## RING-FENCING AND ITS ALTERNATIVES

## DAVID ZARING\*

Steven Schwarcz's "Ring-Fencing" gets much of its impact from its broad definition of the term, which is usually heard these days when thinking about whether a multinational bank ought to be forbidden from removing the assets of its branches in one country to support its activities in another.<sup>2</sup>

One of the singular contributions of the article lies in its willingness to look beyond that use of the term to think about what ring-fencing means more broadly and conceptually. As Schwarcz observes, ring-fencing is nothing less than a way to allocate resources, regulate firms, and reassure stakeholders that could be applied any enterprise.<sup>3</sup> The ring-fencing metaphor posits the separation of assets within a firm—some are inside the ring fence,<sup>4</sup> and others are not. To Schwarcz this amounts to "legally deconstructing a firm in order to more optimally reallocate and reduce risk," which could include any restructuring involving holding companies,

- \* Associate Professor, The Wharton School. Thanks to Steven Schwarcz for comments.
- 1. Steven L. Schwarcz, Ring-Fencing, 87 S. CAL. L. REV. 69, 72 (2013).
- 2. And, specifically, in reference to the U.K.'s Vickers Report—the precursor to the U.K.'s Financial Services (Banking Reform) Act 2013—which calls for separation of retail banking from investment banking, similar to the U.S.'s (now-repealed) Glass-Steagall Act and the Volcker Rule that was proposed as part of the Dodd-Frank Act. See, e.g., Jeremy Hill & Edite Ligere, The U.K.'s Financial Services (Banking Reform) Bill: Expect the Unexpected, 130 BANKING L.J. 334, 335 (2013) (summarizing the key aspects of the Vickers Report); Sam Fleming, Business Hits 'Brick Wall' in Talks on UK Banking Ring Fence, FIN. TIMES, (Apr. 15, 2014, 8:41 PM), http://www.ft.com/intl/cms/s/0/d7904898-c4bc-11e3-9aeb-00144feabdc0.html#axzz30Bn16100 (same); SHEARMAN & STERLING, FIN. INSTITUTIONS ADVISORY & FIN. REG. CLIENT PUBLICATION, VICKERS RECOMMENDATIONS ON BANK RING-FENCING MADE LAW IN THE UK 1–4 (2013) available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2013/12/VickersRecommendations onBankRingfencingMadeLawintheUKFIAFR121913.pdf (same).
  - 3. See Schwarcz, supra note 1, at 81–82.
- 4. In literal usage, "ring-fences" refer to enclosures used to corral stock on farms. *Ring-fencing*, THE PHRASE FINDER, http://www.phrases.org.uk/meanings/302450.html (last visited Oct. 2, 2014).

off-balance sheet entities, and even the creation of corporate subsidiaries.<sup>5</sup>

Schwarcz's normative contribution, in addition to the descriptive one of identifying just how prevalent ring-fencing is, is to subject it to a cost-benefit analysis. That seems appropriate, as the White House's Office of Information and Regulatory Affairs turns to a cost-benefit analysis when assessing any important sort of regulation,<sup>6</sup> and ring-fencing is nothing if not important. As Schwarcz observes, cost-benefit analysis makes an uneasy at best case for ring-fencing in most financial regulatory cases, even those that protect very large banks from panics.<sup>7</sup>

I too take a skeptical view, although I understand that ring-fencing is an attractive transitional form of regulation, adopted by regulators uncertain about new activities that their regulated entities wish to pursue as a potentially useful stop-gap. But because of this, ring-fencing is reactive and unambitious, and thus unlikely to keep up with financial innovation and its attendant risk. In my view, cooperative global regulation is more likely to respond well to the realities of the global financial marketplace.

## I. THE BREADTH OF RING-FENCING

As Schwarcz emphasizes, there is nothing about ring-fencing that makes it solely the purview of the financial regulator. Ring-fencing need not only apply to multibranched banks; it is a way for any business to cabin and separate its operations. Specifically, Schwarcz says, ring-fencing could include creation of "a special purpose entity ("SPE") acting on behalf of an affiliated firm that wants to raise financing," in order to make a transaction bankruptcy-remote and thereby improve the credit-worthiness of the SPE. It also encompasses tools as varied as "contract and legislation," which are the tools utilized in ring-fencing in the public utility context. Ring-fencing through contract, in turn, can take the form of "restrictions on the amount of dividend payments that [a subsidiary public utility] c[an] pay to its new owner," and covenants requiring a subsidiary entity to, among other things, "maintain books and records separate[ly]; to maintain separate accounts; [and] to continue to hold all of its assets in its

<sup>5.</sup> Schwarcz, supra note 1, at 108.

<sup>6.</sup> Exec. Order No. 12,886, 58 Fed. Reg. 51,735 (Sept. 30, 1993) (requiring that federal agencies engage in cost-benefit analysis as part of the regulatory process).

<sup>7.</sup> Schwarcz, *supra* note 1, at 106–08; *id.* at 105–06 (questioning even the ring-fencing of banks to protect essential services, such as deposit-taking, in a competitive market for bank services).

<sup>8.</sup> Id. at 108-09.

<sup>9.</sup> *Id*.

<sup>10.</sup> Id. at 74.

<sup>11.</sup> *Id.* at 75.

own name."12

Anyone, the private sector and the government included, can make these sorts of risk allocations. Schwarcz illustrates how broad the practice of ring-fencing can be by analogizing it to asset partitioning <sup>13</sup>—a fundamental value of the corporate form, according to Reiner Kraakman and Henry Hansmann. <sup>14</sup>

But Schwarcz is primarily interested in the government's use of ring-fencing as a regulatory tool. <sup>15</sup> Accordingly, he distinguishes the sort of judgment-proofing that the private sector might do by ring-fencing a subsidiary or funding vehicle from regulatory ring-fencing. <sup>16</sup> Schwarcz posits that the former focuses on protecting firm owners, often at the expense of creditors, while the latter is more worried about systemic stability, which redounds to the benefit of everyone, including creditors, in that an unstable financial system brings the risk of the collapse of banks, at the cost to shareholders, creditors, and the general public. <sup>17</sup>

The emphasis makes sense for prosaic and conceptual reasons. While private firms will sometimes spin themselves off into different entities to appeal to investors, ring-fencing is also a regulatory tool in surprisingly broad vogue. As Schwarcz recounts, ring-fencing has been adopted by public utilities at the behest of their regulators and by supervisors of banks with branches in different jurisdictions. <sup>18</sup>

Ring-fencing is even a good way to think about the most traditional form of banking regulation that there is—the activity restriction. The Glass-Steagall Act engaged in activity restrictions by preventing commercial banks from engaging in investment banking and other securities-related activities. The modern-day Volcker Rule does the same

- 12. Id. at 77-78.
- 13. Id.

- 15. Schwarcz, supra note 1, at 8384.
- 16. Id. at 82-83.
- 17. Id. at 83.
- 18. Id. at 101–06.

<sup>14.</sup> See Henry Hansmann & Reinier Kraakman, What is Corporate Law?, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1, 7 (2004) (describing the "core element" of th[e] "separate patrimony" of corporations as "shielding the assets of the entity").

<sup>19.</sup> Schwarcz, *supra* note 1, at 72–81. *See also* Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Law*, 2012 WIS. L. REV. 815, 837–38 (2012) (comparing the ringfencing measures recommended in the Vickers Report pertaining to banking to those used by public utilities in the United States).

<sup>20.</sup> Jeff Merkley & Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 516–20 (2011) (describing the Glass-Steagall Act and citing its repeal as one of a series of events leading to the

for proprietary trading, which would be hived off from universal banks that provide any financial services that consumers might want.<sup>21</sup> Schwarcz makes a reasonable case that both of these highly traditional and highly innovative components of American financial regulation simply amount to ring-fencing by another name.<sup>22</sup>

## II. JUDGING RING-FENCING

Regulatory ring-fencing is very much an interference with marketprovided firm structures. It insists on separation when firms ordinarily would not offer it. Market interventions need to be justified, of course, and Schwarcz names five market failures that might trigger the need for a ring fence: (1) monopolies/noncompetitive markets, (2) the public-goods problem, (3) information failure, (4) agency failure, and (5) "responsibility failure" (essentially, the moral hazard problem). 23 In such cases, but only in these cases, the benefits of ring-fencing might outweigh the efficiency costs imposed on firms forced to subdivide themselves.

I view ring-fencing a bit differently. In my view, the phenomenon in practice is really a form of the precautionary principle—the idea that regulators understand, and worry about, one component of what a financial firm does, and therefore will insist on the isolation of that component from exposure to the other portions of the firm that regulators understand less well, but yet are more willing to permit to take risks.

For this reason, I understand the appeal of ring-fencing-indeed, I doubt there are financial regulators who do not assume it to be one of the most important supervisory tools available in their toolkit. But it is reactive.

Consider the effort to ring-fence global banks, as the United Kingdom has considered doing.<sup>24</sup> This would turn these banks into affiliated strings of domestic institutions, funded locally, and serving local customers with local branches.

That would be costly, as Schwarcz observes.<sup>25</sup> But it would also stifle the innovations that could be made with the entry into new markets, not to mention the salutary effects of competition offered by the same.

Rather than insulating the various locals of multinational financial

need for regulatory reform after the financial crisis).

Id. at 533–34 (discussing the initial proposal of the Volcker Rule in 2010).

Schwarcz, supra note 1, 78–81.

Id. at 84.

<sup>24.</sup> See sources cited supra note 2.

Schwarcz, supra note 1, at 100–01.

conglomerates, efficiency would more likely be served by a more global approach to financial regulation. After all, there is little doubt that finance has gone global, and that regulators are struggling to keep up.<sup>26</sup> Ringfencing in the banking industry would probably increase the cost of retail banking.<sup>27</sup> And it could be that a more global approach to the supervision of multinational banks—a college of supervisors in case of emergencies when firms are vulnerable, a consistent approach to safety and soundness in normal times—would make for a more efficient financial sector, one capable of knitting the global economy more coherently together. That global approach has, so far, looked different than ring-fencing done through nationally localized and protective regulation. If it abandoned the cross-border supervisory goal and chose to require national (or possibly multinational) ring-fencing,<sup>28</sup> that could limit the flexibility of large financial institutions, and, by concentrating certain assets in certain activities, make it difficult for firms to diversify and to hedge.

In this way, many current ring-fencing proposals are the opposite of what I view as the more promising multinational approach. More generally, ring-fencing treats financial institutions as sources of risk that can only be mitigated through limitation, instead of through expansion and innovation. Schwarcz seeks not to lionize ring-fencing, but to "tag and bag" it, to describe its capabilities and limitations. But whatever its capabilities, ring-fencing is, in my view, a somewhat depressing approach to financial regulation, limiting banks, rather than embracing their global potential, and assuming regulators can work out a global strategy to keep up with them. The latter approach might be more optimistic about globalization, and better for growth as well.<sup>29</sup>

<sup>26.</sup> See, e.g., David Zaring, Finding Legal Principle in Global Financial Regulation, 52 VA. J. INT'L L. 683, 689 (2012) ("The globalization of the financial economy has created a variety of problems for regulators; they have traditionally been charged with ensuring that financial markets are safe and sound, as reliable and responsible repositories of the money of the nation's citizens. But with globalization, markets—and rogue market participants—can cross borders easily, while regulators can do so only with difficulty . . . . ").

<sup>27.</sup> Op-Ed., *The Vickers Ring Fence*, WALL St. J. (Sept. 13, 2011), http://online.wsj.com/news/articles/SB10001424053111904265504576566431531302762.

<sup>28.</sup> It is possible to imagine, for example, a global version of the Volcker Rule, or global rules requiring banks to push out their derivatives activities to a separate entity in a holding company structure; those would be transactional in scope, but would still have the character of ring-fencing. Many regulators spend more time considering ring-fencing proposals that would draw lines around the assets held in the particular jurisdiction in which they regulate.

<sup>29.</sup> To read more, see David Zaring, Informal Procedure, Hard and Soft, in International Administration, 5 CHI. J. INT'L L. 547 (2005).