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UK independent review of post-financial crisis proprietary trading rules – an opportunity for reform?

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The Financial Services (Banking Reform) Act 2013 requires HM Treasury to appoint an independent panel to review the operation of the bank ring-fencing regime. Separately, the Act also requires HM Treasury to appoint an independent panel to review banks' – and certain investment firms' – proprietary trading activities following the statutory report published by the Prudential Regulation Authority (PRA) in September 2020. In December 2020, HM Treasury appointed a single panel, chaired by Keith Skeoch, to perform both reviews given the inherent links between the two (Skeoch review).

The proprietary trading review will assess: (i) whether the risks related to proprietary trading are appropriately mitigated; and (ii) consider any consequences from the evolution of proprietary trading. The ring-fencing review has a broad mandate, and the terms of reference indicate that the panel will examine how the ring-fencing regime meets its intended purpose of supporting financial stability and minimising risks to public finances through the separation of core banking activities from other banking activities. The terms of reference are indicative of the focus of the panel on issues relating to competitiveness and, in particular, international competitiveness.

Proprietary trading

The PRA defines "proprietary trading" in its report: "Proprietary Trading Review" dated September 2020 (report) as: "trading in financial instruments or commodities as principal. It requires the use of a firm's own capital, or liquidity, or both. The profits or losses of the activity accrue to the firm, rather than to its clients". This definition captures a wide-range of activities from short-term own account trading with the intent of profiting from market movements to client facilitation, liquidity management and hedging activities.

On the one hand, the PRA reports that it did not find evidence of substantial amount of classic proprietary trading activities by banks (i.e. short-term own account trading to profit from market movements), due, at least in part, to: (i) the significant increase in capital required to support such activities introduced after the global financial crisis; and (ii) the operation of the UK ring-fencing regime which structurally separates core retail banking activity from investment banking and prohibits the ring-fenced bank from conducting a number of activities, including classic proprietary trading. The report therefore concludes that the PRA does not need new powers to address the risks of proprietary trading.

In the aftermath of the 2008 financial crisis, jurisdictions around the world deployed different tools to manage and mitigate the risks posed by proprietary trading activities. For example, the United States enacted the so-called Volcker Rule[1] which introduced an effective ban on proprietary trading for all banks, subject to limited exceptions, (as opposed to the UK, where the outright bank only applies in the case of ring-fenced banks) and limits investment by banking entities in certain hedge funds and private equity funds. Whereas in Belgium there is no ban but capital surcharges are imposed if thresholds are exceeded, and in France banks conducting significant amounts of proprietary trading activity are required to do so in a separate entity.

Skeoch review

The Skeoch review is not expected to report for some months yet but it would seem highly unlikely that it will come to different conclusions to those reached by the PRA in its report in terms of the need for additional powers in the hands of the PRA to combat the risks of proprietary trading. However, it is right that 13 years after the financial crisis a review should be undertaken of the post-crisis regulatory measures implemented to combat the perceived causes of the crisis. In 2019, we saw the U.S. regulatory agencies issue a final rule relaxing the "proprietary trading" provisions of the Volcker Rule, and it 2020 those agencies issued a final rule amending the "covered fund" provisions of the Volcker Rule to permit banking entities to make additional investments in certain private funds and loosening other restrictions.

These changes followed a review by the U.S. Department of Treasury in 2017 of the operation of the post-financial crisis Dodd-Frank Act changes, the recommendations of which review included making certain targeted relaxations to the Volcker Rule.

In our view, it is most unlikely that the Skeoch review will recommend a tightening of the rules relating to proprietary trading, and it is possible, in the post-Brexit world, that the recommendations may include certain targeted relaxations of the rules to enable UK banks (other than ring-fenced banks) to compete on the international stage in the post-Brexit world.

[1] Section 619 of the Dodd-Frank Act.

Complaints Procedure