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Proprietary trading

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Written evidence

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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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The Reports and evidence of the Commission are published by The Stationery Office by Order of the House. All publications of the Commission (including press notices) are on the Internet at http://www.parliament.uk/bankingstandards.

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Amélie Baudot, Paul Brione, Suvro Dutta, Oonagh Harrison, Zoe Leung-Hubbard, Julia Rangasamy, John Sutherland, Greg Thwaites and Elizabeth Wilson.

Contacts

All correspondence should be addressed to the Clerks of the Parliamentary Commission on Banking Standards, 14 Tothill Street, London SW1H 9NB. The telephone number for general enquiries is 020 7219 8773; the Commission's email address is bankingstandards@parliament.uk.

List of published written evidence

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

Written evidence

Written evidence from Barclays (V001)

Call for Evidence on Proprietary Trading

The Parliamentary Commission on Banking Standards published its First Report on pre-legislative scrutiny of the Government's draft Financial Services (Banking Reform) Bill on 21 December 2012. The Commission identified the need for further consideration of the implications of introducing a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading.

The Commission requests responses by Friday 11 January.

The Commission would welcome responses to the questions below. It is not necessary to address every question, and those submitting evidence should feel welcome to address other relevant matters not raised in the questions.

Introduction

The definition of proprietary trading is fundamental to this issue generally, as well as the specific questions posed by the Commission.

Defining "proprietary trading" is notoriously challenging. Most commentators define it as "principal trading" (or taking a position for the purpose of profiting on the position itself), but activity that could be regarded as "principal trading" arises from a range of activities in banks, particularly in the context of a client-facing/market making business. Any debate about the appropriateness of proprietary trading must clearly distinguish among three different instances or examples where a bank may assume a principal trading position:

1. Trades performed by "stand-alone", ring-fenced proprietary trading desks that are organised by a bank with the specific purpose of trading in a firm's own capital to profit from short-term price movements;
2. Principal positions entered into within the context of market making/client-facing activities; and
3. Risk-mitigating hedging activities undertaken to offset risks that materialise as a result of a bank providing services to clients.

It's important to stress that trading as principal in the latter two categories, in particular, is beneficial to the liquidity of the market, so any definition should give full regard to this.

For context, it is worth noting that the FSA also employs a definition of "Proprietary Trading"—substantially for the purposes of the UK's "Approved Person" regime—as follows:

> "(in SUP 10 (Approved Persons) and APER) dealing in investments as principal as part of a business of trading in specified investments. For these purposes dealing in investments as principal includes any activities that would be included but for the exclusion in Article 15 (Absence of holding out) or Article 16 (Dealing in contractually based investments) of the Regulated Activities Order."

This is a very broad definition that does not make the distinctions noted above. For the sake of capturing individuals who could be involved in "proprietary trading", this broad definition is appropriately conservative, but it would not be appropriate for the purposes of making decisions about whether or not to prohibit any activity.

Any new statutory framework or prudential regulations would need clarity in what the UK wants to capture within its definition, and where this aligns with/diverges from international standards that exist at the moment or may develop over time. The Basel Committee on Banking Standards could play a role in defining this, to ensure a harmonised playing field.

Stability

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Barclays has made previous submissions on the prohibition of proprietary trading, for instance to US authorities in the context of the Volcker Rule.

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 clients as a part of steps taken to address the potential for conflicts of interest.

A wider definition could bring considerable limitations. Both ring-fenced banks and non-ring- fenced banks need to take some proprietary positions to prudently hedge their risk (eg, Interest Rate in the Banking Book). The Government's Draft Bill made important exemptions in this regard for "Treasury hedging activity", and these should remain. A similar case can be made for market marking activity, which provides a stabilising effect; government bond trading is a good example of the importance of this facility within a well risk-managed non-ring-fenced bank.

Prudential concerns can be generated by any concentration of risk which is not appropriately managed by a combination of eg, internal governance and control tools (including the Board- approved risk appetite framework, and the three lines of defence which include independently managed and incentivised control and control functions) within a firm as well as wider prudential regulatory controls that gauge risk appetite, as applied and monitored by the regulator, whether that risk is generated by trading on "own account" or purely to facilitate client facing business. Our expectation is, therefore, that to the extent that other reforms are not appropriately addressing these prudential risks, simply prohibiting "proprietary trading", however defined, will not address this gap in the reform process.

Standards

2. *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

The extent to which the presence of proprietary trading activity alongside client-facing activity creates the potential for conflicts of interest depends on the nature of the risk involved. This, in turn, is determined by whichever type of proprietary trading is taking place (see the introduction section above, on definition).

Certain trading activity, including trading activity undertaken to support client facing business, has the potential to generate conflicts of interest. Firms are under a clear obligation to manage these risks fairly and expressly to address such conflicts as they might apply between a firm and its clients.

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 discernable influence on any of these.

3. *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

This question is best answered by the FSA.

4. *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

There is nothing unique about the risk created by proprietary trading compared to other forms of risk present in a non-ring-fenced bank, apart from the difference in objective of the trading (ie, creating profit for own account rather than only facilitating client activity). Furthermore, there is no greater risk presented in a group that contains a non-ring-fenced bank, over a standalone non-ring-fenced bank, so no special interventions would be required for such a group.

Practical Considerations

5. *How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?*

There would be no noticeable effect. The two are very different actions, serving different purposes. The purpose of the ring-fence is to facilitate resolution of critical economic functions, whereas a ban on proprietary trading would simply prohibit certain forms of risk that are otherwise present inside a non-ring-fenced bank.

That said, this also therefore implies that a ring-fence and a prohibition on proprietary trading could function alongside each other, if both are defined appropriately.

6. *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

Proprietary trading itself is not a specific regulated activity under the Financial Services and Markets Act (Regulated Activities) Order 2001. However, the FSA does have OIVOP (Own Initiated Variation Of Permission) powers—under s.45 of the FSMA, although these have been used sparingly in practice. It might be worth encouraging the FSA to use their powers to validate risk limits more actively. We expect the FSA could comment more fully on the practicality and benefit of doing so.

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

This question has been answered in the introduction.

Overall Assessment

8. *Given the factors above, how would you assess the case for:*
(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*

As covered in the answer to Q4, 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.

(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*

To an extent, reserve powers already exist; as such, it's unclear what an additional power would add and what its objective would be.

(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*

As set out in the answer to Q5, we do not believe that a ring-fence and a prohibition on proprietary trading are related, so there would be no need to review these separate issues together.

(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

As with part (b) above, we do not think there is a clear purpose behind such a power given the other observations we have made within this evidence. In particular, if the Authorities were to determine that proprietary trading was too risky for one particular firm, it would seem odd not to make a similar determination for all firms generally. If that is because of deficiencies within the particular firm, with respect to governance, tools and/or capabilities, it would surprise us to understand that the FSA does not already have the power to prohibit any individual institution from undertaking any activity in such circumstances.

14 January 2013

Written evidence from Finance Watch (V007)

Preliminary Remarks

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. We are pleased to have this opportunity to contribute to the PCBS's scrutiny of the Financial Services (Banking Reform) Bill on the question of whether to introduce a ban on proprietary trading within banking groups that contain a ring-fenced entity.

Finance Watch is an advocate of structural separation of commercial and investment banking activities. Whilst proprietary trading raises prudential concerns, we feel that these are best addressed by strengthening the ring-fence proposal. Separating proprietary trading is difficult and, for example, increases complexity and the possibility of loopholes. Therefore, on balance, our analysis argues against a ban on proprietary trading. In our view, trading activities should be located in well regulated, supervised, and capitalised investment banks, not least to facilitate visibility and control.

In short, the simpler the rules the stronger the ring-fence. The stronger the ring-fence the less need there is to ban proprietary trading.

Summary

- Proprietary trading gives rise to general concerns, more specifically proprietary trading within banks gives rise to prudential concerns because of the possibility that losses will be borne by society, most directly via some form of bail-out.
- Additionally, recent research from Germany has shown that the presence of proprietary trading activity alongside client-facing activity in banks creates the potential for conflicts of interest directly related to banking standards.
- These concerns are to some extent addressed by ring-fencing; however compared to full structural separation there remain concerns that the ring-fence will not completely remove "perceived implicit guarantees" and their related subsidies.

— A strong ring-fence is therefore the priority. A ban on proprietary trading could reduce risk but the difficulty in defining and enforcing such a ban and the likelihood that this would allow loopholes to undermine the overall robustness of the ring-fenced approach is a greater risk.

— Separating proprietary trading from market making, or indeed hedging from speculation from arbitrage, is very difficult. For example both market making and hedging necessarily involve taking a view on price moves and expressing that view on your own account.

— Proprietary trading is one among a number of investment banking activities that are best located and regulated within a well-capitalised investment bank structurally separate from commercial banking activities and subject to prudential controls. For example, the majority of market making faces only the financial sector. Less than 10% of OTC derivatives face non-financial firms (BIS), less than 15% of UK debt securities are issued by non-financial firms (ECB), world trade is less than 5% of total foreign exchange activity (WTO & BIS).

— The difficulty of distinguishing between different types of trading activity and its overwhelmingly financial nature underline the need for a simply defined, robust ring-fence that will resist attempts to undermine it over time.

— The UK and European banking sectors continue to rely on sovereign support, whether through direct ownership, central bank liquidity or other measures. Far from imposing a cost on banking and hence on society, we consider that structural separation, (including in the form of a strong, loophole-resistant ring-fence) is key to stabilising the sector and would help to restore the flow of credit between banks and from banks to the real economy.

Questions:

Stability

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Proprietary trading within banks gives rise to prudential concerns because of the possibility that losses will be borne by society, most obviously via some form of bail-out.[1] Own-account trading of any kind conducted within an entity which is partly or wholly backed by implicit or explicit state guarantees, such as banks, encourages asymmetric risk-taking (heads I win, tails the taxpayer loses). This contributes to micro- and macro-prudential risk and can increase resource misallocation and systemic risk.

These concerns are to some extent addressed by ring-fencing, in particular if the ring-fence effectively separates trading from those parts of the banks which must be bailed out and if the investment banking entity which bears trading losses is not too-big-to-fail. However compared to full structural separation (which Finance Watch advocates),[2] prudential concerns remain. As the PCBS's first report notes, ring-fences are fallible (see also our response to question 4 below). 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.

Furthermore, allowing some trading activities within the ring-fenced entity could increase prudential concerns. All own-account trading contains a proprietary element, including those which are labelled hedging and market making (see our response to question 7 below for more details).

We note that the government's response to the PCBS report states that it "strongly agrees with the PCBS that the overall objective of banking reform should be to curtail any perceived implicit guarantees enjoyed by banks seen as 'too big to fail'" (para 2.6).

The draft legislation published 4 February 2013 provides for some trading activities to be allowed inside the ring-fence in certain circumstances provided they do not threaten the continuity of core services (142D).

This gives rise to some concerns in part because proprietary elements are present in all trading activity, making it difficult to distinguish between trading activities on this basis. Allowing trading activities within the ring-fenced entity increases prudential risk, as noted above, but is also likely to weaken the ring-fence, as former ICB members Sir John Vickers and Martin Taylor have testified to the PCBS. Attempts to distinguish between different types of trading will require constant monitoring of loopholes that arise and give banks an incentive to "innovate" in order to benefit from explicit guarantees.

The same logic applies to any attempted ban on prop trading. As has been seen with the implementation of the Volcker Rule in the United States, distinguishing and separating proprietary trading can lead to complex

[1] Proprietary trading, with its focus on profiting from short-run price moves, also gives rise to more general concerns. Prop traders must form beliefs about the beliefs of other market participants, most famously explained by Keynes' beauty contest analogy. Finance Watch believes that assessing and investing for long run returns of underlying projects is more "socially useful" than betting on price moves (see our report "Investing not Betting" at http://www.finance-watch.org/2012/04/investing-not-betting-download-finance-watchs-position-paper-on-mifid-2–2/).

[2] See Finance Watch responses to the Liikanen consultation and final report: http://www.finance-watch.org/wp-content/uploads/2012/06/Finance-Watch-response-to-consultation-on-EU-banking-structure.pdf, and http://www.finance-watch.org/wp-content/uploads/2012/11/12.11.13_Answer_to_EC_Consult_SENT.pdf

rules. The danger exists that the more complex the rules the more likely banks will "innovate" to benefit from (in the proposed UK case) implicit guarantees created by weaknesses in the ring-fence. In addition, clarity is reduced for investors and regulators in this situation.

> [NB—The general objective of the PRA as amended by section 1 of the 4 Feb draft bill, which can be summarised as ensuring the continuity of core services in the face of internal and external threats and of ring-fence bank failure, appears to us to be narrower than the three objectives set out by the ICB, which can be summarised as protecting taxpayers, ensuring the continuity of essential services and curtailing government guarantees (PCBS 130).
>
> In particular there is no express reference to "mak[ing] it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, *without the provision of taxpayer-funded* solvency support" or to "*curtail[ing] government guarantees*, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place." (PCBS 130, emphasis added)
>
> Framing those two ICB goals as subsidiary parts of the continuity of core services objective, for example by reference outside the legislation to resolution and bank conduct (Govt. response para 2.15), is not enough in our view to ensure that the ICB's public policy goals are fully taken into account by the PRA. We fear that the ICB's objectives will not be fully translated into legislation without an explicit reference in the PRAs statutory objectives to reducing the role of taxpayers in bank failures and to curtailing government guarantees.
>
> The public policy grounds for doing so are summed up clearly by the PCBS: *"A guarantee, whether implicit or explicit, distorts incentives of managers and creditors, encouraging them to pursue excessive risk and leverage. It also distorts competition, and the allocation of resources, away from smaller banks to those large enough to be regarded as systemic"* (PCBS 104). These objectives are central to the effectiveness of the secondary legislation envisaged in the bill and to the PRA's statutory review of ring-fencing and should therefore be clarified to ensure that the purposes of the ring-fence as outlined by the ICB are not undermined or eroded (PCBS 171).]

Standards

2. *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

Research from Germany into banks which managed assets for clients and undertook proprietary trading shows that:[3]

— 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.

A strong ring-fence, or better still full structural separation, would go some way to mitigating this problem by separating commercial banking from the trading culture of investment banks. One way in which separation would help is if it gives investors a clearer choice between investing in commercial or investment banking and thereby going some way to insulating investors in retail banks from investment banking culture. For example, there is evidence that investors would rather that investments in retail banks were insulated from cases of miss-selling in investment banks.[4] Steps to shift the focus of financial markets from short term price moves to long term investing would also help in this regard.

3. *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

4. *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

Yes. Proprietary trading within a group that contains a ring-fenced bank raises concerns that may not apply to proprietary trading in a standalone investment bank because funding and subsidy leakages may occur between the parts of a ring-fenced entity. As mentioned above and in the PCBS's first report, fences may be leaky, may require maintenance and may be blown over in a crisis.

For example (a) if the ring-fenced and non-ring-fenced operations are funded with capital raised at the holding company level, the blended cost of that capital would necessarily include a subsidy; (2) if, in a crisis,

[3] For Presentation of this research at the Banque de France (December 2012): http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/Economie_et_Statistiques/slides_Fecht.pdf. For a fuller write up at an earlier stage see: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783679

[4] See quote from Investment Management Association in the following article: http://thetradenews.com/news/Asset_Classes/Derivatives/Derivatives_key_to_success_of_UK_banking_reforms.aspxhttp://thetradenews.com/news/Asset_Classes/Derivatives/Derivatives_key_to_success_of_UK_banking_reforms.aspx

the ring-fenced bank were able to transfer surplus capital and/or liquidity to the non-ring-fenced entity, that would also represent the extension of a subsidy to the proprietary trading operations; (3) if the market were to doubt the effectiveness of untested resolution mechanisms it might supply capital to the non-ring-fenced proprietary trading activities at artificially low rates; (4) in a worst-case scenario, a serious failure in one part of the group resulting from proprietary trading could result in a loss of market confidence in other entities in the group and require government support for one or more of them.

Full separation of well-regulated and well-capitalised, not-too-big-to-fail, investment banks would greatly reduce the reasons for a ban on proprietary trading. Such investment banks would be able to take more or less proprietary risk as they saw fit (and as their shareholders saw fit) without posing systemic risks. Likewise, within a group containing a ring-fenced entity *the stronger the ring-fence the less the need for a ban* (the strength of the ring-fence is also affected by its location, as is discussed more fully in response to question 7). From a regulatory and a reporting perspective such investment banks offer the best chance to regulate and report on a variety of investment banking activities including proprietary trading.

Bank lending and facilitating lending via securities markets are fundamentally different banking activities. Allowing these activities to mix freely has proved very costly for the economy and financial system in the past

Practical Considerations

5. *How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?*

A ban on proprietary trading does not undermine the case for ring-fencing. Structural separation remains a critical mitigant of prudential concerns. Any ban on proprietary activity would aim to support structural separation. However a ban on proprietary trading may not be the best way to strengthen the effectiveness of separation.

It is likely that for practical purposes only a small part of proprietary trading could be banned from groups containing a ring-fenced entity, ie dedicated proprietary trading activities (see our response to question 7 below). The remaining investment banking activity would still require a robust ring-fence.

Implementing a ban in addition to the ring-fence might remove a source of potential loss and asymmetric risk-taking from a ring-fenced group; however, the difficulties of regulating and enforcing such a ban are likely to be considerable, as has been seen in the United States. 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.

6. *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

Distinguishing and separating proprietary trading from other trading activities including from market making and from hedging, is very difficult. Trading is trading.

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. Market making does not involve simply adding a margin to a (hypothetical) mid-price, it involves adjusting your price to buy and your price to sell to "win" or "miss" client trades and to adjust your inventory accordingly, all the while bearing in mind your reputation.[5]

Similarly hedging necessarily involves transforming rather than eliminating risks. Simply put the only way to eliminate a risk is to sell the source of that risk. A hedge, by definition, is something other than selling the underlying source of risk. Therefore hedging always involves taking a proprietary view eg on counterparty risk, on the movements in an index vs. the price moves of a component, on movements in prices of similar instruments with different maturities and so on.[6]

[5] This might be thought of as a traders view. A more theoretical view might argue that the separation of prop from market making (and for that matter of arbitrage from hedging from speculation) is a theoretical separation which relies on the hypothetical idea of complete markets. In such markets a single pure market price exists at which markets clear. This theory is adjusted through various market imperfections to account for market makers and their bid-ask where market makers add a margin to the pure or mid price. But this logic is in fact inverted. The perfect market does not, cannot exist except as an abstract and mathematical idea. For the market to exist requires market makers. With this, alternative, theoretical starting point the first and fundamental prices to exist are the bid-ask prices of those that make the market. Any "mid" price is then derived from bid-ask (and not the other way around).

[6] Even insurance ie against a specific and even deliverable loss involves taking counterparty risk, as counterparts to US monoline insurers and to AIG found in the recent financial crisis.

Managing derivatives positions implies by definition opening risk positions on multiple parameters (market level, interest rates, volatility, correlation, etc…) and in the reality of a trading operation there is very little, if any, economic difference between "pure prop trading" and the management of client facing derivatives positions that require the bank to take a view on the evolution of those market parameters. This issue is particularly important in the UK case given the size of derivatives positions held by the largest UK banks.[7]

The fundamental similarity between all trading activities and their difference from commercial banking activities is one reason why we prefer full structural separation to ring-fencing; and, in the absence of full separation, a strong ring-fence that would keep all market making activities out of the subsidised ring-fenced entity.

The difficulty of distinguishing between trading activities provides a strong argument for simplicity, with regard to proprietary trading but also in the location of the ring-fence. Aside from the possibility of losses, a complex definition of permitted trading activities, either inside the ring-fenced entity or elsewhere in the group, will be subject to attempts at regulatory arbitrage and to degradation over time. Simple rules, on the other hand, would simplify the choices of investors in commercial and investment banks with their respective risk profiles.

Simple rules that group trading activities in an investment bank, separated from commercial banking activities, would aid regulatory control, including addressing public interest concerns across a range of investment banking activities. For example market making involves activities that might not be fully in the public interest. The "real" economy might need investment banking (to raise large scale finance) but, funding subsidies aside, one can reasonably ask how much investment banking needs the "real" economy. The majority of investment bank trading appears to be directed elsewhere. Less than 10% of OTC derivative notional outstanding faces non-financial firms.[8] Less than 15% of UK securities outstanding (excluding shares) are issued by non-financial firms.[9] World trade is less than 5% of foreign exchange activity.[10] In short, the vast majority of financial market activity is not concerned with financing the "real" economy. Nevertheless it is banks, and only banks, that organise the issuance of these securities and make markets in them. It is not simply proprietary trading that should be insulated from public support, but also finance-to-finance securities and derivatives trading that should be forced to stand apart from (implicit) public support.

It is sometimes argued that separating all market making activity from ring-fenced subsidies would have costs as well as benefits. Specifically, it might increase market making costs for securities that are issued by non-financial firms (market making in corporate bonds), or instruments that are used by non-financial firms to hedge, eg interest rate and foreign exchange risks. We would contest this, above all we would note:

> First, we would fundamentally contest the premise of the trade-off. While UK and European banking remains in dire shape (in public hands and often in receipt of central bank liquidity provision) measures to stabilise the sector and bring a return of confidence are more likely to decrease (stand-alone) funding costs than to increase them. Comparisons between a banking system post-structural separation and a theoretical healthy banking system pre-structural separation serve no purpose in assessing current policy options.
>
> Second, as pointed out above only a small percentage of investment banking activity relates to non-financial firms. Removal of the funding subsidy (in conjunction with other measures) might remove some trading activity which does not relate to financing non-financial firms. This could be considered as a positive development for taxpayers as it would reduce both systemic risk and the "taxpayer put" subsidy for these activities.
>
> Third, there is no reason that a loss of subsidy would necessarily be passed on to corporate customers. Given the right incentives banks could choose to reduce their margins rather than pass on any increased funding cost.[11] Investment banks in recent years have been targeting very high returns on equity eg much higher than GDP growth.
>
> Fourth, for essential activities like making markets in Government bonds, funding of inventory is not an issue as the assets traded (Government bonds and bills) can be easily financed through repurchase agreement ("repo") operations which are, regardless of market circumstances, always the easiest and cheapest way of refinancing available for such activities.
>
> Fifth, if one considers the total cost of funding of a bank (and therefore of a universal bank) is a direct function of the risks taken on the asset side of the balance sheet and if excluding a number of risky trading activities increases the cost of funding of these activities, this will also mechanically decrease the cost of funding of ring-fenced activities which, by definition will be positive for the economy and for society.

In short, there is great difficulty in distinguishing and separating proprietary trading from other trading. All own-account trading contains elements of proprietary trading, including market making and hedging of "simple

[7] For example the Liikanen report (p124) shows that RBS and Barclays held considerably higher percentages of derivatives than other large European banks with the exception of Deutsche Bank.

[8] http://www.bis.org/statistics/derstats.htm

[9] http://www.ecb.int/stats/money/securities/html/index.en.html

[10] http://www.bis.org/publ/rpfxf10t.htm and http://www.wto.org/english/news_e/pres12_e/pr658_e.htm#table4

[11] Given non-financial firms' lack of financial market experience relative to banks it is possible that they are already charged higher margins than eg, hedge funds (in fact this is very likely to be the case).

derivatives" and other trading activities that the law as currently drafted might allow inside a ring-fenced entity. We feel the challenges of distinguishing and separating proprietary trading are best addressed by not attempting to do so—and instead by corralling all trading activity into well regulated, supervised and capitalised investment banks.

Overall Assessment

8. *Given the factors above, how would you assess the case for:*
(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*

While proprietary trading in banks gives rise to prudential concerns, attempts to prohibit it also come with dangers. On balance, Finance Watch feels that rather than trying to ban prop trading, the best approach is to strengthen the ring-fence to ensure that losses from proprietary trading cannot blow it over.

Only the most obvious proprietary trading could be banned with ease, while the remaining own-account trading will retain proprietary elements. Moreover any attempt to define proprietary trading is likely to create opportunities for banks to "innovate" around the definition. Simple rules reduce the opportunity for lobbying[12] and are easier for regulators to enforce.[13] Simple rules also increase the transparency for investors. Finally there are also regulatory advantages from keeping proprietary trading in investment banks under the control of banking supervisors and regulators and capitalised under Basel and Capital Requirements Directive regulations.

Finance Watch has been active in the banking separation debate in several places in Europe (see our responses to the Liikanen Commission and Report, and to the French Parliament for example).[14] We would note that the proposed approach in the UK is closer to that of the EU's Liikanen Commission, which did not recommend a ban on proprietary trading, than current proposals in France and Germany are. In this regard, the UK has the opportunity to inspire a race to the top.

(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*

(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*

(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society.

Its mission is to strengthen the voice of society in the reform of European financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large section of European citizens.

Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society.

13 February 2013

Written evidence from the Financial Services Authority (V005)

Stability

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Whenever banks engage in trading activities they take on risks—in particular the risk that their investments will fall in value (market risk) and the risk that the counterparties to their investments will fail to pay them (counterparty credit risk). Losses caused by these risks will erode a bank's capital base. Banks are required to hold capital to protect against such risks. Whether banks are trading for proprietary reasons, or to facilitate client business, they will be exposed to some market and counterparty risks. The key difference is the scope and breadth of these risks.

When facilitating client business a bank is likely to try and "hedge" most of its risks. However this will never be certain as: (i) there will often be some mismatch between the position and the hedge—known as basis

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[12] As noted in previous evidence. Eg, MTaylor Q386
http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/c606-vii/c606vii.pdf

[13] As noted in previous evidence. Eg JVickers Q2574
http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/c606-xxiii/c60601.htm

[14] See http://www.finance-watch.org/2013/01/finance-watch-proposes-amendments-to-french-bank-reforms/

risk; (ii) there will be a need, and a cost, to "rebalance" hedges as market moves alter risk profiles; (iii) there will always be a reliance on the "hedge counterparty" to remain solvent.

When undertaking proprietary trading, banks will try and target certain risks that they wish to take, and hedge others—thus all the same hedging risks apply. However, 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.

We consider that a strong ring-fence should help insulate the provision of core financial services from losses that could arise from proprietary trading. We also note that the Basel Committee is conducting a review of the capital requirements for trading activities which will further supplement the changes to the capital regime made following the banking crisis.

2. *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

Where a bank decides to engage in proprietary trading there is a potential for increased principal-agent conflicts with its clients. 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.

In terms of remuneration, front office staff across different industries tend to have pay and bonuses linked to sales and profitability. In a highly volatile environment such as trading in financial instruments, this can bring along unwelcome incentives in the form of excessive risk taking and short-termism.

To help address this, the objective of the FSA's Remuneration Code, which implements the remuneration provisions of the Capital Requirements Directive III, is to ensure that firms adopt remuneration policies which are consistent with and promote sound and effective risk management. The code recognises that perverse incentives encourage excessive risk taking. These incentives exist in varying degrees across banks' operations as a whole and are not restricted to one type of activity.

Overall, the PRA's approach to improve banking standards will be to expect the banks' governing bodies to embed and maintain a firm-wide culture that supports the safe and sound management of the firm. The PRA will expect boards and management to understand clearly the circumstances in which the firm's viability would be under question and to take action to address risks on a timely basis.

3. *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

The current conduct regulatory framework (both rules and high level Principles for Businesses) provides the requisite degree of flexibility for supervisors to exercise the necessary degree of supervisory judgment. The framework takes into account the variety of activities and business models in the financial sector, together with the multiplicity of circumstances in which conflicts of interest and risks may arise in practice as a result of firms' proprietary trading activities.

For these reasons, it is not currently envisaged that the FCA will introduce additional conduct rules to strengthen the current framework. That said, it is important to note that the FSA's rules derive from European legislation with the trend continuing to be for Europe to adopt directly applicable regulations.

Conduct risks, and potential conflicts of interest are ubiquitous in the financial services industry although the potential for risks to arise is likely to be greater under the universal investment banking model where firms provide a wide range of financial services and activities. In this context, the potential for conflicts of interest where firms engage in proprietary trading in addition to providing services to their clients is particularly acute.

The FSA manages the risk of detriment to clients arising from firms' proprietary trading activities in two ways.

— 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.

With the changes to the UK's regulatory structure the FCA's approach to supervising the conduct of firms' wholesale activities will undergo an evolution. The regulatory framework will not change, however the FCA's approach to supervising against it will. The FCA will place more focus on the rules and supervising against them. The FCA will recognise that the wholesale conduct and the internal organisation and arrangements of firms can pose risks to all participants in the conduct of their activities and cause harm to retail consumers.

For this reason, in order to enhance trust and the integrity of financial markets, the FCA will be willing to intervene in a greater range of client relationships. This will mean that areas which have not been a focus for the FSA in the recent past will be looked at more closely. This will be through the FCA's Supervisory Framework or event-driven work.

4. *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

Yes, potentially. There are three reasons for this.

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.

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.

Practical Considerations

5. *How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?*

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 practise.

The ICB concluded that its reform package for the UK would achieve the main aims of full separation at a lower cost, and without creating a potential risk to financial stability that could come from having undiversified, correlated, stand-alone domestic retail banking.

A strong ring-fence can achieve the banking reform objectives as set out by the ICB; however, if the intention is to focus additionally on reducing the potential for conflicts of interest to arise then some form of the Volcker rule may provide additional benefits to ring-fencing but, as stated previously, we consider that enforcement of existing conduct rules and principles can address conflicts of interest issues that arise.

6. *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

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 (ie 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 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.

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.

We consider that a ban on the acquisition of UK retail or ring-fenced banks by UK investment banks would be beyond the scope of the BCD, provided it is for the purpose of the prudential supervision of UK investment banks. However, a blanket prohibition on the ownership of UK retail or ring fenced banks by EEA investment banks or holding companies that also own investment banks could be incompatible with the BCD.

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

The main challenge is defining proprietary trading in a manner that banks could not circumvent by claiming to be engaging in some form of market making activity on behalf of their clients. For example, some banks may claim that they are hold positions (stock) in a market in the expectation of future client needs. This is because it is always possible to sell products to a client and then immediately hedge the resulting market risk. However, clearly until they offset the market risk they have a proprietary position.

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.

Overall Assessment

8. *Given the factors above, how would you assess the case for:*
(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*

This proposal amounts to overlaying (some of) the Volcker rule on top of ring-fencing. Both ring-fencing and the Volcker rule seek to address similar objectives. In our view, the size of the benefits arising from overlying the Volcker rule on top of ring-fencing is dependent on two factors: (i) how robust the fence will be, and (ii) whether in practice we will end up with ring-fenced banks that effectively undertake all banking services that we would want to preserve in a time of crisis.

The stronger (and wider) the fence the lesser the case for overlying the Volcker rule on top of ring-fencing. In any event, trying to do both ring-fencing and the Volcker rule at the same time may lead to overly complex pieces of legislation and regulation.

Assessing the development and practical effects of the Volcker rule in the US could form part of the proposed independent review of the ring-fence.

(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*

The reserve power that was suggested in the Parliamentary Commission's first report could potentially be used to impose some form of prohibition.

(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*

If this is an issue that Parliament wishes to consider then it could be included in the terms of reference of the future review of ring-fencing.

(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

See response to b) above. There is a legitimate question as to whether powers giving effect to structural reform of this magnitude is a matter for the regulator or for Government and/or Parliament. Although clearly there is a role for the regulator in advising Parliament as to whether such a prohibition would help it meet its statutory objectives.

15 January 2013

Written evidence from HSBC (V002)

Preamble

It is important at the outset to recognise that 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. Accordingly, it is not possible to define proprietary trading by reference to the beneficiary of market price movements as the impact of all such movements accrue to equity holders yet only a subset of activities would be regarded as trading and only a subset of these would be regarded as proprietary trading by most analysts. Proprietary trading definition is both complex and subject to considerable interpretation challenges.

We hope the comments below are helpful to the Commission in its deliberations on this important topic. The comments follow the pattern of questions set out in the Commission's request for an additional submission.

Stability

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

The prudential risks of proprietary trading arise in three main areas:

(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; and

(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 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.

A further risk increasingly being recognised arises from the possibility of market disruption from algorithmic or high frequency trading where the impact of programming errors or mis-keyed data input can cause a huge volume of automated trading to occur with potential to disadvantage other market participants who deal in the period of market disruption. While algorithmic and high frequency trading can improve pricing and transparency for all market participants automated trading systems do not have behavioural standards—they simply do what they have been programmed to do.

Valuation and calibration concerns

The run-up to the financial crisis saw increased and widespread acceptance of and reliance on internal models by both management and regulators. These proved defective in many ways; they were highly pro-cyclical, they took inadequate account of leverage and liquidity risks and, because there had not recently been crises, most did not reflect adequately the potential scale of tail risks inherently accepted. The complexity of the models however created a false sense of precision of risk metrics which allowed a build-up of directional and tail risk. As a result many risk models failed to be valid at precisely the point where they were most needed—with the realisation of tail events.

To address these issues the completeness and adequacy of trading book risk models has now been extensively re-assessed. Pro-cyclicality remains, but with the introduction of various incremental models for tail risk, capital standards for bank trading books have been strengthened by a multiple. Wider reforms in the capital markets, in particular a substantial increase in trading book capital requirements, will also reduce the quantum of trading assets and the associated capital risks carried by banks. In large part this is because higher capital and liquidity standards have rendered arbitrage trading activity that relied on leverage uneconomic.

Even with more comprehensive models, improved calibration and strengthened capital levels, there remains some residual danger that these have not been calibrated for all possible risks. For less sophisticated banks, for example, there is a residual risk that standardised capital requirements have been wrongly calibrated, and that their proprietary trading operations, albeit smaller, could create a risk of unexpected capital loss. Valuation, particularly in illiquid market conditions will remain an issue and be most difficult for the more complex instruments or structured products, in particular so called Level 3 assets, as defined for accounting purposes, where the inputs to valuation are not observable and the valuation has therefore a greater element of judgment.

Contagion

The creation of central counterparties for standardised derivatives and the severe capital penalties for using OTC derivatives will be an important structural mitigant against contagion from proprietary position-taking through derivatives. In addition, for the six largest banks in the UK, the ring-fencing proposals together with recovery and resolution planning including bail-in debt will protect systemically important retail and commercial banking activities from exposure to risks from inaccurate risk calibration or valuation of proprietary transactions. However, the current ring-fencing proposals do not address:

(a) the risks which may still reside in smaller banks which could continue to take deposits and engage in proprietary trading; or

(b) the potential impact on the other important but non-proprietary trading activities which are outside of the ring-fenced bank; for example lending and money transmission for non ring-fenced corporate entities.

The proposals from the High Level Expert Group chaired by Erkki Liikanen have set out a different approach to addressing the risks arising from trading activities within banks by considering both the absolute size of these operations and their size relative to the remainder of the firm. Once a materiality threshold has been reached on both bases, a separate subsidiary would be required. This structural requirement is premised on an assessment of the extent to which risks from trading activity could damage the capacity of the bank to support its other activities. It also reflects a judgment that trading risks, of an appropriate size and properly capitalised, within a much larger balance sheet should give rise to no more prudential concerns than an equivalent risk profile arising from any other asset classes such as UK mortgages or SME loans which could also be subject to material fluctuations in value.

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. In the UK proposals, relationships with financial institutions and market-making activities are required to be excluded from the ring-fenced bank and so like the Liikanen proposals they are specifically included alongside proprietary trading activities within a separate subsidiary.

But 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.

We note that both the US and proposed French approaches to structural reform have recognised this by drawing the line for ring-fencing simply to separate all the activities which are established to support customers from any residual proprietary trading activities. This recognises, amongst other things, the importance of acceptable market-making to facilitate client funding and investing activity.

Standards

2. *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

As noted in the preamble, whether in proprietary activities or in market making or other financial markets activity, banks trade as principal and therefore there are inherent conflicts which are addressed through formally regulating conduct—best execution standards for example—and through firms' own conduct rules. The key structural protection arises from the firm's own conduct rules bolstered by regulation around transparency, conduct, concepts of fairness (including addressing information asymmetry) and most importantly classification of which customers are regarded as sophisticated enough to deal on a principal basis with banks. Essentially the inherent conflicts are regarded as acceptable and manageable if there is clear disclosure of the nature of the potential conflicts and clients are regarded as sufficiently sophisticated and well informed to deal with the bank on a principal basis, understand all aspects of the transactions being undertaken and have alternative suppliers for these services.

There is clearly the potential for conflict when firms have both proprietary trading activities (which have no client relationship) and client-related activities, and the two operations have underlying positions which are in conflict; 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.

It should be understood that, by definition, market activity requires two sides to a transaction and therefore differing views on market movements. As a consequence, banks and their counterparties will always have both same way and offsetting exposures at any point in time. The inherent conflicts have less behavioural implications when they arise from market making or risk management activity as opposed to proprietary trading; essentially this is because the firm is not seeking in these activities to benefit from directional moves and so has no incentive to attempt to influence pricing. Remuneration from market-making and the firm's own risk management activities is also not structured around trading profits as would be the case in respect of proprietary trading.

Some of these issues were highlighted in the report of the US Senate's Permanent Subcommittee on Investigations into Wall Street and the Financial Crisis: Anatomy of a Financial Collapse published on 13 April 2011. We would expect that firms which engage in proprietary trading and client-focused will have modified their activities in the light of these findings.

However, given that we do not undertake proprietary trading activities, HSBC does not feel it is in a good position to comment further.

3. *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

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.

4. *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

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.

Practical Considerations

5. *How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?*

If the UK's ring-fence proposal had been based solely upon the perceived risks to critical activities arising from proprietary trading, then the prohibition of such trading would have been the most appropriate parameter for the ring-fence. This would have been in line with the US approach and what is now being contemplated in France.

But this was not the case and the UK ring-fence draws a distinction between retail activities, where customers are less sophisticated in their ability to assess the position and stability of their bank and have fewer options for their financial needs, and wholesale activities, where customers do have the capacity to understand these risks and manage or switch their providers accordingly. The UK approach also is designed to offer a distinct resolution approach for the retail ring-fenced bank versus the non ring-fenced bank, with the former to be restructured using bail-in of unsecured uninsured creditors but leaving the option of liquidation open for the latter (although the practicalities of that distinction are questionable).

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. This is a discussion which is taking place in Europe but it was not the approach adopted by the Independent Commission on Banking ("ICB").

If there is to be further consideration of the nature of the ring-fence, we believe that the Commission should also reflect on the increasing trend towards geographic subsidiarisation which has developed since the ICB took its evidence and produced its first report. We see a significant trend towards this in recent proposals from the US on the regulation of Foreign Banking Organisations and in the actions of our own FSA to restrict the authorisation of branches for non-EU banks. This will significantly change the nature of banks in the UK—at the time of the ICB's interim report, we estimated that drawing a perimeter to exclude non-EEA assets would reduce the scale of the UK domestic banking sector by some 30% and so offer potentially considerable protection to UK financial stability from risks arising from non EEA operations.

In essence we are now seeing four distinct types of ring-fencing emerging:

- the UK ICB proposals based on ring-fencing critical activities, drawing a distinction between retail and wholesale;
- the US approach based on prohibiting defined proprietary trading;

— the proposed French approach defining acceptable market making and risk management activities and prohibiting everything else; and

— geographic ring-fencing in a variety of formats.

6. *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

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. 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. Finally, in the current environment, reaching out to the Board of the bank concerned would undoubtedly, at least in an HSBC context, be effective in curtailing activity of concern to the supervisory authorities; a Board would not lightly go against a regulatory concern over a trading operation.

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

The most useful definition which goes to the heart of where there are public policy issues is that "proprietary trading" is specific risk positions taken by banks solely in pursuit of their own profits and not undertaken to support clients or to hedge the bank's own risk profile including prospective risks. Proprietary trading would typically be identified as activity undertaken by separately identified trading desks with identified capital, risk limits and specific proprietary trading goals in terms of profitability.

The main challenge is that there can be a lack of distinction between positions which are undertaken to support client activity or hedging and "proprietary trading"; this makes it difficult to set out clear technical and legal distinctions. Again as set out in the preamble, all banks trade as principal and therefore the price risks from market positions are identical irrespective of the purpose of the trade. The largest exposures to capital within banks typically arise from structural interest rate and foreign exchange positions rather than any trading activities and these risks are inherent in the core business model of lending long at market interest rates funded by short term deposits priced at administered interest rates, as well as deploying a portion of the capital base in markets other than the domestic base of the bank.

Even the simplest core banking activity exposes a bank to market risk as principal. Consider a bank making a fixed rate mortgage offer: it will hedge its interest rate exposure risk on those loans through interest rate swaps or by raising fixed rate funding from the market. It can do this in two ways:

(a) it can raise a tranche of fixed rate funds for lending in advance of the mortgage sales, but with the risk that it will not be able to distribute these funds and so be left with an amount of fixed rate funding unmatched by fixed rate loans; or

(b) it can build a portfolio of loans with the expectation that these can be hedged in tranches as the portfolio is built but thereby accepting the risk that it might be unable to fund the loans at the expected price after it has committed the fixed rate to the borrower.

Banks will choose which approach to use depending on their own circumstances (for example, do they have an existing source of funds or is additional funding required) but both have risks—there is a danger that the mortgage loans cannot be originated or the funding risks cannot be hedged. Most practitioners would not regard this as proprietary trading but, in both cases, since any gains or losses which occur during the transition period are taken by the bank to the profit and loss account, it might fall under some definitions of "proprietary trading".

More generally, banks do not perfectly match the risks which they accumulate from their dealings with customers and from the risk mitigation contracts which they place in the market; partly this is infeasible and partly this is a management decision to run an inventory of open risk to facilitate market-making and to profit from knowledge gained from market flow information. For example, 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".

The most difficult areas in attempting to identify proprietary trading are how to distinguish this from both client-driven activities such as market-making and risk management operations of the bank, hedging its own exposures including structural exposures. Essentially there are two possible routes to go down; first a very precise definition of activity that is regarded as proprietary trading—for example investment in hedge funds—with everything else not so regarded; or alternatively a definition of what is not proprietary trading based on purpose and intent of the underlying transactions with everything else regarded as proprietary trading.

In seeking to define proprietary trading, regulators and commentators have used a number of dimensions to separate the mainstream activities which enable banks to support customers and manage their own risks from "proprietary trading". These include:

— direct links to specific client activities;

— links to overall bank risks arising from multi-client activities (ie hedging);

— expected and actual investment durations;

— relative and absolute scale of risk positions;

— organisation (separation, desks); and

— profitability (volatility of daily/weekly profits).

We believe that these dimensions can be used to create a good working definition of proprietary trading and, indeed, these will underlie the French approach to structural separation. Within this, there will be a definition of acceptable market-making and this has already been developed in a number of areas including the EU Short Selling Regulation which contains an exemption for market-making.

For the purposes of this response, a working definition of proprietary trading might be: *"transacting in contracts, assets and securities not directly related to:*

(a) activities undertaken on behalf of customers; or

(b) the prospect of activities to be undertaken by customers; or

(c) market-making; or

(d) the hedging of such market making , or actual or prospective activities; or

(e) the management of balance sheets and structural risks arising from activities undertaken to support customers".

This is consistent with the underlying approach of the Volcker Rule in the US and the French proposals on separation published on 19 December 2012.

Overall Assessment

8. *Given the factors above, how would you assess the case for:*
(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*
(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*
(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*
(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

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. This may not be warranted given that ring-fenced banks will already be prohibited from undertaking these activities.

We note also that the Commission has suggested that regulators should have a reserve power to require the full separation of the non-ring fenced bank and as this would necessarily include any proprietary trading activities within that bank it would be possible to distance the ring-fence bank further if thought desirable in the future.

If there is concern that the non ring-fenced bank has exposure to proprietary trading risks that could critically damage the important real economy activities that will reside in the non ring-fenced bank then there would be a case to prohibit such activities. In such circumstances we believe the French approach of defining what is not proprietary trading is the better solution to address the definitional challenge.

However, 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.

Finally, we believe that if the supervisor has concerns about the risks involved in any proprietary trading operations, it can already with existing powers effectively prohibit these activities in an individual bank if so required.

15 January 2013

Written evidence from Lloyds Banking Group (V003)

We refer to your letter of 21 December 2012 and welcome the opportunity to comment on the implications of introducing a prohibition on banking groups containing a ring-fenced bank from engaging in proprietary trading, as being considered by the Parliamentary Commission on Banking Standards ("*PCBS*"). For clarity, we assume your question related to whether banking groups can conduct proprietary trading anywhere in the group.

Defining Proprietary Trading

To answer the specific questions raised in your letter, it is useful to start by defining proprietary trading. 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. It 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. Typically the positions would be recorded in the trading books of the entity.

Lloyds Banking Group (the Group) has no such segregated unit.

Answers to specific questions:

Stability

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Having "true" proprietary trading within the same legal entity as insured retail deposits raises the risk that capital and funding could be mis-allocated and a "cross-subsidy" could occur, in terms of lower cost of funding and lower cost of capital. Placing any such proprietary trading activities into a separately capitalised and funded subsidiary outside the ring fenced bank ensures that these activities would be subject to a stand-alone cost of capital and funding that appropriately reflect the activities' risk.

Standards

2. *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

As noted above, 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.

In view of the cyclical nature and higher risk of proprietary trading, the remuneration of management and staff should be designed to discourage conflicts of interest. Remuneration at banks (as is the case at the Group)—including that of trading staff—should always reflect a balance of a broad range of objectives. These should cover client service and franchise development, risk management and financial performance.

3. *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

The current conduct rules provide an adequate framework for the identification and management of potential conflicts of interest. The current regime combines a high level principle (Principle 8: "*a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client*") with detailed requirements contained within the Senior Management Arrangements, Systems and Controls requirements ("*SYSC*") section of the FSA's Handbook. SYSC requires firms 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. SYSC 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.

4. *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

No, all other things being equal, there should be lower concerns. 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. Banning proprietary trading would therefore be redundant if the activities which are permissible within the ring fenced bank are clearly set out, including those activities indicated above as *not* constituting proprietary trading.

For the avoidance of doubt, the Group does not have a segregated proprietary trading unit.

Practical Considerations

5. *How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?*

Different jurisdictions are taking different approaches to containing risk taking activity in banks. In the US, via the Volcker rule, a ban on proprietary trading is being developed as an alternative to the UK's ring-fencing of core activities. The Liikanen proposals are another option where the proposal is that large-scale market activities are ring-fenced from the rest of the bank group.

In our view, a properly implemented ring fence should be sufficient to insulate the key economic functions of a ring fenced bank from any risks posed by any proprietary trading elsewhere in the group. Furthermore, ensuring the continuity and security of key economic functions is better served by identifying those activities, rather than the reverse, as proposed by Liikanen.

6. *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

The regulator already has the powers to restrict or suspend any permission which a firm has to carry on regulated activity, including dealing in investments as principal. Exercise of these powers would be subject to the existing constraints on the FSA's exercise of its regulatory authority.

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

Defining proprietary trading as distinct from market-making is clearly difficult, as evidenced by the volume of regulation that has sprung up in the context of the Volcker Rule. Given the importance of providing groups which contain retail and commercial banks with the tools necessary for providing a sufficient range of services to their customers and managing their own balance sheet in a prudent manner, it is particularly key to identify activities which should be excluded from the scope of any discussion on proprietary trading, and therefore permissible in a group containing a ring-fenced bank.

In our view, the purpose for which activities are undertaken should play a role in determining whether an activity is classified as proprietary trading. In particular, the following should be excluded from the definition of proprietary trading, to the extent undertaken by a banking group containing a ring fenced bank:

(1) Own balance sheet risk-mitigating hedging and asset and liability management activity.

(2) Underwriting securities and associated primary issuance transaction support.

(3) Transactions on behalf of customers (such as the purchase or disposal of securities).

(4) Provision of non-complex hedging to customers.

(5) Providing capital to businesses and public welfare entities as a general investing activity.

(6) Any insurance business (including the investment by insurance companies for their general account).

(7) Initial investment by way of providing seed capital to asset management funds.

(8) Buying and selling government and municipal debt securities, to the extent this activity is carried out:

  (a) by or on behalf of the treasury function of the Group for the purposes of the bank liquidity portfolio; or

  (b) purely for the purposes of gilt edged market making.

(9) Market making.

Market making is an essential part of the services provided by retail and commercial banks to their clients, and should be distinguished from proprietary trading. As a simple analogy the bank will, like a retailer, hold a certain number of days of anticipated turnover of relevant inventory to meet future client demand efficiently and cost-effectively. If the bank was unable to hold inventory, this would impact clients both in terms of timing—the client may have to wait until the bank could find an offsetting order against which to match the demand—and effectively would leave the client carrying the market risk exposure until an offset could be found.

At the Group, and many other banks, the degree of market risk taken in order to facilitate client activity, is carefully controlled and sized relative to the volume of that client activity. Specifically the scale of market risk undertaken by the (Trading) market-making desks is strictly limited by risk controls set by the overall Board risk appetite and specific risk limits for:

— Overall Group risk limit which are determined by the Board Risk appetite. These limits are cascaded down to business divisions and ultimately desks and are monitored by an independent Risk function which reports via the CRO to the CEO; and

— A specific Value At Risk (VAR) limit for the Trading desks in aggregate and at a sub-desk level (calculated on a 1-day 95% confidence level, ie a 1 in 20 day worst case scenario) This is sized as a very small percentage of the overall revenue budget for the Sales & Trading (client market transactions) business. The VAR limit can be temporarily increased in exceptional cases to meet larger than normal client flows with clearance from the Risk function.

Since some of the activities listed above may evidence similar characteristics to proprietary trading, even though they pursue different objectives, it is important to have strong risk policies, procedures and regulation to help overcome these challenges.

We agree that banking entities should have and maintain a robust and comprehensive set of internal policies and procedures, meeting regulatory standards, to ensure that only permitted activities are carried out and to identify when breaches have occurred. By way of example, it could be required that banking entities produce operating procedures for each business/desk regarding permitted trading activity, and including (i) the mandate of each trading unit/profit area, (ii) a description of how revenues are generated and positions hedged, (iii) activities engaged in by the trading unit/profit area, (iv) a list of the types of products approved for transactions, (v) a description of the remuneration policy for those engaged in risk-taking activities; (vi) the types/levels of risk which are permitted to execute the stated mandate of each such trading unit/business, and (vii) the review and escalation procedures for breaches of limits and controls.

Developing and maintaining these policies and procedures at the level of each business/desk will help avoid a generic approach in a banking institute which could inadvertently prohibit a permitted activity or permit a prohibited activity. It would also assist with the supervisory assessment of the appropriateness of overall compliance programmes.

Overall Assessment

8. *Given the factors above, how would you assess the case for:*
(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*
(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*
(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*
(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

As outlined above, we reaffirm our support for strong and clear rules to be put in place to create a ring fenced bank to establish a delineation between traditional client-oriented banking/banking group management and higher-risk activities to be kept outside the ring fenced bank. To the extent that the above guidelines can be agreed for identifying what should be excluded from the scope of proprietary trading, or identifying what activities should be permitted within a ring fenced bank/its group, this will strongly support the aim of the ICB and the draft legislation in promoting a stable retail banking system providing client-oriented services. Subject to this, we consider that it is unnecessary and redundant to ban proprietary trading by any banking group containing a ring fenced bank. Additionally it would add a further level of complexity to the regulatory structure without providing additional protection to the ring fenced bank or to general financial stability of the United Kingdom.

As with any extensive new reform, however, 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. Including measures in current legislation to anticipate potential future problems gives rise to the risk that regulators' tools are ill-suited to their needs.

22 January 2013

Written evidence from The Royal Bank of Scotland Group plc (V006)

Overview

We respond below to the Commission's consultation in relation to proprietary trading and the potential impact that proprietary trading may have on the stability of financial groups that include a ring fenced bank.

1. Introduction

A. As in most forms of commerce, a degree of build up of stock or inventory forms a component of a bank's trading activities. In relation to customer driven activities inventory is built up to allow the bank to anticipate and meet customer driven demand.

Trading activity may consist of a combination of activities undertaken purely for the bank's own account (where the bank trades against its own capital to build up potentially illiquid positions which are held with the intent of generating profit and not as part of supporting customer activities) and other own account trading which is connected to customer activities. 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. If the position taking that results in a build up of inventory is related to actual or anticipated customer activity then that is still a form of own account risk taking (but is not "pure" proprietary trading) but is an activity that we believe is necessary in order to support customer activity and drive overall economic activity (see 3. below).

Given that the own account trading that RBS undertakes is predominantly connected to customer activities and given the risk controls we have in place (see section 5. below) we do not believe that there is a material risk that such trading could disproportionately affect RBS' financial or capital position. Our analysis is based upon an assessment of both the character of the activity undertaken and the controls and cultural changes we have introduced since 2008 to better manage the risks associated with these activities.

B. When considered through an analytical (objective) lens the trading risk that is created in banks as a result of "pure" proprietary trading is potentially hard to distinguish from that which is connected to actual or anticipated customer activities (including market making), meeting customer portfolio needs and portfolio hedging (as described in section 3. below). Both forms of activity can result in the build up of significant volumes of inventory. Some of this inventory may be present on banks' balance sheets for extended periods of time. This poses a significant challenge when considering how law and regulation might be used to restrict proprietary activity as there is no bright line that can be drawn to differentiate between the two types of activities.

In the US designing the implementing regulations for the Volcker Rule which seeks to address proprietary trading has proved challenging (please see section 4. and response to Q7. below).

C. We believe the concerns expressed by the Commission about the risks associated with "pure" proprietary trading are fair but that they can be addressed: (i) by ensuring that banks are prudently managed, that their own account trading activities are prudently controlled and restricted to trading connected to customer activities; and (ii) through exercise of existing regulatory and supervisory powers supplemented by granting a reserve power to the regulator to impose a restriction on the nature and scale of own account trading activity undertaken in any regulated institution, which power could be invoked if the regulator concludes the institution is not being prudentially managed.

D. We believe that any absolute prohibition on own account trading activity within a financial group that includes a ring fenced bank would be unlikely to deliver material additional prudential or systemic benefits beyond those that are achievable through a combination of the existing regulatory controls and the other structures proposed by the Commission.

Conversely we believe that such a prohibition (that goes beyond "pure" proprietary trading and extends to own account trading activity connected to customer activity) would: generate very significant costs for the relevant financial groups; be complicated for regulators to administer; call into question the investment case for shareholders in those financial groups; and would have a significantly adverse impact on customer services and related levels of economic activity.

2. Trading, Market and Credit Risk

For banks almost any activity could be described as taking a "proprietary" risk and, if that risk relates to credit, trading or market risk then it is possible for that to be "proprietary" trading in a general common language sense.

For example, even when making a simple loan the bank is taking a credit risk which is itself proprietary. That is the bank has deployed capital under the reasoned assumption that it will see its capital plus interest in return, within an agreed time period. The bank will then consider its risk and either dispose of some of that risk through a proprietary transaction or alternatively hedge its credit risk in the market by entering into a transaction with a market counterparty which hedge itself will be a proprietary transaction.

The hedging of its loan position creates its own trading risk, where the bank may or may not realise a profit on that transaction with reference to price agreed at the purchase and sale of the asset. Another common trading activity which is needed by our customers and which gives rise to trading risk is market making (where we offer prices to buyers or sellers of assets traded in those markets in order to create liquidity), a core activity necessary to support stable economic activity.

There are risks created by any kind of trading, proprietary or not and whether in financial assets or physical goods. Businesses looking to sell traded goods to customers need to hold inventory in order to allow prompt satisfaction of customer orders. The holding of inventory also gives rise to trading risk—before inventory can be sold to clients the prevailing market price may move against a trader (or in his favour). It is the change in the underlying economic indicators and market confidence (equity prices, interest rates, commodities) that may result in a market risk that needs to be managed and controlled.

The difference in the level of trading risk associated with a given transaction relates principally to the relative liquidity of the goods traded—ie the ease with which the goods can be sold—and how long the trader is likely to hold them for, not whether the trader's intent at the time of purchase was to sell the asset to an end user or for its own financial gain. This risk is "market risk".

The same risk analysis applies whether the trader is buying and selling refrigerators, commodities or financial products singularly or in bulk, ie, building inventory of goods or financial positions or assets. In more volatile and illiquid markets the management of this market risk is much more important, particularly for businesses taking market risk on a material scale. The longer the inventory is intended to be held the greater the exposure to price volatility and market risk.

The key issue to address in order to determine whether the credit, trading and/or market risks the bank or other commercial party is taking are manageable is whether the quality of the controls and analysis that that party is using to measure and manage its trading activity on an informed risk basis are sufficient to allow that party to take controlled risks within its stated risk appetites. Please see section 5. below for a summary of the controls we have in place and which we believe are satisfactory to manage the own account trading risks we undertake in connection with our customer activity.

Given the analysis in Section 1. and this Section 2. above, our response is intended to explain both why: (i) the risks associated with "pure" proprietary trading are not wholly different, except in relation to the motivation for the original build up of inventory, from those associated with trading connected to client activities, market making and client related hedging activity; and (ii) nevertheless we do not believe our business model would be adversely impacted by restrictions upon "pure" proprietary trading.

3. RBS Context and Customer Activity

As part of its post-2008 restructuring plan RBS decided to exit and transfer to its Non Core division those activities which it regarded as involving material levels of "pure" proprietary trading. Further, as part of the State Aid resolution reached by HMG with the European Commission RBS was committed to not re-engage in any such activities. The scale of "pure" proprietary trading which remains within the RBS Group today is not material and is predominantly held within the Non Core division. We do, however continue to provide a range of customer services that require us to undertake own account trading activities. These result in the Bank holding market positions and substantial volumes of inventory for its own account. These activities include:

- Being an active participant in government bond auctions, in both the UK and other countries. This activity results in inventory holdings of government bonds which, while generally liquid, normally are not driven by specific client demand and consequently create market risk for RBS.
- Market making in the markets we are active in to ensure liquidity for our customers and the issuers we support.
- As part of offering services to our investor/customer base we trade actively to build inventory, in particular in expectation of forthcoming customer orders. Moreover, where we are trading to fulfil client orders, the available trades in the market may not exactly match the order, leaving a residual balance on the RBS trading book. Controls are in place to ensure the liquidity of the portfolio, and the quality of the balance sheet held at any time (see section 5. below).
- In some instances, we also conduct trading, and build and hold strategic inventory positions, in anticipation of longer-term customer orders. (Those strategic inventory positions are taken in connection with our customer related activities which include providing our customers with related asset analysis and market intelligence). This activity can result in the build up of significant volumes of inventory and result in our holding that inventory for significant periods of time. Again, this activity is conducted within specific controls and risk appetites including specified risk limits and inventory ageing policies.
- We execute trades to hedge the risks held in our banking and trading books. These hedges are often necessarily undertaken at portfolio level and not ascribed to specific client transactions, particularly where we are supporting SMEs and smaller corporate.

The purpose of these activities is to support actual or anticipated customer business needs or to enable us to manage the risks we take when supporting our customers.

We presume the type of activities listed above would be exempted from any prohibition on “pure” proprietary trading as they are connected to offering services to our customers and are core components of economic activity. If our presumption is correct, the impact on RBS of a prohibition would mainly be associated with the challenges and expense of monitoring and tracking any additional regulatory requirements introduced to measure and control “pure” proprietary trading and/or own account trading rather then any significant reduction in activities undertaken in connection with our customer activities.

4. Providing a Clean Definition of Proprietary Trading is Challenging

We do not oppose the introduction of a rule that restricts the conduct of “pure” proprietary trading within a group that includes a ring fenced bank. RBS’ strategy is focused on the own account trading activities described at 3 above. Nonetheless we do not think there is a simple analytical way to distinguish an asset bought with the intent solely to speculate upon the future value upon sale to another trader (which would be “pure” proprietary trading) from the same asset bought with the expectation of sale to an end user customer—as we said above there is no bright line that allows the activity to be readily and objectively differentiated solely on the basis of the intention that motivated the purchase of the inventory. The principle distinction between these two types of trading activity is the intent or motive for entering into the trade. The key way to control the risk is the same—through effective controls, surveillance, capital charges and by ensuring the culture in the business is the right one (see section 5. below).

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. (See response to Q7. below for more detail.)

We believe that monitoring and tracking such indicators will be expensive both for institutions involved and for the regulators. 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.

5. RBS Controls Around its Own Account Trading

During the past four year, RBS has reviewed and enhanced its risk and control environments and has put in place a comprehensive Supervisory Control Framework (the SCF) to address and manage the trading risks of the Bank. The SCF establishes Risk Limits (Golden Rules) and addresses trading and markets risks in turn through: i) Dealing Authorities, ii) Independent Pricing Valuations (IPV) and Reserving, iii) Aged Position Marks and iv) Aged Asset and Stale Inventory amongst other indicators. The SCF places upon the senior managers of the business the authority, responsibility and accountability of addressing trading risks with a robust focus on the correct culture and behavioural standards.

The Bank’s Golden Rules place upon the senior business management, in conjunction with market risk management the responsibility to define the overall market risk limits, structure, ownership and delegation for business units. Along with credit risk management, senior business leaders define the overall credit risk limits, structure, ownership and delegation of risk controls. The Golden Rules provide for clear determinations and sanctions of rule transgressions.

More specifically, these trading risk management measures provide senior executives and control teams with the risk programme and the tools to approve and monitor:

— traders’ permissions, overall position limits and utilisation triggers,

— monthly P/L, reserve balances and IPV data, including inputs on explanation, methodology and justification, Independent Pricing Valuations and Reserving,

— Key Risk Indicators (KRIs), trends and trigger breaches as well as the review of position marks across trading desks, Aged Position Marks, and

— Review of KRIs that assist in the responsibility and review of a desk’s stale/aged positions with the intent to take action or escalate any concerns identified (Aged Asset and Stale Inventory).

With respect to Aged Assets and Stale Inventory monitoring, RBS calculates the position age at issue level of the individual security/ISIN. The data points used are very granular and include:

— position age that accrues on a “First-In” basis—the oldest transaction on record after a zero balance in inventory is set as the age date,

— measurement of directional increase of the position which after the first trade inherits the inception date of the “First-In” exposure,

— age measures that reset to zero when reduction of 20% of the nominal amount of the position is achieved in one day, and

— designation of an asset as "aged" if held for more than 90 days without a reset.

CONDUCT RISK

In addition to the empirical data that make up our markets and trading risk measure, the SCF is supported by our Conduct Risk programme which focuses on conduct risk and staff behaviours (including ensuring incentives are aligned to behaviours, not pure revenue targets).

To back up our words with actions, we have made conduct risk management a commercial imperative. For our staff, we have enhanced our recruitment and performance measurement disciplines (eg, 360° feedback, independent Risk function inputs); ensured that all bonus awards are subject to objective remuneration committee oversight, and robust risk adjustment; and claw back has been applied to historic bonuses awarded to individuals responsible for risks and losses that have been identified after the fact.

6. RESPONSES TO THE COMMISSION'S QUESTIONS

Q1: *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Uncontrolled "pure" proprietary trading exposes a bank's capital to significant risks as well as exposing the bank to reputational harm and posing potential risks to overall financial stability. Any form of own account trading activity and risk taking requires robust controls and a culture where risk is taken on a controlled and informed basis. As described at section 5. above at RBS we have implemented detailed risk management controls that measure and manage the scale of market and other risks that the bank is exposed to and have implemented significant cultural changes to ensure that a prudent approach is taken to managing risk and servicing customer needs. 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. We believe the existing controls (plus the regulatory powers described at section 4. above) are sufficient to control trading activities within a group that includes a ring fenced bank.

The prudential risks inherent in any "own account" positions are independent of the intent of the trade (whether proprietary or client-driven), and we consider them to be adequately covered by the current legislative framework and our own risk controls. 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.

ICB regulation will of course ensure that depositors in the ring-fenced bank are further protected from risks posed by permitted trading activities.

STANDARDS

Q2: *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

Q3: *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

Q4: *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

The nature of any trading activity requires buyers and sellers to take different market positions. As such any trading activity can give rise to potential conflicts of interest between a bank and its customers. This is true for all trading that results in the bank holding positions on its own account, regardless of whether the intent is hedging risk, building customer inventory or generating proprietary gain; these risks also exist where the bank is providing non-traded products and services to customers. These are risks managed through existing, well established, regulations and controls (including the requirements under FSA General Principle 8).

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 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.

Within RBSG, very significant efforts have been made to address these broader cultural concerns and to enhance our overall control environment. Details of these changes do not properly belong in this letter but we have summarised them in section 5 above.

The creation of the ring-fence will create an additional legal and financial fire break to protect customers within a ring-fenced bank from any volatility in market risk exposures that arise as a result of banks conducting own account trading activity connected to customer services.

Based on the analysis in this letter 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.

Practical Considerations

Q5: *How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?*

We believe that the simultaneous imposition of ringfencing and a ban on own account trading would create additional costs for both the banks and the regulators, increase costs and materially and adversely impact liquidity, customer services and economic activity without materially reducing either risks of resolvability for a bank or systemic risks.

Q6: *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

The FSA and other international lead regulators have multiple powers to require financial institutions to be run on a well managed/prudent basis, to have effective controls in place and to ensure that operations are run with skill, care and diligence, effectively controlled and that customer interests are respected and conflicts managed. We believe the existing powers available to the FSA, including the ability to impose additional capital requirements on firms that are not being prudentially managed and ability to vary regulatory permissions are sufficient to control the own account trading activities continuing within banking groups that include a ring-fenced bank. 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.

Q7: *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

The experience of US regulators suggests that establishing a clear and unambiguous definition of proprietary trading is difficult. There is no bright line that can be drawn between "pure" proprietary trading and own account trading connected to customer activity including market making. After several years the US regulators have yet to agree upon a clear definition and have moved away from attempting any direct operational definition. Latest drafts focus on establishing a process for monitoring the relative trading position of any organisation vs. its peers, across a range of 17 different metrics, which the regulator regards as useful indirect indicators of whether an activity is proprietary in intent. Senior US regulators have queried the rule and its implementation. Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, was quoted as saying "Work on the [Volcker] rule is diverting resources from more essential requirements in the [Dodd Frank] act", while Sheila Bair, former Head of the Federal Deposit Insurance Commission, was quoted as telling Congressional hearings that "the Volcker rule is so complicated that regulators should consider starting over".[i]

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, with controls being placed at the heart of a well managed culture aimed at serving clients' best interests. In particular, past experience across many spheres of regulation suggests that complex regulations promote a search for workarounds and loopholes whereas a simpler, principle-based approach can be more effective. Given that, if a definition were required, we would advocate a simple, principle-based view—for example, requiring all trading that results in an own account position to be conducted in connection with actual or anticipated client activity or for the purpose of hedging the bank's risks.

Overall Assessment

Q8: *Given the factors above, how would you assess the case for:*
(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*

Since 2009 RBS Group has changed its' operational focus, and consequentially we do not envisage that our business model would be significantly affected by the introduction of a Volcker style rule in the UK presuming this is designed to restrict "pure" proprietary trading but to still allow own account trading in connection with customer activity of the type referred to at 3. above.

Nonetheless we do not believe that there is likely to be a material benefit from introducing a full prohibition on banks conducting "pure" proprietary trading in the UK. We consider that the tighter capital and prudential controls put forward post-crisis and the other controls referenced above will have the effect of restricting the appetite of any bank for increasing its "pure" proprietary activities. It is also clear from the US example that the complexity of operationally defining proprietary trading and the cost of development, implementation and monitoring of these proposals is likely to be substantial, both for the banks and the regulators. This is unlikely to be proportionate to the perceived benefits and could detract from the already complex process of introducing the ring-fencing reforms.

Nevertheless, we do consider it appropriate that the regulators satisfy themselves that banks have appropriate risk controls in place (and that the culture and incentive schemes in the trading businesses rewards good, risk sensitive and client focused behaviours and punishes poor risk decisions and bad behaviours) such that regulators are satisfied banking groups are being prudently managed and do not pose reasonably avoidable systemic risks.

(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*

(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*

(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

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.

10 February 2013

Reference

[i] Both quotes from Bloomberg article, 4 April 2012: *Fed's Lacker Says Volcker Rule May Be "Impossible" to implement*

Written evidence from Standard Chartered Bank (V004)

Stability

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Whilst Standard Chartered has a client-focused business and has no dedicated proprietary trading desks, 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.

Even with no focus on proprietary trading, there are legitimate and important reasons that banks would take on market risk in order to meet the needs of clients. Much of the current regulatory approach seems to be based on the belief that trading can be achieved with exact and instantaneous risk layoff, as if it were undertaken on a stock exchange and that trading desks could in fact be brokers. This is not the case in the many over-the-counter ("OTC") markets (eg government and corporate bonds, commodities, foreign exchange and interest rate derivatives). 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.

We would be very concerned if a prohibition on proprietary trading resulted in a restriction on banks' participation in private equity. Whilst we understand the concerns about US banks' involvement as principals in highly leveraged buyouts in the period before the crisis, we think there is a compelling economic case for banks being able to provide equity to their clients as part of our overall role as providers of capital. Smaller companies do not typically have access to public equity markets, and in many of the countries in which we operate, alternative sources of equity finance are extremely limited. Constraining banks to providing debt will only magnify the risk of over-leverage. A ban on private equity would therefore diminish banks' ability to provide appropriate capital solutions to SMEs.

Risk oversight is a critical focus for our business, including limiting exposure to country, sector or other relevant forms of risk in the portfolio. This is supported by a track record in which, of 30 investments, our loss ratio is 2% of the total investment.

We understand the concerns about private equity in the context of advanced economies, such as the US, given the history of very large, highly leveraged buyouts. This is not the sort of private equity business we conduct and we suspect such transactions would in any case be much more difficult to execute in the post-crisis environment, not least because the capital treatment under Basel III is very different. Standard Chartered would not be opposed to the imposition of limits on the proportion of RWAs that banks could deploy in private equity (for example, not more than 10% of total RWAs). Such an approach highlights the importance of banks operating models in which their risks are effectively diversified.

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. Such fundamental questions will help supervisors understand whether a bank's business model is sustainable. To this end we welcome the focus the Prudential Regulation Authority has said it will take with the use of judgement-based supervision which will be more likely to identify and address emerging risks.

Standards

2. *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

Please see answer to question 3.

3. *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

The current conduct rules (reinforced by the Financial Services Authority ("FSA") Principle 8) address the fact that conflicts of interest can take many forms. Whilst these rules are prescriptive, to the extent that they require firms to have effective arrangements in place to manage such conflicts (and evidence this in a policy with mandatory content), they do not seek to pre-empt all potential conflicts that could arise nor prescribe how such conflicts should be managed. We believe there is justification for such an approach, not least because the types of conflict, and the arrangements required to effectively manage them, will depend on the size and organisation of the firm in question and the scale and complexity of its business.

The FSA has also undertaken a number of thematic reviews in this area over the last few years and issued a number of Market Watch newsletters, setting out very clearly what its expectations are in relation to conflict management in certain specific areas. Most recently, we have received a "Dear CEO" letter asking us to review how conflicts of interest are managed when undertaking asset management activity and to pro-actively attest that the firm's arrangements in this area are sufficient and in compliance with FSA rules.

The effective management of conflicts of interest and the fair treatment of our customers form an integral part of our Group Code of Conduct which reflects our Group values and sets out our expectation for minimum standards of behaviour. In addition, we have a framework of policies and procedures in place globally for the identification and management of conflicts of interest. These are supported by mandatory training for staff.

4. *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

We do not believe that the creation of ring-fenced banks will improve financial stability; indeed, it could do the reverse, as it will concentrate risk in a legal entity. We believe it is better to diversify risk to ensure the risks created by one part of a bank can be mitigated by other parts.

Practical Considerations

5. *How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?*

We have stated in our previous responses to the PCBS that we do not believe ring-fences are an effective means by which to regulate banks because they do not fundamentally address risks in the financial system. We believe it is more appropriate to address the risks associated with activities rather than to create structural solutions.

6. *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

The FSA already has the power under the Financial Services and Markets Act 2000 ("FSMA") to determine which activities a bank can undertake. These begin with the initial licensing and approval of an institution under FSMA (Part IV permission), authorisation of individuals to undertake an activity and the associated permissions for the undertaking of regulated activity and any exclusions or categorisation of counterparty, granted under such an approval. Undertaking regulated activity without the appropriate authorisation is a criminal offence.

Regulated activities are set out in the Regulated Activities Order. If a firm is to undertake any proprietary trading activities it will need a permission for "Dealing in investments as principle" since this is a regulated activity. The activity is defined as:

> "*Dealing in investments as principal*: Buying, selling, subscribing for or underwriting securities or contractually based investments (other than investments of the kind specified by article 87, or article 89 so far as relevant to that article) as principal is a specified kind of activity."

Additionally, once approved, a firm will be subject to ongoing supervision of these activities. Regulators have a number of options to control the firm and its activity on a risk-based approach eg capital charges applied under Pillar 2. The ultimate action is that the regulator can force the business to stop an activity via forcibly amending its permissions/license (removing the legal approval to undertake the regulated activity).

With the creation of Recovery and Resolution Plan ("RRPs"), regulators have additional opportunities to address concerns about a bank's business models. Where they believe business activities or structure will impede the ability of supervisors or a resolution authority to resolve a failing bank they will enter into dialogue with the bank to find a way of removing such risks.

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

As discussed above, it is difficult to draw a distinction between proprietary trading and risk taking as banks undertake trades in order to facilitate client activities and although all of these activities may not relate directly to a client order these trades will help banks to maintain the liquidity to meet the needs of clients. Without such activities the cost of finance would be both likely to increase and clients may find they are simply unable to access the services they need within the time frames they currently expect. Even dedicated proprietary trading may be difficult to define and identify unless it is already structurally separated eg an internal hedge fund.

Overall assessment

8. *Given the factors above, how would you assess the case for:*
(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*
(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*
(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*
(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

We believe such decisions would be best made by supervisors who would be able to consider the extent to which the activities of the ring-fenced bank may inhibit the ability of the bank to implement an effective RRP. We believe it is best to provide supervisors with such powers to apply them where they see necessary.

18 January 2013

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