Volcker and Vickers are bringing necessary – albeit challenging – change to US and UK financial systems

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The UK and the US are moving in tandem to rein in the risky, unmonitored trading and investment activities at banking institutions that are believed to have been the root cause of the global financial crisis of 2008. Overarching alterations are set to take effect in the near future, and the legal and financial ramifications for institutional investors on both sides of the Atlantic will be far-reaching. The US proposal, known as the Volcker Rule, and its UK analog, the Vickers Report, have already stirred considerable controversy.

Volcker Rule outlines drastic change for United States' financial institutions

The Volcker Rule – brainchild of former US Federal Reserve Chairman Paul Volcker – calls for a full separation of commercial and investment banking in the US. Part of the Dodd–Frank Wall Street Reform and Consumer Protection Act, the Volcker Rule bans proprietary trading and sponsoring or holding an ownership interest in a hedge fund or a private equity fund by commercial banks. It is essentially a modern version of the Glass-Steagall Act of 1933 which also separated commercial and investment banking activities.

The Volcker Rule, formally published in November 2011, is now front and centre as the comment period expired February 13, 2012. Its provisions are scheduled to take effect on July 21, 2012. Once the rule is in effect, banking entities will have until July 21 2014 to cease any impermissible trading and investment activities. While many key elements of the rule have yet to be fleshed out, compliance and reporting requirements will likely be extensive. For example, every banking institution in the US will be required to establish a compliance programme.

United Kingdom proposes most far-reaching banking reform in modern history

In Britain, the Independent Commission on Banking (ICB) proposed reform contained in the Vickers Report. Chaired by Sir John Vickers, the commission was formed in June 2010 to consider ways to promote financial stability and competition in the UK banking sector. The Commission made its recommendations to the UK government in September 2011.

Regarding structural reform – or reorganising the financial system to strengthen it – the ICB recommended ring-fencing UK retail banking from investment banking. It also recommended imposing stricter capital and leverage ratios – a primary loss-absorbing capacity of at least 17 to 20% – to strengthen a bank's capacity to absorb losses.

The ICB recommended that the divestment required of Lloyds Banking Group be enhanced to ensure that any emerging entity could compete effectively. The ICB recommended that the legislation to implement the proposals be put in place by 2019. Legislation necessary to introduce the ring-fence is intended to be in place by May 2015.

Tales of the good, the bad and the very expensive

Competition is one of critics' key concerns. Many fear the UK legislation will reduce competition in the marketplace and cause banks to leave the country. Opponents to the Volcker Rule say it will make the US banking business less competitive with foreign rivals. Volcker rebuts this criticism, saying competition in banking is desirable for the benefits it brings in institutional efficiency and better, more economical, service to customers.

Another major concern is the cost of implement these regulations. While there is widespread agreement that major reform is necessary to repair the damage to the financial system and better position it for the future, large financial institutions argue that the costs of compliance will be onerous, a strain on already beleaguered balance sheets. One industry-funded study estimated that the Volcker Rule could cost companies and investors $350 billion.

The ICB estimated that the annual pre-tax costs to UK banks of the proposed reforms would range from £4 billion to £7 billion. The Government has adjusted the cost range to £3.5 billion to £8 billion. Insofar as the expenses associated with these reform measures are material, institutional investors with significant positions in major banks should be aware of the possible impact on their share value.

Also at issue is the possibility that ring-fencing UK retail operations may encourage banks to take greater risks with activities that are grouped inside the fence, such as mortgages and corporate and personal loans, because they are more confident of being bailed out.

More criticism of the Vickers Report comes from none other than Paul Volcker. Volcker has said that the British approach leaves many questions unanswered. Indeed, Volcker takes issue with the key point of the Vickers Report – ring-fencing. The question will inevitably arise, he says, as to the financial and regulatory logic of maintaining a retail bank as part of a much larger, highly diversified and systemically significant organisation. Volcker says the overriding question will remain how to deal with the failure of significant financial institutions.

Potential for interconnections to firms engaging in prohibited activities varies greatly between proposals

While the proposals share a number of common elements, there are important differences in the number of prohibited services as well as the degree of interaction permitted with service providers and the relative constraints imposed by the proposals. For example, while the ICB proposes to prohibit more activities than the Volcker Rule, it permits greater intra-group transactions and exposure to non ring-fenced affiliates. The sheer complexity of having so many intersecting initiatives may prove to be daunting to institutional investors and companies alike.

Key to the success of both rules is how effectively they are actually implemented. Investors all over the globe should keep a close watch on regulators to determine whether real change is on the way – or whether we will soon slide back into the old habits that had such disastrous consequences for market stability.