broad, discretionary powers which they could use to discourage or prevent proprietary trading. These include imposing additional capital requirements and the ability to require firms to reform or cease activities which cause concern. However, it is not clear that supervisors would currently be willing to use such powers specifically to restrict proprietary trading, except where it poses a clear prudential risk. Since supervisors do not appear to view proprietary trading as a

significant threat on these grounds, it is also unlikely that they currently seek actively to identify where a bank is undertaking such activity. (Paragraph 44)

Reforms currently in progress

10. Implementation of a robust ring-fence in the UK, strengthened by measures to give effect to the recommendations in the Commission's First Report, will create a degree of organisational separation between those parts of some banks which might in future carry out proprietary trading and the core banking services provided by those banks. By seeking to confine the benefits of the implicit guarantee to retail banking, with a view to its eventual elimination, the ring-fence should also further raise the cost for a non-ring-fenced bank in funding risky trading activity, including proprietary trading. (Paragraph 55)

11. However, no measures proposed under legislation currently before Parliament would directly restrict the ability of non-ring-fenced banks to engage in proprietary trading. The possibility of contagion between a non-ring-fenced bank and a ring-fenced bank will not be eliminated. A ring-fence is not the same as full structural separation, and potential channels of contagion will remain a cause for concern. In addition, the risks and conduct of investment banks—including those which are not part of a group containing a ring-fenced bank—remain grounds for public concern, because such firms may still be of systemic importance and could contain critical economic functions. (Paragraph 56)

12. The Commission believes that, while current and planned reforms will mitigate the risks (although not the full extent of the cultural threat) from proprietary trading within certain banks, these do not go far enough. Further measures to address proprietary trading within the banking sector, including outright prohibition, could therefore be desirable in principle, provided they can be implemented in a proportionate and effective way. (Paragraph 57)

Conclusions on controlling proprietary trading

13. We have received extensive evidence from banks, and particularly from regulators and independent experts, about the practical difficulties of establishing a definition of proprietary trading which meets the standard necessary to support effective enforcement. An individual proprietary trade may outwardly appear to be similar or identical to trades arising from client activity such as market-making, with the main difference relating to the intent behind the trade. (Paragraph 76)

14. Attempting to categorise individual trades as proprietary or non-proprietary is likely to be particularly challenging. Attempting to use a broad definition would risk capturing activities which all would accept perform a useful economic and social function, such as serving clients, supporting markets or mitigating risk; in such cases supervisors could be faced with a burdensome task of having to assess firms' justifications for exemption on a case-by-case basis. However, using a narrow definition, or setting out category exemptions up-front, risks making it too easy for creative traders or firms who wish to continue speculating to evade the rules by re-classifying or disguising their activity. Another argument advanced by several

witnesses was that attempting to prohibit proprietary trading in the UK would risk distracting attention from implementation of the ring-fence. (Paragraph 77)

15. An alternative way of enforcing prohibition, as currently being developed by US authorities, would be to use a range of metrics to monitor and track patterns of trading activity in order to identify where it appeared to have the characteristics of proprietary trading. Although this would not identify which individual trades are proprietary or client-related, such metrics could be able to signal which banks are engaged in proprietary trading, highlighting risks to the regulator. While this new approach appears more promising than attempting to categorise individual trades, it remains unproven, relatively complex and resource-intensive. (Paragraph 78)

The priority for action

16. In the previous chapter we noted the challenges associated with defining those types of proprietary trading that are undesirable. We also noted the concerns expressed about the possible distraction that an attempt to prohibit such undesirable activities now might represent to other regulatory priorities. One or both of these arguments have led many, including Sir John Vickers, Mark Carney and the FSA, to oppose the introduction of a ban on proprietary trading in the UK now. (Paragraph 86)

17. The issues we have identified have not prevented proposals from being developed in other jurisdictions. The progress—or otherwise—of the USA, and, to a lesser extent, France and Germany, in establishing a definition of proprietary trading and enforcing their measures should become apparent over time. This will provide valuable evidence to enable a better assessment of the feasibility and likely effectiveness of similar action in the UK, although the different banking and legal traditions and regulatory approach in each country mean that experiences will not be fully transferable. (Paragraph 87)

18. The UK ring-fence, in its electrified form, is intended to protect core banking services by separating all investment banking activity, including proprietary trading, in contrast to other jurisdictions which are proceeding with structural reforms focused solely on proprietary trading. Given the present uncertainty about the feasibility and burden of prohibiting proprietary trading within banks, the Commission believes that it would not be appropriate to attempt immediate prohibition using the legislation currently before Parliament. (Paragraph 88)

The way forward: our recommendations

19. The main UK-headquartered banks have told us that they do not engage in proprietary trading at the present time and do not wish to do so. We recommend that the PRA, with immediate effect, ensure that their regular scrutiny of banks monitors this assertion and holds banks to it. In particular, the PRA should play close attention to trading units which have characteristics such as large open or arbitrage positions and volatile revenue flows. Were a bank unable to demonstrate satisfactorily that certain trading activities relate to their core business of serving customers, this would be an indication of proprietary trading or of a more general prudential weakness in the bank. In such cases, the PRA should use its existing tools

such as capital add-ons or variations of permission to bear down on such activity and incentivise the firm to exercise tighter control. As part of their commitment to enhanced disclosure, banks should be required to agree with the PRA a published statement of risk exposures in their trading book and of control issues in their trading operations raised by the PRA during the last year. Parliament will expect the PRA to report on these statements. It is possible that the PRA may not be able to justify use of existing tools in this way under its current mandate. We therefore further recommend that the Government consult the regulators on whether the current legislation needs amendment to give regulators the authority to carry out activities in pursuit of these regulatory aims. (Paragraph 97)

20. We further recommend that the current legislation require the regulators to carry out, within three years of the Act being passed, a report to include:

    i) analysis of the monitoring and corrective actions conducted in accordance with the recommendations in paragraph 97;

    ii) an assessment of any impediments encountered to such actions;

    iii) the impact, by then, of the moves towards ring-fencing on banks' trading activities;

    iv) lessons about the feasibility of defining and prohibiting proprietary trading within banks, based on the experience of other countries, in particular the USA, attempting to do this; and

    v) a full assessment of the case for and against a ban on proprietary trading. (Paragraph 98)

21. We would expect this report to be presented to the Treasury and to Parliament and to serve as the basis of full and independent review of the case for action in relation to proprietary trading by banks. We recommend that legislation be introduced to provide for such a review and to provide assurances about its independence, including a role for the House of Commons Treasury Committee in the appointment of the persons to carry out the review. (Paragraph 99)

Formal Minutes

Tuesday 5 March 2013

Members present:

Mr Andrew Tyrie MP, in the Chair

The Lord Archbishop of Canterbury
Mark Garnier MP
Baroness Kramer
Rt Hon Lord Lawson of Blaby
Mr Andrew Love MP
Rt Hon Mr Pat McFadden MP
Rt Hon Lord McFall of Alcuith
John Thurso MP
Lord Turnbull KCB CVO

Draft Report (Proprietary trading), proposed by the Chair, brought up and read.

Ordered, That the Chair's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 99 read and agreed to.

Resolved, That the Report be the Third Report of the Commission to each House.

Ordered, That the Chair make the Report to the House of Commons and Lord Lawson of Blaby make the Report to the House of Lords.

Ordered, That embargoed copies of the Report be made available (Standing Order No. 134 of the House of Commons).

[Adjourned till Wednesday 6 March at 9.30 am

List of published written evidence

Written evidence published by the Commission regarding Proprietary Trading is listed below. This and other evidence taken by the Commission and its Panels is available at www.parliament.uk/bankingstandards.