Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The banking sector is regulated by the Financial Services Authority (the FSA). The FSA is required, so far as is reasonably possible, to act in a way that is compatible with specified regulatory objectives.

These objectives are:

> maintaining confidence in the market system;
> promoting public understanding of the financial system;
> securing the appropriate degree of protection for consumers; and
> the reduction of financial crime.

The Financial Services Act 2010 will add a financial stability objective.

In discharging its functions the FSA must have regard to:

> the need to use its resources in the most efficient and economic way;
> the responsibilities of those who manage the affairs of authorised persons;
> the principle that a burden or restriction should be proportionate to the benefits;
> the desirability of facilitating innovation;
> the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
> the need to minimise adverse effects on competition; and
> the desirability of facilitating competition between those subject to regulation.

2 Please summarise the primary statutes and regulations that govern the banking industry.

The primary statute governing banking is the Financial Services and Markets Act 2000 (FSMA 2000). Under FSMA 2000 it is a criminal offence for a person to engage in ‘regulated activities’ in the United Kingdom unless he is authorised to do so or is exempt from the authorisation requirement. Regulated activities are defined in secondary legislation.
Accepting deposits is a regulated activity where such deposits are lent to third parties, or where any other activity is financed wholly or to a material extent out of capital or interest on deposits. Banks must therefore obtain authorisation under FSMA 2000 to accept deposits.

Other regulated activities that may be relevant to banks include dealing in investments as principal, dealing in investments as agent, arranging deals in investments, managing investments, safeguarding and administering investments (i.e., custody), providing investment advice and mortgage lending. Investments include shares, debentures, public securities, warrants, futures, options, contracts for differences (e.g., swaps) and units in collective investment schemes.

Consumer credit is regulated under the Consumer Credit Act 1974. Banks that engage in retail lending (other than mortgages) need to obtain a consumer credit licence. This act imposes detailed formal and substantive requirements.

The Banking Act 2009 introduced a new special resolution regime for banks to facilitate the orderly resolution of banks in financial difficulties. The act also established a new bank insolvency regime as well as formalising the Bank of England’s supervisory role in respect of inter-bank payment systems.

The Financial Services Act 2010 is summarised in the ‘Update and trends’ box.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The FSA is responsible for the regulation of banks, including authorisation and supervision. Enforcement is also carried out by the FSA. The Office of Fair Trading issues consumer credit licences and is responsible for the enforcement of UK competition law and much consumer law. The Bank of England has responsibility for the oversight of payment systems and, together with the Treasury, has a role in operating the special resolution regime for failing banks.

4 Describe the extent to which deposits are insured by the government.

Deposits are not insured by the government but by the Financial Services Compensation Scheme (the Scheme). The Scheme is an independent body set up under FSMA 2000. The FSA is responsible for determining the rules within which the Scheme operates, including the persons eligible to make a claim, and the level of compensation. The Scheme is free to consumers and protects deposits as well as covering insurance policies, insurance broking, investment business and mortgage advice.

Since 7 October 2008 the Scheme insures deposits up to a maximum of £50,000 and applies, mainly, to retail customers. Deposits by large companies are not insured. Amounts owed to a failed bank (for example loans, mortgages or credit cards debts) are currently taken into account before any compensation is paid.

In July 2009 the FSA made changes to the Scheme that will apply from 31 December 2010 (with the exception of the new rules on eligibility, which came into effect in August 2009). The main changes are:

> simplification of the eligibility criteria for claims;
> requiring ‘fast payout’ of claims with a target of payment within seven days;
> calculating compensation on a gross basis (thereby ignoring any debts a depositor owes to the bank); and
> imposing new systems requirements on firms to enable them to provide a single customer view (SCV).

In March 2009 the FSA published proposals to provide additional protection for temporary large balances. The consultation paper proposed that high balances should be covered where they arise in connection with:

> sale of a home;
> pension lump sums;
> inheritance;
Implementation of these changes has been postponed pending a review of temporary high balances by the European Commission. A decision on this is expected in the course of 2010.

The EU Deposit Guarantee Schemes Directive was amended in March 2009. The directive will provide a harmonised EU-wide deposit protection limit of €100,000 from 31 December 2010, unless a European Commission review concludes that the increase is not needed and the Council and European Parliament agree. This report has not yet been published.

5  Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an ‘affiliate’ for this purpose?

The directors of a bank must act in a way that they consider is most likely to promote its success. While directors can take into account a bank’s membership of a wider group, they are not entitled to subordinate the interests of the bank to those of other group companies, such as, by lending to an insolvent parent or sister company.

If a bank is a member of a group whose shares are listed on the London Stock Exchange, the Listing Rules impose requirements in respect of ‘related party transactions’. Group companies are related parties.

The FSA also places restrictions on ‘large exposures’. A large exposure is an exposure of 10 per cent or more of a bank’s tier 1 and tier 2 capital (after deductions from capital) to:

> a single counterparty;

> connected counterparties; or

> a group of connected clients.

Large exposures must be reported periodically to the FSA. Exposures of more than 25 per cent of a bank’s capital are generally prohibited. This limit may, however, be exceeded where the excess arises in respect of trading activity and the bank holds additional capital (although the FSA proposed abolishing this possibility in December 2009). The aggregate of all large exposures cannot exceed 800 per cent of a bank’s capital. These limits apply to affiliates as well as to unrelated third parties.

A person is a connected counterparty if:

> he or she is closely related to the bank;

> he or she is an associate of the bank;

> the same persons significantly influence the governing body of that person and the bank; or

> the bank has an exposure that was not incurred for the clear commercial advantage of the bank, or its group, and that is not on an arm’s-length basis.

The application of these rules is adjusted where a bank forms part of a UK integrated group (a group or sub-group of UK-incorporated entities that satisfy certain requirements) or a wider integrated group. The effect is to relax the limits on intra-group transactions provided that certain conditions are met. In December 2009 the FSA proposed to tighten the requirements, including by abolishing the wider integrated groups regime, and replacing it with a 100 per cent overall limit on exposures to connected counterparties that are included within the same regulatory consolidation. Exposures between members of the ‘core UK group’ will continue to be exempt.
6 What are the principal regulatory challenges facing the banking industry?

The principal regulatory challenges facing the banking industry arise from the financial crisis. This demonstrated the inadequacy of existing regulatory structures to contain risk within the financial system, as well as the need to refocus regulation on macro-prudential issues affecting financial stability.

7 How has regulation changed in response to the recent crisis in the banking industry?

The UK government adopted emergency measures in response to the crisis in the banking sector, including liquidity assistance, recapitalisations and an asset protection scheme. Major UK banks committed to increase their tier 1 capital to 8 per cent. The government also made capital investments in RBS and Lloyds Banking Group of £37 billion in total. In January 2009 the government announced the establishment of an asset protection scheme (APS) to provide banks with protection against future credit losses on portfolios of troubled assets. RBS is the only bank to have participated in the APS.

The government also took steps to resolve failing institutions including Northern Rock plc, Bradford & Bingley plc and the UK operations of the failed Icelandic banks. In other cases, the government or FSA has facilitated mergers involving weaker financial institutions.

The March 2009 Turner Review set out 32 steps required to create a stable and effective banking system. These include:

> increasing the quality and quantity of capital;
> ensuring that the implementation of Basel II does not create unnecessary pro-cyclicality;
> enhancing the supervision of banks’ liquidity;
> ensuring that regulatory and supervisory coverage follows economic substance and not form;
> developing clearing and settlement to cover standardized credit default swaps (CDS);
> ensuring greater macro-prudential analysis and collaboration between the FSA and the Bank of England;
> improving the quality of supervision; and
> enhancing co-ordination of banks operating on a cross-border basis.

Changes to the style of regulation have followed. Principles-based regulation has been superseded by a focus on outcomes and more intensive scrutiny of firms and, in particular, senior management. The FSA has stated its intention to make ‘judgments on the judgments’ of firms. Supervision now focuses on the risks inherent in a firm’s business model and requires the FSA to be proactive in the management of those risks. In March 2010 the FSA announced that it will investigate financial products to ensure that they are suitable before they go on sale, rather than seeking to assist consumers to get redress once problems emerge. The FSA has also increased its emphasis on enforcement, adopting a policy of ‘credible deterrence’, as well as making increasing use of criminal prosecution for insider dealing and other regulatory offences.

The Walker Review (November 2009) recommended changes to the corporate governance arrangements of banks and financial industry entities.

Changes to regulatory capital are considered in question 17. The FSA announced new requirements for bank liquidity in October 2009. The key elements of the new regime (which will apply to UK banks as well as the UK branches and subsidiaries of foreign banks) include:

> principles of self sufficiency and adequacy of liquidity resources;
> enhanced systems and control requirements, which implement the Basel Committee’s updated Principles for Sound Liquidity Risk Management and Supervision;
quantitative requirements, coupled with a definition of liquid assets to meet such requirements; and
detailed and frequent reporting to the FSA.

Under the new rules, banks will be subject to liquidity risk management, stress-testing and contingency funding requirements. Banks will need to have robust systems and controls to identify, measure, manage and monitor the liquidity risks to which they are exposed. The new standards are based on an initial two-week firm-specific and market-wide stress, with a wider market-wide stress continuing for three months.

The FSA has stated that it will implement the new regime gradually. Initial low-level individual guidance and floors will be provided to firms as they migrate to the new regime. This will be followed by a gradual raising of liquidity standards over time, paced according to wider macro-economic developments. In March 2010 the FSA stated that it would be premature to increase liquidity requirements across the industry at the current time. This position will be reviewed in the final quarter of 2010. Meanwhile, the FSA continues to work with firms most affected by the new regime focusing on the steps they are taking to mitigate liquidity risk and on the impact of progressively tightening requirements over time.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

Changes are being driven by the need to respond to the causes of the financial crisis. The Basel Committee on Banking Supervision (the ‘Basel Committee’) and the European Commission have proposed amendments to Basel II. The proposals are summarised under question 17.

The European Commission proposed in September 2009 establishing a European Banking Authority (EBA), which will replace the Committee of European Banking Supervisors (CEBS). Under the proposal:

- the EBA will be able to develop technical standards to facilitate the creation of a single EU rulebook. Such standards will need to be adopted by the Commission to become binding;
- the EBA, on its own initiative, or upon request from one or more national supervisors, or from the Commission, will be able to investigate cases of the misapplication of EU law by national supervisors and, where necessary, to adopt a recommendation for action;
- if the recommendation is not complied with, the European Commission may take a decision, requiring the national supervisor either to take specific action or to refrain from action;
- in exceptional situations where a national supervisory authority does not comply, the EBA may adopt a decision addressed to banks requiring them to respect certain provisions of Community law;
- again in exceptional circumstances, the EBA will have the power to require national supervisors to take specific action; and
- the EBA will be empowered to mediate disputes between national regulators.

The intention is that the EBA will play an active role in developing a common European supervisory culture, and in promoting regulatory convergence throughout the EU.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Banks are supervised by the FSA. Supervision is carried out through the Advanced Risk-Responsive Operating Framework (ARROW), which seeks to identify the main risks to the FSA’s statutory objectives, measure the importance of those risks, mitigate them where their size justifies this and monitor and report on progress.
The FSA accepts that risks cannot be eliminated and does not apply a zero failure regime. Examples of risks taken into account under ARROW include the failure of a firm, mismanagement, fraud, market abuse and money laundering. Potential problems are scored, based on the likelihood of the problem occurring, and the impact if it does occur. The FSA has four categories within the ARROW framework: low, medium low, medium high and high. The main focus of FSA supervision is on firms within the latter two categories.

The FSA allocates individual banks to one of three categories: small firms, ARROW light and full ARROW. Banks falling into the latter two categories will have an FSA supervisor responsible for supervision. Under the full ARROW approach the FSA carries out a full risk assessment of risks within the firm. The supervisory team has discretion to investigate any areas to the extent they see fit. ARROW light involves a reduced-scope risk assessment covering certain core areas and sectorally-important issues. Small firms do not have a relationship manager and are not subject to firm-specific assessments.

The March 2008 review of the supervision of Northern Rock identified a number of areas where the regulatory framework could be improved. High-impact firms should be subject to ongoing supervision of core risk areas, with a specific focus on capital and liquidity. Supervisors should perform an annual review of the bank’s business and strategic plans. Day-to-day supervision should also be more rigorous. These changes were implemented through the Supervisory Enhancement Programme (SEP), which was completed in August 2009 (see question 12).

The March 2009 Turner Review proposed further changes including the need for an approach to banking supervision that is more intrusive and systemic.

The FSA generally carries out its supervision in a non-contentious manner and without reliance on formal powers. Nonetheless, such powers exist as a backstop if a bank fails to engage constructively with the FSA.

**10 How do the regulatory authorities enforce banking laws and regulations?**

If the FSA identifies a breach of its rules or principles it may bring enforcement proceedings. Sanctions include fines, banning orders and public disclosure of non-compliance (naming and shaming). Where a person has committed certain criminal offences (eg, insider dealing, market manipulation, carrying on a regulated activity without authorisation) the FSA may initiate a criminal prosecution. In March 2008 the Treasury announced proposals to enhance the ability of the FSA to prosecute financial crimes including protection for whistle-blowers and powers to engage in plea bargaining. These powers were enacted by the Coroners and Justice Act 2009. In March 2009 the FSA brought its first successful prosecution for insider dealing. A second successful prosecution followed in December 2009 and other cases are pending. The FSA has also recently brought successful prosecutions for acquiring control over an authorised person without obtaining prior FSA consent.

**11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?**

Most issues are resolved between the FSA and banks as part of the ARROW framework, thereby avoiding the need for enforcement action. However, recent themes in enforcement have been failings in systems and controls in respect of the pricing of financial products, a failure to treat customers fairly and the misselling of payment protection insurance (PPI). Examples of recent enforcement action are set out below.

In December 2009 Toronto Dominion Bank was fined £7 million as a result of serious failings in systems and controls concerning trading book pricing and marking within the bank’s credit products group. Toronto Dominion failed appropriately to escalate issues that might have led to earlier detection of the pricing issues. An aggravating factor was that Toronto Dominion have previously been subject to enforcement action for failings in the pricing of financial products.

In November 2009 the FSA fined Nomura International plc (Nomura) £1.75 million for a large number of serious failings in relation to the book marking within its International Equity Derivatives (IED) business. The systems and controls around marking the IED book fell far short of those expected for a business trading in complex and high-risk financial products.
Barclays Capital Securities and Barclays Bank (Barclays) were fined £2.45 million in August 2009 for failing to submit accurate transaction reports in respect of an estimated 57.5 million transactions. The FSA found that the failings demonstrated a failure by Barclays to take reasonable care to organise and control its affairs responsibly and effectively, and failed to conduct its business with due skill, care and diligence. Aggravating factors included the volume of transactions involved, a failure to respond adequately to a compliance review into transaction reporting and the potential impact the inaccurate transaction reports could have had on the FSA's ability to detect and investigate market abuse. Credit Suisse was fined £1.75 million in April 2010 for failing to submit accurate transaction reports in respect of approximately 40 million transactions.

HFC Bank Ltd was fined £1,085,000 in January 2008 for failing to take reasonable care to ensure that the advice it gave to PPI customers was suitable, and for failing to have adequate systems and controls in place for sales of PPI. Capital One Bank (Europe) plc was fined for failing to have adequate systems and controls for selling PPI and for failing to treat customers fairly. In October 2008, the FSA imposed a fine of £7 million on Alliance & Leicester plc in respect of advised telephone sales of PPI in connection with unsecured personal loans. In December 2008, the FSA fined Egg Banking plc £721,000 in relation to non-advised telephone sales of credit card PPI.

In August 2008, the FSA imposed a fine of £5.6 million on Credit Suisse International and Credit Suisse Securities (Europe) Ltd for failure to put adequate systems and controls in place to detect mismarks and pricing errors that led to the repricing of certain asset-backed positions (in particular, CDOs). Credit Suisse failed to use their controls over a highly complex business effectively and failed to supervise adequately the business of its structured credit group.

There has been litigation in recent years between the Office of Fair Trading (OFT) and all major UK retail banks on the fairness of charges for unauthorised overdrafts. On 25 November 2009 the Supreme Court held that the OFT had no jurisdiction to examine the issue under the Unfair Terms in Consumer Contracts Regulations. However, the OFT has stated that it will continue to monitor developments in the market, in particular the options available for customers who do not want access to unarranged overdraft facilities, choice around charging structures and the level of unarranged overdraft charges.

12 How has bank supervision changed in response to the recent crisis?

The FSA has implemented changes to its supervisory policy as part of the Supervisory Enhancement Programme. This involves:

- a significant increase in resources devoted to the supervision of high impact firms and, in particular, to complex banks;
- a shift in supervisory style to focus on key business outcomes and risks, and on the sustainability of business models and strategies;
- emphasis on technical skills as well as probity in assessing approved persons;
- an increase in supervisory resources devoted to sectoral and firm comparator analysis, to better identify firms that are outliers in terms of risks and business strategies, and to identify emerging sector-wide trends that may create systemic risk; and
- a much more intensive analysis of information relating to key risks.

Capital requirements

13 Describe the legal and regulatory capital adequacy requirement for banks.

Regulatory capital requirements are derived from the EU Capital Requirements Directive (CRD), which applies to all UK authorised banks.

The FSA requires banks to hold capital on initial authorisation and also capital against risks. The former represents a minimum although for most banks the capital they are required to hold against risks will be significantly in excess of the authorisation minimum.
On authorisation, banks must hold capital resources of €5 million. Thereafter, a bank must hold capital equal to the sum of its requirements for credit risk, market risk and operational risk.

Banks have a choice between a standardised approach to credit risk and advanced approaches. The standardised approach imposes capital charges on exposures falling into particular classes (e.g., corporate, retail, mortgage, inter-bank and sovereign lending). The capital charge generally depends on the external credit rating of the borrower. The requirements also cover credit risk mitigation (collateral, guarantees, credit derivatives) and securitisation.

Banks may seek FSA approval to use their own internal models to calculate capital requirements for credit risk, including credit risk mitigation and securitisation. The FSA recognises two advanced approaches: the foundation internal ratings-based approach (foundation IRB) and the advanced internal ratings-based approach (advanced IRB). Under foundation IRB banks are required to determine the probability of default of exposures; the other risk factors are calculated based on supervisory estimates. Under advanced IRB banks determine all the risk factors based on their own internal estimates. For retail exposures, however, there is only one IRB approach under which banks calculate all risk factors.

FSA requirements for market risk follow a ‘building block’ approach, identifying particular risks against which capital must be held. It follows that if a transaction gives rise to more than one type of risk it may trigger several capital charges. Capital is required to be held in respect of position risk, counterparty risk, foreign exchange risk, commodities risk and large exposures risk (i.e., large exposures that exceed the 25 per cent limit, although the FSA has recently proposed abolishing the ability of banks to exceed large exposure limits if they hold additional capital).

In addition, banks must hold capital in respect of operational risk. This is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risk includes legal risk but excludes strategic or reputational risk.

Banks are required to assess the adequacy of their capital (a process known as ICAAP) which is then subject to review by the FSA (the SREP). This usually results in the FSA providing individual capital guidance (ICG) to the firm. Forthcoming changes to the capital adequacy framework are described in question 17.

14 How are the capital adequacy guidelines enforced?

The FSA enforces compliance. Banks are required to submit periodic returns and must notify the FSA of any failure to hold adequate capital.

15 What happens in the event that a bank becomes undercapitalised?

The bank will need to agree with the FSA a remedial programme to bring it back into compliance. The terms of such programme will depend on the circumstances, and cannot be described in generic terms, but are likely to include raising new capital, a reduction of exposures, or both. If a bank is unable to agree with the FSA how to remedy the situation the FSA may revoke the bank’s authorisation. Additional powers to deal with failing banks have been enacted in the Banking Act 2009 (see question 16).

16 What are the legal and regulatory processes in the event that a bank becomes insolvent?

The Banking Act 2009 introduced three pre-insolvency stabilisation options as well as two new insolvency procedures for banks in financial difficulties. The intention is to provide the Treasury, the FSA and the Bank of England (the authorities) with a range of tools to deal with failing banks.

The stabilisation options are:

> the transfer of all or part of a bank to a private sector purchaser (PSP);
> the transfer of all or part of a bank to a ‘bridge bank’ owned by the Bank of England (Bridge Bank); and
> the transfer of a bank or a bank holding company into temporary public ownership (TPO).
These powers apply only to a UK bank or bank holding company. They do not apply to overseas banks with a branch in the UK.

A stabilisation power may only be exercised if the FSA is satisfied that:

- the bank is failing, or is likely to fail, to satisfy the threshold conditions for authorisation under FSMA 2000; and
- having regard to timing and other relevant circumstances it is not reasonably likely that action will be taken to satisfy those conditions.

In exercising any of the stabilisation powers, or the new insolvency procedures, the authorities must have regard to specified objectives. These are the protection and enhancement of the stability of the UK financial systems, the stability of the UK banking systems, protecting depositors, protecting public funds and avoiding unjustified interference with property rights. These objectives are to be balanced as appropriate in each case. The Treasury is required to publish a code of practice about the use of the new powers, although this code is not legally binding. This was published in February 2009.

The Bank of England can exercise the PSP or Bridge Bank powers if it is satisfied (after consultation with the Treasury and the FSA) that it is necessary having regard to the public interest in the stability of the UK financial systems, the maintenance of public confidence in the stability of the UK banking systems or the protection of depositors.

The Treasury may exercise the TPO power if it is satisfied (after consultation with the Bank of England and the FSA) that either the exercise of the power is necessary to resolve or reduce a serious threat to the stability of the UK financial systems or that is necessary to protect the public interest where the Treasury has previously provided financial assistance to the bank.

In addition, the Banking Act creates two new insolvency procedures for failing banks: the bank insolvency procedure and the bank administration procedure.

The Bank of England, the FSA or the secretary of state may apply to the court to make a bank insolvency order. An order may be made if:

- the bank is unable, or is likely to become unable, to pay its debts;
- winding up would be in the public interest; or
- winding up the bank would be fair.

The bank must have depositors eligible to be compensated under the Scheme. Banks that do not have such depositors may still be subject to the stabilisation powers referred to above, or to administration or winding up under the Insolvency Act 1986. Once a bank insolvency order is made the liquidator has two objectives. The first is to work with the Scheme to ensure, as soon as is reasonably practicable, that accounts are transferred to another bank, or that eligible depositors receive compensation under the Scheme (see question 4). Once this objective has been accomplished, the task of the liquidator is to wind up the affairs of the bank. The general law of insolvency applies with some modifications to a bank insolvency and the liquidator has similar powers to get in the bank’s assets and, once the eligible deposits have been transferred, or compensation paid, creditors will receive a distribution in accordance with their rights. Deposits not protected under the Scheme are unsecured claims and will be paid, if funds are available, pari passu with payment to other unsecured creditors.

Other insolvency proceedings remain possible (eg, administration or liquidation), although no application can be determined until the FSA has decided not to apply for a bank insolvency order. A resolution for voluntary winding up has no effect without prior approval of the court.
The Banking Act 2009 introduced a new bank administration regime. This may be used where part of the business of a UK bank is sold to a commercial purchaser, or is transferred to a Bridge Bank, under the stabilisation powers. The purpose of bank administration (which should not be confused with administration under the Insolvency Act 1986) is principally to ensure that the non-sold or transferred part of the bank continues to provide services to enable the purchaser or Bridge Bank to operate effectively. Once the Bank of England notifies the bank administrator that the residual bank is no longer required, the bank will proceed to a normal administration where the objective is either to rescue the residual bank as a going concern or, if this is not possible, to achieve a better result for the bank’s creditors as a whole than in a winding up.

17 Have capital adequacy guidelines changed, or are they expected to change in the near future?

Yes. The Turner Review indicated the need for significantly greater capital in the banking system, as well as an improvement in the permanency and quality of capital. Comprehensive proposals to increase the quality and quantity of capital have been published by the Basel Committee and the Commission. A brief summary of the principal proposals follows.

The first set of amendments (CRD II) was adopted in September 2009 and is required to be implemented by 31st December 2010. The FSA consulted on implementation in Strengthening Capital Standards 3 (December 2009). CRD II will:

- tighten requirements on banks’ large exposures. The current exemption from large exposure limits for inter-bank loans of less than one year will be abolished;

- introduce harmonised requirements for tier 1 hybrid capital. Hybrid capital will be capped at 50 per cent of tier 1 after deductions, and there will be separate non-cumulative sub-limits for:
  - innovative and dated instruments (15 per cent);
  - other non-innovative hybrid capital (35 per cent); and
  - quasi-equity (50 per cent);

- improve the supervision of banking groups through reinforcing colleges of regulators for banking groups operating in more than one EU or EEA state; and

- improve the framework for securitisation. Banks will only be permitted to invest in a securitisation if the originator, sponsor or original lender (which may or may not be regulated) retains a 5 per cent economic exposure (referred to as ‘skin in the game’).

In July 2009 the Commission proposed further changes in respect of trading book capital, re-securitisations and the supervisory review of remuneration policies (CRD III). These proposals were foreshadowed in a June 2009 Commission Communication and are intended to be consistent with the enhancements to the Basel II framework adopted by the Basel Committee in July 2009. The FSA consulted on implementing CRD III in Strengthening Capital Standards 3 (December 2009).

The following changes are proposed:

- an additional capital buffer will be introduced based on a stressed value at risk (VaR) to the ordinary VaR for banks using their own internal model to determine the capital charge for market risk. The intention is to capture tail events as well as sustained movements in market prices that are not adequately captured under existing VaR models;

- extending the capital charge for default risk in the trading book to capture mark to market losses caused by changes in creditworthiness (ie, ratings downgrades). Such downgrades were a major source of loss on traded debt positions during the financial crisis;
introducing new (and higher) capital charges for re-securitisations (such as CDO of ABS); and

requiring the use of banking book capital charges for securitisation positions that are held in a bank’s trading book. Previously many banks had treated trading book securitisation positions as straightforward debt positions.

These changes are expected to roughly double the amount of capital required to be held in respect of banks’ trading books.

In February 2010 the Commission published a consultation document on further changes to banks’ capital requirements (CRD IV). This consultation will implement the proposals published by the Basel Committee on Strengthening the Resilience of the Banking Sector (December 2009). The main changes include:

> improving the quality of capital through new harmonised definitions of core tier 1 capital, non-core tier 1 capital and tier 2 capital;

> setting new capital ratios in respect of core tier 1, tier 1 and total capital;

> abolishing innovative tier 1 capital and tier 3 capital. Tier 2 capital will be simplified with a single definition based on lower tier 2 capital;

> adopting a harmonised approach to deductions from capital, with most deductions being made from common equity;

> introducing new requirements in respect of counterparty credit risk on derivatives, repos and securities financing transactions;

> adopting a leverage ratio as a non-risk-based measure to curtail the growth in banks’ balance sheets;

> requiring banks to build up capital buffers in good times that are capable of being drawn down in periods of stress; and

> addressing the risks posed by financial institutions that are systemically important.

The Commission is also proposing to reduce the number of national discretions in the CRD.

Work on the calibration of CRD IV will take place through 2010 with a final decision expected by the end of 2010. It is currently envisaged that the new requirements will come into force at the end of 2012.

Pending implementation of these new capital requirements, the FSA is operating a ‘supervisory policy’ under which UK banks are required to maintain a minimum core tier 1 ratio of 4 per cent. Banks are expected to meet a post-stress tier 1 ratio of 6 to 7 per cent corresponding to a pre-stress tier 1 ratio of 8 per cent. The capital floor under which banks are required to hold capital of at least 80 per cent of their Basel I requirement has been extended and the FSA intends to keep it in place until the new leverage ratio is implemented.

The FSA requires banks to carry out stress tests to ensure that they hold adequate capital in the event of plausible adverse economic conditions. In its 2010 Business Plan the FSA stated that it will be carrying out annual stress tests for all major financial institutions. The 2010 Financial Risk Outlook states that banks will need to ensure that they continue to meet their minimum capital requirements in the event of a peak to trough decline of 8.1 per cent in GDP, a 36 per cent decline in house prices, a 60 per cent decline in commercial property prices and an increase in unemployment to 13.3 per cent.
Ownership restrictions and implications

18 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes ‘control’ for this purpose?

The UK implemented the EU Acquisitions Directive on 21 March 2009. A person who decides to acquire or increase control over a UK authorised person must notify and obtain consent from the FSA in advance. Failure to do so is a criminal offence. In February 2010 Semperian pleaded guilty to acquiring control where it had completed an acquisition already notified to the FSA without waiting for FSA approval and was fined £1,000. Vijay Sharma was convicted of acquiring a controlling interest in a regulated firm without giving the FSA prior notice in September 2009. In 2009 the maximum penalty for such an offence was increased from £5,000 to an unlimited fine.

The FSA has 60 working days from receipt of the notice to approve the acquisition of control (with or without conditions), or to object. This period may be interrupted by up to 20 days where the FSA requires further information.

The thresholds for notifying the FSA of the acquisition of control are 10, 20, 30 or 50 per cent of the shares or voting power in a bank.

A parallel regime exists in respect of the reduction of control, where a person is required to notify the FSA of any reduction in control to below 50, 30, 20 or 10 per cent of the shares or voting power. Failure to notify is an offence, although there is no requirement for FSA consent to the reduction of control.

The Acquisitions Directive has tightened the assessment criteria for objections to a change of control (see question 25).

19 Are there any restrictions on foreign ownership of banks?

No.

20 What are the legal and regulatory implications for entities that control banks?

There are no restrictions on the business activities of a parent or acquirer of a UK bank, or on those of affiliates of a UK bank, although such activities will be taken into account as part of the FSA’s assessment of the acquisition. A bank may be owned or acquired by a company whose business is wholly non-financial in nature. As a result of changes in August 2009 the directors, officers and employees of a holding company of a UK bank whose decisions or actions are regularly taken into account by the governing body of the bank must be approved by the FSA.
The FSA carries out the consolidated supervision of banking groups. Consolidated supervision applies at the level of the highest EEA group company whose subsidiaries and participations (basically, a 20 per cent holding) are banks or engage in broadly financial activities. The FSA will not normally undertake worldwide supervision of a group headed by a parent outside of the EEA.

The practical effects of consolidated supervision applying will depend on the individual group’s structure. However, the following points may be noted:

> the group will need to hold adequate capital to cover the exposures and off-balance sheet liabilities of all members of the group (and not just regulated entities), including the parent and its subsidiaries and participations; and

> limits on large exposures will apply.

21 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

Where a banking group is subject to consolidated supervision the FSA will apply its prudential rules to the group as a whole (see question 20). It will not, however, directly regulate non-authorised entities in the group.

Each regulated firm (including banks) will need to meet the regulatory requirements applicable to it on a stand alone basis. This includes, but is not limited to, capital adequacy and liquidity. Beyond this, the entities and individuals that control a bank are not subject to particular requirements. There is no legal obligation on a parent to provide additional capital if a subsidiary bank becomes undercapitalised. However, in this case, unless the bank is able to rectify the situation by raising capital elsewhere, or by reducing its exposures, then it will cease to meet the authorisation criteria and will lose its authorisation. In addition, the authorities may invoke the stabilisation powers under the Banking Act 2009 (see question 16).

A failure to recapitalise a bank, where this is practical, is a factor that the FSA may take into account in determining whether the controllers of the bank remain fit and proper persons. If the FSA concludes that they are not, they may be prevented from acquiring control over further authorised persons, or even be required to dispose of shareholdings in existing authorised firms. A decision not to recapitalise a bank will not, of itself, have this consequence, and there may be valid reasons for allowing an insolvent bank to fail, eg, where this permits the remaining companies in the group to survive.

22 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

We have referred in question 16 to the pre-insolvency stabilisation powers as well as the new bank insolvency procedure and bank administration.

A controlling entity or individual is not liable for the debts of an insolvent subsidiary. Liability depends on the application of general rules of insolvency law, which also apply in a bank insolvency or bank administration. The following are the main circumstances in which a shareholder or parent may incur liability.

**Transactions at an undervalue**

If a company has entered into a transaction at an undervalue and at the time the company was unable to pay its debts, or became unable to do so as a result of the transaction, in the two years prior to the onset of insolvency, the court has wide powers to set aside the transaction. There is a presumption of insolvency if the transaction is with a controller or parent.

**Preferences**

If a company does anything that puts the controller or parent in a better position in the event that the company goes into insolvent liquidation in the two years prior to the onset of insolvency, the court may set aside the preference if the company was insolvent or became insolvent as a result.
Fraud on creditors

The court has wide powers to set aside transactions entered into for the purpose of putting assets beyond the reach of creditors or otherwise prejudicing the company’s creditors.

Shadow directorship

A controller or parent may be a shadow director if the directors of the company are accustomed to act in accordance with its directions. A shadow director may incur personal liability for fraudulent trading and wrongful trading. Fraudulent trading requires proof of dishonesty and is also a criminal offence.

A director is responsible for wrongful trading if a company goes into insolvent liquidation and at some time before the commencement of the winding up the director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation, and the director failed to take every step with a view to minimising the potential loss to the company’s creditors as he or she ought to have taken. A director that is guilty of wrongful or fraudulent trading may be ordered to contribute such amount to the company’s assets as the court thinks proper.

Disqualification

The court has powers under the Company Directors Disqualification Act 1986 to disqualify company directors (including shadow directors) guilty of misconduct for up to 15 years. In particular, a director of an insolvent company may be disqualified if his or her conduct makes him or her unfit to be concerned in the management of a company.

Changes in control

23  Describe the regulatory approvals needed to acquire control of a bank. How is ‘control’ defined for this purpose?

See question 18. Approval may also be required under UK or European competition law.

Within 14 days of a person becoming or ceasing to be a controller of a consumer credit licence holder the person must notify the licensee of that fact. The licensee will then notify the Office of Fair Trading. Certain changes may require notification to the Information Commissioner under the Data Protection Act 1998.

24  Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The place of incorporation or nationality of an acquirer is not relevant. There is no difference in the process for approval.

25  What factors are considered by the relevant regulatory authorities in considering an acquisition of control of a bank?

See question 18. The FSA may only object to an acquisition on the basis of the following matters (or the submission of incomplete information):

- the reputation of the acquirer;
- the reputation and experience of any person who will direct the business of the UK bank;
- the financial soundness of the acquirer, in particular in relation to the type of business that the bank pursues;
- whether the bank will be able to comply with applicable prudential requirements;
- whether the FSA can effectively supervise the group including the target; or
- whether there are reasonable grounds to suspect money laundering or terrorist financing in connection with the proposed acquisition.
26 Describe the required filings for an acquisition of control of a bank.

The first step is normally an informal approach to the FSA. This is followed by submission of the required information. A prospective controller should use the FSA prescribed forms unless there are good reasons for not doing so. From 21 March 2009 the following forms are relevant:

- corporate controllers form, for a controller that is a limited company or a limited liability partnership;
- partnership controllers form, for a controller that is a partnership;
- individual controllers form, for an individual controller; and
- trust controllers form for a trustee settler or beneficiary of a trust.

Completion of the forms can be time-consuming and the forms require supporting documentation such as group structure charts and a business plan where the acquirer intends to change the manner in which the firm will be run. Having received the notice, the FSA can require additional information or documents if it considers this necessary and may carry out interviews. Where a proposed new or increased controller is regulated elsewhere in the EEA the FSA must consult with the relevant home-state regulator. The same applies if a UK bank is controlled by a parent company located in another EEA state. It should be emphasised that control does not stop at the level of the acquirer and can pass all the way up the corporate chain to the ultimate beneficial owners.

27 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The FSA has 60 working days to approve an acquisition, although the process may be shortened where the controllers are already known to the FSA. In such cases, six weeks is not uncommon. It facilitates approval for the acquirer to discuss a proposed acquisition with the FSA informally in advance. This enables the FSA to identify potential issues and request any further information before the formal notification is submitted. If approval is granted, the prospective controller must complete the acquisition within one year, or such shorter period as the FSA specifies.