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CONTENTS

Editor’s Preface ........................................................................................................................................... xi
Jan Putnis

Chapter 1 INTERNATIONAL INITIATIVES ........................................... 1
Jan Putnis and Tolek Petch

Chapter 2 ANGOLA ........................................................................ 40
Mafalda Oliveira Monteiro and Bruno Sampaio Santos

Chapter 3 ARGENTINA.................................................................... 52
Santiago Carregal and Diego A Chighizola

Chapter 4 AUSTRALIA...................................................................... 66
Louise McCoach and David Landy

Chapter 5 AUSTRIA ....................................................................... 115
Alexander Taiyo Scheuwimmer

Chapter 6 BARBADOS ................................................................... 125
Sir Trevor Carmichael QC

Chapter 7 BELGIUM ..................................................................... 134
Anne Fontaine

Chapter 8 BOLIVIA ....................................................................... 146
Carlos Pinto-Meyer and Lindsay Sykes

Chapter 9 BRAZIL ......................................................................... 154
José Eduardo Carneiro Queiroz

Chapter 10 CAMBODIA ................................................................. 160
Bun Youdy
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Authors</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>24</td>
<td>GUERNSEY</td>
<td>John Lewis and Helen Wyatt</td>
<td>400</td>
</tr>
<tr>
<td>25</td>
<td>HONG KONG</td>
<td>Laurence Rudge and Peter Lake</td>
<td>412</td>
</tr>
<tr>
<td>26</td>
<td>HUNGARY</td>
<td>Péter Köves and Szabolcs Mestyán</td>
<td>429</td>
</tr>
<tr>
<td>27</td>
<td>INDIA</td>
<td>Cyril Shroff and Ipsita Dutta</td>
<td>436</td>
</tr>
<tr>
<td>28</td>
<td>INDONESIA</td>
<td>Yanny M Suryaretina</td>
<td>452</td>
</tr>
<tr>
<td>29</td>
<td>IRELAND</td>
<td>William Johnston, Robert Cain, Eoin O’Connor and Niall Esler</td>
<td>476</td>
</tr>
<tr>
<td>30</td>
<td>ITALY</td>
<td>Giuseppe Rumi and Andrea Savigliano</td>
<td>491</td>
</tr>
<tr>
<td>31</td>
<td>JAPAN</td>
<td>Hirohito Akagami and Wataru Ishii</td>
<td>505</td>
</tr>
<tr>
<td>32</td>
<td>JERSEY</td>
<td>Simon Gould and Sarah Huelin</td>
<td>516</td>
</tr>
<tr>
<td>33</td>
<td>KOREA</td>
<td>Sang Hwan Lee, Chan Moon Park and Hoin Lee</td>
<td>528</td>
</tr>
<tr>
<td>34</td>
<td>KUWAIT</td>
<td>Haifa Khunji and Basem Al Muthafer</td>
<td>540</td>
</tr>
<tr>
<td>35</td>
<td>LATVIA</td>
<td>Armands Skudra</td>
<td>554</td>
</tr>
<tr>
<td>36</td>
<td>LUXEMBOURG</td>
<td>Franz Fayot</td>
<td>565</td>
</tr>
</tbody>
</table>
Chapter 37 MALTA ................................................................. 586
   David Griscti and Clint Bennetti

Chapter 38 MOZAMBIQUE ..................................................... 596
   Paulo Pimenta and João Leite

Chapter 39 NETHERLANDS .................................................... 606
   Joost Schutte, Annick Houben and Mariken van Loopik

Chapter 40 NEW ZEALAND ..................................................... 619
   Guy Lethbridge and Debbie Booth

Chapter 41 NICARAGUA ......................................................... 633
   Rodrigo Taboada R

Chapter 42 NORWAY ............................................................. 646
   Terje Sommer, Richard Sjøqvist and Markus Nilssen

Chapter 43 PHILIPPINES ......................................................... 657
   Rafael A Morales

Chapter 44 POLAND .............................................................. 673
   Tomasz Gizbert-Studnicki, Tomasz Spyra
   and Michał Bobrzyński

Chapter 45 PORTUGAL .......................................................... 688
   Pedro Cassiano Santos

Chapter 46 ROMANIA ............................................................ 706
   Alexandru Birsan, Carmen Peli and Alexandra Manciulea

Chapter 47 RUSSIA ............................................................... 721
   Vladislav Skvortsov and Stefan Wolfgang Weber

Chapter 48 SINGAPORE .......................................................... 736
   Francis Mok and Wong Sook Ping

Chapter 49 SPAIN ................................................................. 748
   Juan Carlos Machuca and Tomás José Acosta
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Country</th>
<th>Pages</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 50</td>
<td>SWEDEN</td>
<td>777</td>
<td>Niclas Rockborn, Nils Unckel and Björn Dahlén</td>
</tr>
<tr>
<td>Chapter 51</td>
<td>SWITZERLAND</td>
<td>797</td>
<td>Shelby R du Pasquier, Patrick Hünerwadel, Marcel Tranchet, Valérie Menoud and David Violi</td>
</tr>
<tr>
<td>Chapter 52</td>
<td>THAILAND</td>
<td>821</td>
<td>Montien Bunjarnondha and Rabat Alikhan</td>
</tr>
<tr>
<td>Chapter 53</td>
<td>UKRAINE</td>
<td>836</td>
<td>Denis Lysenko, Yulia Kyrpa and Maryna Fedorenko</td>
</tr>
<tr>
<td>Chapter 54</td>
<td>UNITED ARAB EMIRATES</td>
<td>848</td>
<td>Amjad Ali Khan and Stuart Walker</td>
</tr>
<tr>
<td>Chapter 55</td>
<td>UNITED KINGDOM</td>
<td>855</td>
<td>Jan Putnis, Benjamin Hammond and Nick Bonsall</td>
</tr>
<tr>
<td>Chapter 56</td>
<td>UNITED STATES</td>
<td>888</td>
<td>Luigi L De Ghenghi and Reena Agrawal Sahni</td>
</tr>
<tr>
<td>Chapter 57</td>
<td>VENEZUELA</td>
<td>978</td>
<td>Pedro Planchart Pocaterra and Ana Karina Gomes Rodriguez</td>
</tr>
<tr>
<td>Chapter 58</td>
<td>VIETNAM</td>
<td>987</td>
<td>Samantha Campbell and Pham Bach Duong</td>
</tr>
<tr>
<td>Appendix 1</td>
<td>ABOUT THE AUTHORS</td>
<td>1009</td>
<td></td>
</tr>
<tr>
<td>Appendix 2</td>
<td>CONTRIBUTING LAW FIRMS’ CONTACT DETAILS</td>
<td>1045</td>
<td></td>
</tr>
</tbody>
</table>
The past year has seen a number of critically important bank regulatory initiatives reach interim conclusions.

In the European Union we have seen the finalisation and coming into force of the primary measures that are required to implement Basel III, as well as – at long last – political agreement on the Recovery and Resolution Directive and the principal elements of the banking union proposals. We have also seen the first foray of the European Commission into bank structural reform, with its controversial proposal for EU legislation on that subject, after the enactment of detailed domestic bank structural reform measures in a number of member states.

In the United States, the past year has seen the culmination of a number of regulatory initiatives, including the issue of final rules implementing the Volcker Rule and the issue of rules that will require large foreign banking groups to establish intermediate holding companies for their US subsidiaries. Both of these sets of rules stem from the Dodd-Frank Act: predictions that numerous legal careers would be made by that legislation are so far proving to be accurate.

I refer to these developments above as ‘interim conclusions’ because, of course, even though a period of primary rule-making has reached a conclusion, the full implications are still emerging. That said, there are helpfully more certainties now about the future direction of banking regulation than was the case a year ago. The combination of that fact, generally improving western economies and shareholder pressure has made many banks take the plunge and start to reorganise and restructure.

Recovery and resolution planning work remains a powerful driver of structural reform. It does not, however, require a particularly sophisticated legal and regulatory view to conclude that the world remains far from a position where we can have confidence that a global systemically important bank could be resolved in an orderly manner today without significant disruption and damage to the world economy. The fact that some regulators occasionally argue to the contrary disregards the detailed work that still has to be done so that governments and regulators may have a good chance of attaining that confidence in the next few years. But that work is, in general, progressing and reassuringly
shows no real sign of faltering yet as memories begin to fade of just how close the world came to economic calamity during the financial crisis.

Divergent approaches to structural reform in different countries could, however, make group-wide resolution more difficult to achieve. Localism, in the form of requirements that banking subsidiaries hold additional, more loss-absorbent capital and additional pools of liquidity, and have boards of directors with a significant independent membership, all have the potential to threaten the concept of a global banking group unless careful thought is given in such groups to how to address these challenges. The ways in which banking groups can best coordinate their relationships with multiple regulators are high on this agenda.

Perhaps the most difficult challenge facing banks in their relationships with their regulators is that of how to reconcile the need for close and cooperative working relationships with those regulators against the backdrop of seemingly never-ending conduct-related investigations and enforcement action. This difficulty varies according to which regulator is carrying out the investigation and the extent to which the investigation relates to matters that are historic and which the banking group concerned has taken steps to address. The challenge is clearly greatest where a major investigation concerns recent conduct and is led by a regulator with which the relevant bank requires good relations in order to achieve its commercial objectives to the satisfaction of its customers and shareholders.

It will be increasingly important for banks to appreciate the capacity of the more material investigatory and enforcement activity to shape business structures as much as structural reform itself. The changes to the ways in which certain markets and trading operations will be organised in the future in response to enforcement activity will be at least as significant as the changes that are brought to those markets and operations by, for example, resolution planning.

The upheaval that all of this implies for some banks’ corporate and business structures, as well as for their staff, is combining with changes to previously held assumptions about the profitability of certain activities as Basel III capital requirements bite. The result is uncertainty, but with some grounds for cautious optimism, at least for those banking groups that are less seriously affected by conduct investigations and are firmly on the road to developing simpler, more capital-efficient structures.

Banks that have adopted a properly integrated and global approach to structural reform will, in my view, reap the benefits. While, in the short term, that is likely to be more expensive from a resourcing perspective, in the long term it should achieve savings. It is all too easy to address each regulatory initiative as it comes along, not recognising that this reactive approach runs the risk of structural muddle and missing out on developing business models that address multiple regulatory concerns at the same time. It is to be hoped that more regulators start to recognise positive proactivity on the part of banks not just as commercial astuteness but as a contribution to the restoration of trust that is required to make bank regulatory reform a success.

One increasingly important aspect of reform in the banking sector concerns the capital structures of banking groups. The requirement for more and higher quality loss-absorbing capital under Basel III, coupled with the introduction of bail-in as a resolution tool in a number of important banking jurisdictions, means that banking groups are having to rethink which company or companies they will use to raise capital.
and what form that capital will take. Particularly in Europe, the issue of additional Tier I capital and other contingent capital instruments has added complexity to banks’ capital structures and a need for banks to engage with current and potential investors to explain those structures.

This fifth edition of *The Banking Regulation Review* contains submissions provided by authors in 56 jurisdictions between late February and mid-April 2014, as well as the chapters on ‘International Initiatives’ and the European Union. Preparing the chapters has been a particularly onerous task for the authors this year because many of their clients have now moved from observing the regulatory revolution that has taken place in the banking sector to taking tangible steps to reorganise in order to make themselves fit for the new world in which the sector finds itself. My thanks go to all of the authors for their dedication in completing their chapters.

Thank you also to Adam Myers, Shani Bans, Nick Barete and Gideon Roberton at Law Business Research Ltd for their patience, understanding and – above all – great effort in preparing this edition.

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**Jan Putnis**

Slaughter and May
London
May 2014
I INTRODUCTION

The banking and finance sector plays a pivotal role in the United Kingdom's economy, contributing a material part of gross domestic product. London, in particular, is a banking centre of global importance: many global banking groups are either headquartered or have a significant presence in the city.

In response to the 2007–2009 financial crisis and the subsequent effects of that crisis on the UK economy, the coalition government that was formed in 2010 pledged significant financial regulatory reforms. Many of those reforms have now been implemented, and other key reforms have progressed reasonably significantly over the past year. The fundamental reform of the financial regulatory framework, which saw the dismantling of the United Kingdom’s previous primary financial regulator (the Financial Services Authority (FSA)) and the creation of the new Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), is more than 12 months old and the approaches of the new authorities can now be discerned. It is clear, for example, that the FCA intends to build upon the intrusive approach to conduct of business supervision that was taken by the FSA in the few years before it was dismantled and that the FCA can be expected to be proactive in encouraging competition in accordance with its new statutory objective.

A significant development over the past year was the enactment in December 2013 of the Financial Services (Banking Reform) Act 2013 (Banking Reform Act). The Banking Reform Act sets out the framework for the implementation of many of the recommendations of the Independent Commission on Banking (ICB), which was a Committee established by the government in June 2010 to consider and provide recommendations for reforms to the UK banking sector. The ICB’s final report and recommendations were published in September 2011, and led to a governmental White

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1 Jan Putnis is a partner and Benjamin Hammond and Nick Bonsall are associates at Slaughter and May.
Paper in June 2012. The recommendations that were taken forward into the Banking Reform Act included a requirement for the largest banking groups to ‘ring fence’ certain core banking activities critical to retail and small and medium-sized enterprise clients from wholesale and investment banking services, a new regime for the regulation of certain senior individuals in banking groups and a new resolution tool enabling the mandatory ‘bail-in’ of certain creditors of failing banks. Each of these developments is discussed further below.

The Banking Reform Act is largely an enabling act, which provides powers to HM Treasury to make secondary legislation and powers to the PRA, the FCA and the Bank of England to make regulatory rules and requirements setting out the detailed scope and operation of the new reforms. Much of this detail is at a reasonably early stage of development, and further engagement with the banking sector (both on a formal and informal basis) can be expected before final measures are passed into law or regulation.

The top five UK banking groups by market capitalisation are: HSBC Holdings plc, Lloyds Banking Group plc, Barclays plc, Standard Chartered plc and the Royal Bank of Scotland Group plc. These banks (other than Standard Chartered Group) continue to dominate the UK personal and business banking markets, but the market share of the smaller, so-called ‘challenger’, banks continues to develop, and banks face increasing competition in the savings and loans markets from alternative business structures ranging from large life insurers to ‘peer-to-peer’ lending intermediaries.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i The UK regulatory framework for banks

The regulatory and supervisory responsibility for UK banks is divided principally between the PRA (which is a subsidiary of the Bank of England) and the FCA. The Financial Policy Committee (FPC) within the Bank of England, while not directly responsible for the regulation or supervision of individual banks, has a macro-supervisory mandate to identify imbalances, risks and vulnerabilities in the UK financial system and to take action to mitigate those risks to protect the wider economy.

The authority of both the PRA and the FCA derives from the Financial Services and Markets Act 2000 (as amended) (FSMA). The FSMA sets out objectives for each regulator, and requires each regulator to exercise its powers in a manner that will advance those objectives. The powers, responsibilities and objectives of each regulator are discussed in more detail below.

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2 We have listed the five largest UK banking groups ranked by market capitalisation as of 27 February 2014. While this measure benefits from its simplicity of verification, we recognise that it is not a measure of the relative market share of banking business in the United Kingdom. That said, data on the relative market shares within the UK retail banking market was published in the UK Office of Fair Trading’s ‘Review of the Personal Current Account Market’ (January 2013). According to that data the top five providers of personal current accounts in the United Kingdom to retail customers were Lloyds Banking Group, Royal Bank of Scotland, HSBC, Barclays and Santander UK (the UK operation of the Spanish banking group), together making up approximately 85 per cent of the market.
The PRA

The PRA is the prudential regulator of all UK deposit-taking institutions (i.e., banks and building societies), along with insurance companies and certain large investment firms. PRA-regulated firms are also regulated by the FCA in respect of conduct of business matters, which means that such firms are termed ‘dual-regulated’.

Under the FSMA it is a criminal offence for a person to engage in ‘regulated activities’ by way of business in the United Kingdom unless authorised (an ‘authorised person’) or exempt from the authorisation requirement. Regulated activities are prescribed in secondary legislation made under the FSMA. 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, and the regulated activity of ‘accepting deposits’ is specified for the purposes of the FSMA 2000 (PRA-Regulated Activities) Order 2013 and is thus regulated by the PRA.

Consequently, firms that wish to carry on deposit-taking activities (i.e., prospective banks) are required to seek authorisation to do so from the PRA. The application to the PRA for authorisation must also cover all regulated activities that the prospective bank wishes to carry on, regardless of whether those activities are specified in the FSMA 2000 (PRA-Regulated Activities) Order 2013. The PRA is required to obtain consent from the FCA before granting any authorisation, which means the FCA is fully involved in the authorisation process for such firms and may request information from, or ask questions of, the applicant.

Other regulated activities under the FSMA that may be relevant to banks include dealing in investments as principal, dealing in investments as agent, arranging deals in investments, advising on investments, managing investments, certain residential mortgage-lending activities, safeguarding and administering investments (i.e., custody activities). The ‘investments’ to which these activities relate are set out in secondary legislation and include shares, debentures, public securities, warrants, futures, options, contracts for differences and units in collective investment schemes. Since 1 April 2014, certain consumer credit-related activities have also been regulated.

The PRA has a statutory objective under the FSMA of promoting the safety and soundness of the firms it regulates (including banks). The PRA is required to advance this objective primarily by seeking to ensure that the business of PRA-authorised firms is carried on in a way that avoids any adverse effect on the stability of the UK financial system, and also by seeking to minimise the adverse effect that the failure of a PRA-authorised firm could be expected to have on the stability of the UK financial system. The second element of this objective reflects the principle that the PRA supervisory regime is not intended to operate on a ‘zero-failure’ basis. Accordingly, a core aspect of the PRA’s approach to banking supervision is its focus on avoiding any adverse effect on the stability of the UK financial system.

3 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended) (SI 2001/544) and the Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order 2013. The latter of these two Orders specifies the regulated activities that, if carried on, bring a firm within the regulatory purview of the PRA.

4 Ibid.
on the establishment, maintenance and implementation of appropriate recovery and resolution arrangements.

The PRA has a general power under FSMA to make rules that apply to the firms it regulates, and to issue related guidance, with respect to (1) the carrying on by such firms of regulated activities, and (2) other unregulated business activities carried on by such firms (e.g., certain business lending activities that fall outside the regulatory perimeter in the United Kingdom). The PRA may, however, only make such rules as it considers necessary or expedient for the purpose of advancing any of its objectives.

Following the reform of the regulatory framework and the creation of the PRA in April 2013, the PRA adopted certain pre-existing rules relating to prudential supervision in the FSA's Handbook. The PRA also adopted, with certain amendments, the FSA's 'Principles for Businesses', a series of high-level principles underpinning the UK regulatory framework. The Principles for Businesses can be divided into those that are most relevant to prudential supervision, those that are most relevant to conduct of business supervision, and those that are relevant to both. The focus of the PRA is on those Principles relating to prudential supervision, the most fundamental of which is the 'financial prudence' principle that states simply that 'a firm must maintain adequate financial resources'. From a supervisory perspective, the relations with regulators' principle is fundamental, requiring dual-regulated firms to deal with both the PRA and the FCA in an open and cooperative way, and to disclose appropriately to the regulators anything relating to the firm of which the regulators would reasonably expect notice.

The PRA has started to develop its rule-making approach, and in January 2014 commenced a consultation on its proposals to redraft elements of its Handbook and, more generally, to reshape Handbook material that it inherited from the FSA. Significantly, the PRA will replace the Principles for Businesses with a new series of 'Fundamental Rules'. In some respects, these Fundamental Rules reflect the substance of the previous Principles, for example, in requiring firms to maintain adequate financial resources and not to give the PRA any material that is false or misleading. But the rules will also include new concepts, requiring firms to act in a prudent manner and to make preparations for orderly resolution. Until the new rules are implemented, the Principles will continue to be relevant.

The PRA takes a proactive approach to supervision, but focuses on the most significant risks to its statutory objective. The PRA draws on a broad set of information and data in forming supervisory judgments, and relies on banks – and other firms that it regulates – to submit such information and data. Periodically, the PRA may validate such data either through on-site inspection by its own supervisory staff, or by third parties. To support its information-gathering and analysis, the PRA requires firms to participate in meetings with supervisory staff at senior and working levels.

The PRA's supervisory approach is informed by its assessment of a firm's 'proximity to failure', which it captures using its 'Proactive Intervention Framework' (PIF). The PRA forms its judgement of a bank's risk of failure using elements of the PIF that reflect the risks faced by the bank and its ability to manage those risks, in particular: the external context, business risk, management and governance, risk management and controls, and capital and liquidity. The PRA has designed five demarcated PIF 'stages', with each stage indicating a step closer to failure: the stages range from 'Stage 1 (Low risk to viability of firm)' through to 'Stage 5 (Firm in resolution or being actively wound up)'. The PIF reflects the PRA's aim of identifying and responding to emerging risks at an early stage.
and, consequently, as a bank moves through the PIF stages it can expect to be subjected to greater supervisory intervention, including greater pressure on senior management to implement effective remedial action to reduce the likelihood of failure. The PRA reviews each firm’s PIF stage at least annually, and in response to relevant material developments.

From a governance perspective, the board of the PRA is chaired by the governor of the Bank of England, Mark Carney, while the Bank’s Deputy Governor for Prudential Regulation, Andrew Bailey, is the PRA’s chief executive. The board also includes the Bank’s Deputy Governor for Financial Stability, the chief executive of the FCA, and certain non-executive directors. The PRA, through its board, is accountable to the Bank of England for administrative matters and the Bank of England also reviews the PRA’s strategy.

The FCA
The FCA is responsible for the regulation of conduct of business at all FSMA regulated firms (including banks and other PRA-authorised firms), as well as conduct of business in respect of wholesale and retail financial markets, and the market infrastructure that supports those markets. The FCA is also responsible for the prudential supervision of firms that are not subject to prudential regulation by the PRA, which could include certain of a bank’s subsidiaries (such as those carrying on investment intermediation activities). Firms subject to prudential and conduct of business regulation by the FCA need seek authorisation only from the FCA to carry on regulated activities (i.e., such firms are not dual-regulated).

Under the FSMA, the FCA has a ‘strategic objective’ to ensure that markets for financial services in the United Kingdom function well. This is supported by the following operational objectives:

\[ \begin{align*}
& a \quad \text{securing an appropriate degree of protection for consumers;} \\
& b \quad \text{protecting and enhancing the integrity of the UK financial system;} \\
& c \quad \text{promoting efficiency and choice in the market for financial services; and} \\
& d \quad \text{promoting effective competition in the interests of consumers in the markets for regulated financial services or services provided by investment exchanges.}
\end{align*} \]

When pursuing its consumer protection objective, the FCA must have regard to consumers’ needs for ‘timely’ information and ‘advice that is accurate and fit for purpose’, as well as the principle that firms must provide an ‘appropriate’ level of care to consumers.

The FCA intends to take a proactive approach to satisfying its consumer protection and competition objectives. Despite only being in existence for a short time, the FCA has launched a number of market studies, including a market study on cash savings, and has indicated that it expects market studies to become a more commonplace tool.

The FCA is expected, as time develops, to pursue an aggressive consumer protection agenda, and has stated that it will put ‘appropriate consumer outcomes at the centre of the regulatory process’. Consistent with this agenda, the FCA has powers under the FSMA to introduce product intervention rules (which may include the ability to ban the sale or distribution of certain products), for use where the FCA identifies a risk of significant consumer detriment caused by a financial product that requires urgent intervening action. Moreover, the FCA has additional powers of early-stage regulatory intervention, including:
the power to publicise the issue of a ‘warning notice’ (the first stage of an FCA regulatory investigation, prior to any finding of guilt or wrongdoing); and

b the power to publicise the banning of misleading financial promotions.

The FCA has the power under the FSMA to make rules that apply to all regulated firms, and to issue related guidance, with respect to (1) the carrying on of regulated activities, and (2) other unregulated business activities carried on by regulated firms. The FCA may, however, only make such rules as it considers necessary or expedient for the purpose of advancing one or more of its operational objectives. Under the Principles for Businesses, the FCA focuses on principles relating to the conduct of firms’ businesses, of which arguably the most important principle is the ‘customers’ interests’ principle. This states that ‘a firm must pay due regard to the interests of its customers and treat them fairly.’

Until 1 April 2014, most consumer lending in the United Kingdom was governed and regulated by the Office of Fair Trading (OFT) under the Consumer Credit Act 1974 (CCA). From 1 April 2014, the regulation of consumer credit was transferred from the OFT to the FCA. The FCA has made a number of its own consumer credit rules to replace certain provisions of the CCA, although various sections of the CCA are being retained.

From a governance perspective, the FCA is governed by a board of directors with a majority of non-executives appointed by HM Treasury. The board of the FCA is led by a chief executive and chairman, both of whom are appointed by HM Treasury. The current chief executive is Martin Wheatley (previously a managing director in the FSA’s Conduct of Business Unit) and the current chairman is John Griffith-Jones (who joined the FSA as a non-executive director in 2012 having previously been chairman and senior partner at KPMG in the United Kingdom).

The FPC

The FPC is a committee of the Bank of England and has a macro-prudential objective of protecting and enhancing financial stability and the resilience of the UK financial system by monitoring threats and taking action where necessary to address any perceived or identified vulnerabilities and imbalances in the UK financial system. The FPC also has supervisory oversight of both the PRA and the FCA and, in this capacity, the FPC has the power to issue macro-prudential directions to the PRA and the FCA. The FPC does not, however, have the power to exert control over, or issue directions to, individual firms.

The FPC has two main powers over the PRA and the FCA. These powers are:

a a broad power of recommendation regarding any matters relevant to financial stability, backed up by a statutory requirement for the PRA and the FCA to ‘comply or explain’; and

b a narrower power of direction to require the PRA to exercise its functions to implement a macro-prudential measure (any such measure must be prescribed by HM Treasury by statutory order). This power may require the PRA to implement the relevant measure in relation to all regulated persons or a class of regulated persons.

The FPC is chaired by the Governor of the Bank of England, and its other members include the Bank of England’s Deputy Governors for Financial Stability and Monetary
Policy, the chief executive of the PRA, the chief executive of the FCA, four independent external members and a representative of HM Treasury.

ii Management of banks

Individuals performing certain functions at UK banks are subject to an ‘approved persons’ regime under the FSMA. This section provides an overview of the regulatory framework for approved persons, which is split between the PRA and the FCA, along with a summary of the liabilities of approved persons. The Banking Reform Act will introduce enhancements to the regulatory regime that applies to senior individuals in banking groups, but the rules for this enhanced framework are not yet finalised and are unlikely to come into effect before 2015.

Approved persons

Individuals intending to carry on certain ‘controlled functions’ at regulated firms require the prior approval of either the PRA or the FCA. Controlled functions fall broadly into two categories: functions involving the exercise of significant influence over the conduct of a firm’s regulatory affairs, known as ‘significant influence functions’ (SIFs), and functions involving dealing directly with customers of the firm or their property, known as ‘customer dealing functions’. Within these two categories, 18 specific controlled functions are specified, each of which is labelled with a ‘CF’ number. Of these, the controlled functions that are most relevant to banks are the director (CF1), non-executive director (CF2), chief executive (CF3), apportionment and oversight (CF8), compliance oversight (CF10), money laundering reporting (CF11), systems and controls (CF28), significant management (CF29), and customer (CF30) functions.

‘Required functions’ are those controlled functions that every authorised firm (including every bank) is required to have where appropriate in its business. These include the apportionment and oversight function, which is essentially the function of allocating and overseeing the appropriate apportionment of responsibilities in the firm, the compliance oversight function and the money laundering reporting function.

The systems and controls function (CF28) exists to ensure that an authorised firm has appropriate systems and controls in place in order to comply with the requirement to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk-management systems. This function encompasses employees of a regulated firm with responsibility for reporting to the firm’s governing body or audit committee (or its equivalent) in relation to:

a its financial affairs;
b setting and controlling its risk exposure; and
c adherence to internal systems and controls, procedures and policies.

The significant management function (CF29) applies only to firms that apportion significant responsibility to a senior manager of a significant business unit. As such, this function generally applies only to larger, more complex firms or groups. Whether someone carries on the significant management function depends on a number of factors, including the particular management structures of the firm. Whether a business
unit is ‘significant’ will depend on factors such as the size of the unit, its contribution to the capital or income of the firm and its risk profile.

The customer function (CF30) encompasses activities including the provision of advice on investments, the managing of investments and dealing in investments, in each case for, or on behalf of, a firm’s clients.

In April 2013, following an investigation into misconduct relating to various interbank benchmarks (most notably, in the United Kingdom, the LIBOR benchmark), the FCA introduced two new SIFs that relate to the performance of roles related to benchmark submission and benchmark administration. The SIFs cover individuals managing teams responsible for submission to LIBOR (the CF40, Benchmark Submission Function) and individuals managing teams responsible for calculating and corroborating daily benchmark submission (the CF50, Benchmark Administration Function).

Individuals need not necessarily be employed by the relevant regulated firm itself in order to be identified as carrying on controlled functions for that firm. Individuals employed elsewhere within a firm’s group may, for example, perform a controlled function by virtue of duties that they perform for the firm, and the director function applies to directors, officers, (or as the case may be, partners or members), senior managers and employees of a parent undertaking or holding company of the firm whose decisions or actions are regularly taken into account by the firm’s governing body (and the non-executive director function similarly encompasses non-executive directors of a firm’s parent undertaking or holding company with such influence).

Responsibility for specifying controlled functions at banks (and all other dual-regulated firms), and for approving individuals to carry on such controlled functions, is split between the PRA and the FCA. In essence:

a The FCA may specify both SIFs and customer dealing functions as requiring its approval. The FCA is under a duty to ‘minimise the likelihood’ that a person will require SIF approvals from both regulators in respect of the same position at a firm. In other words, the FCA should consider carefully whether a PRA-approved person additionally requires FCA approval.

b The PRA may only specify SIFs as requiring its approval.

c The PRA and the FCA must consult each other before specifying SIFs in relation to a firm.

d The PRA must obtain the FCA’s consent before approving a person for a SIF, unless the FCA waives this requirement.

e Both regulators have the power to withdraw approval from an individual carrying on a SIF, regardless of which regulator gave approval. If one regulator decides to withdraw an approval given by the other regulator, it must consult that other regulator first.
The split of controlled functions between the PRA and the FCA for dual-regulated firms is as follows:

<table>
<thead>
<tr>
<th>PRA controlled functions</th>
<th>FCA controlled functions</th>
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<tr>
<td><strong>Significant influence functions</strong></td>
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<td><strong>Governing functions</strong></td>
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<tr>
<td>CF1</td>
<td>Director</td>
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<td>CF2</td>
<td>Non-executive director</td>
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<td>CF3</td>
<td>Chief executive</td>
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<td><strong>Required functions</strong></td>
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<td>CF8</td>
<td>Apportionment and oversight</td>
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<td>CF10</td>
<td>Compliance oversight</td>
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<td>CF10A</td>
<td>Client assets</td>
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<td>CF11</td>
<td>Money laundering reporting</td>
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<td>CF40</td>
<td>Benchmark submission</td>
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<td>CF50</td>
<td>Benchmark administration</td>
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<tr>
<td>CF28</td>
<td>Systems and controls</td>
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<tr>
<td><strong>Significant management function</strong></td>
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<td>CF29</td>
<td>Significant management</td>
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<td><strong>Customer functions</strong></td>
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<td>CF30</td>
<td>Customer function</td>
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An individual can carry on more than one controlled function, which means that it can be necessary for an individual to apply for approval from both regulators. The most frequent overlaps occur where an individual is applying to perform one or more of the PRA-regulated governing functions, as well as one or more FCA-regulated functions. The FCA and the PRA have agreed that where a person seeks ‘twin’ approvals, the application should be made to and processed by the PRA on behalf of itself and the FCA, except where the only FCA-regulated function to which an application relates is the CF8 ‘Apportionment and oversight’ function. An application for twin approvals requires the FCA to give its approval, but this is sought through interaction between the PRA and the FCA without firms actively being required to take any additional steps.

**Qualifications of approved persons**
Approval is granted by the PRA or the FCA only if it is satisfied that an individual candidate is a fit and proper person to perform the controlled function for which an application for approval has been made. The PRA and the FCA both apply a ‘fit and proper test for approved persons’, which includes a number of factors that the regulators will take into account when assessing the fitness and propriety of an individual to perform a particular controlled function. The most important of these factors are concerned with the individual’s:

a honesty, integrity and reputation;
In addition, a firm must employ approved persons with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them (‘the competent employees rule’). This also includes achieving a good standard of ethical behaviour. The PRA and the FCA provide guidance on the training and supervision that employees, including approved persons, will require in order to ensure compliance with the competent employees rule.

Both regulators generally look carefully at the qualifications of prospective directors of banks, and expect banks to carry out extensive referencing and due diligence before appointing new directors and other SIFs. The PRA and the FCA have the power to interview prospective directors and SIFs at banks, and they exercise this power frequently.

**Liabilities of approved persons**

If, taking into account any factor that it would take into account in relation to a grant of approval, either regulator considers that an approved person is no longer fit and proper to undertake their responsibilities, it has the power under Section 63 of the FSMA to withdraw that individual’s approval. If the PRA decides to withdraw an approval given by the FCA, it must consult with the FCA first (and similarly the FCA is required to consult with the PRA if it decides to withdraw a PRA approval). When considering withdrawing an approval, the relevant regulator must have regard, *inter alia*, to the criteria for fitness and propriety, any failures to comply with the Statements of Principle and Code of Practice for Approved Persons (APER) mentioned below, and the qualifications and training of the approved person. Moreover, the PRA and the FCA have powers under Section 56 of the FSMA to issue prohibition orders, prohibiting approved persons from carrying on any controlled functions. Prohibition orders may be limited to specified periods of time and/or specified controlled functions or specified regulated activities.

Both the FCA and the PRA have the power to issue ‘statements of principle’ relating to the conduct expected of approved persons. The FCA has the power to issue statements of principle for the conduct expected of individuals approved by either regulator but the PRA is permitted only to issue statements of principle relating to the expected conduct of (1) individuals that it approves to perform a controlled function; and (2) individuals in dual-regulated firms whom the FCA has approved to perform a SIF. The Statements of Principle cover issues such as acting with integrity, due care, skill and diligence, observing proper standards of market conduct, and dealing openly and cooperatively with regulators. Significantly, the statements of principle apply in respect of all activities carried on by an approved person that relate to the firm’s regulated activities, including such activities that fall outside the formal scope of the controlled functions for which the individual is approved.

An approved person who fails to comply with a statement of principle, or is knowingly concerned in a contravention by an authorised firm of any requirement imposed on it by or under the FSMA, or FCA or PRA rules, may be fined or publicly censured (or both). Both regulators have the power to discipline an approved person who has breached a statement of principle that it has issued, irrespective of whether it has approved the individual.
The FCA and the PRA are also required to issue codes of practice providing greater detail on the circumstances in which an approved person’s conduct would cease to comply with the statements of principle.

Third parties (e.g., customers) do not have a general right of action against approved persons for breach of their regulatory obligations. Under Section 138D of the FSMA, third-party rights of action can, in certain circumstances, be brought for contraventions by authorised firms of certain FCA and PRA rules, and may normally only be brought by a private person, ‘private person’ being defined in secondary legislation for this purpose. However, third-party actions against approved persons under the common law (e.g., for torts or deceit) may still be possible if the requisite elements of the relevant common law claim are established.

Under Section 382 of the FSMA, the FCA or the PRA can apply to a court for a restitutionary action against an approved person to recover any profits made from a contravention of a regulatory requirement, such as a failure to comply with its statements of principle.

Insurance companies are prohibited from providing, and consequently banks are unable to seek the benefit of, insurance policies that indemnify any person against any financial penalties imposed by either the FCA or the PRA under the FSMA. This prohibition does not extend to the provision of certain contractual indemnities including, for instance, those given as part of an employment contract with the authorised firm. An indemnity may, however, separately fall foul of common law provisions rendering it unenforceable if it purports to indemnify against deliberate, fraudulent or criminal wrongs. In addition, extensive indemnities may be contrary to the Principles for Businesses. If the indemnity is provided to a director of a UK-incorporated company, certain restrictions apply under the Companies Act 2006: in particular, Section 234(3) of that Act prohibits indemnities covering any sums payable to a regulatory authority by way of penalty in respect of non-compliance with any requirement of a regulatory nature (however arising). For these purposes, ‘any requirement of a regulatory nature’ would include a requirement arising under FCA or PRA rules.

**Senior persons regime: banking groups**

The Banking Reform Act has introduced a new framework for the supervision of individuals within banks and large investment firms that are authorised by the PRA. The new framework is intended to implement the recommendations of the final report of the UK Parliamentary Commission on Banking Standards (PCBS), which concluded that the existing approved persons regime acted merely as an initial gateway without adequately ensuring the individual responsibilities of senior bankers were adequately defined.

The Banking Reform Act sets out a framework for the replacement of the existing SIF controlled functions with a new ‘senior persons regime’. The key features of the senior persons regime (which is not yet in force) are:

- **Conditional approvals**: the regulators will have the power to grant senior person approvals subject to specified conditions, or for only a limited time period;
- **Reversal of the burden of proof**: where either regulator takes action against an approved senior person for misconduct, the relevant individual will be required to demonstrate that they took all reasonable steps to prevent the contravention occurring or continuing; and
licensing regime: the senior persons regime provides for a licensing framework for those individuals in banks who are not carrying out controlled functions but who, nevertheless, could cause serious harm to the bank or its customers.

Moreover, the Banking Reform Act introduces a new criminal offence for reckless misconduct by an individual that leads to the failure of a bank. The offence is limited to individuals who are approved for the purposes of the senior persons regime, and becomes relevant where – upon the failure of a UK bank – such an approved individual took (or failed to take) steps such that their conduct falls below what could reasonably be expected of a person in that individual’s position.

The Banking Reform Act will apply the new senior persons regime only to the UK banking sector, although the recommendations of the PCBS were intended to have a wider application. The FCA has expressed its intention to consider the implications for the wider financial services industry, but no firm decision has been announced regarding the extension of the regime.

III PRUDENTIAL REGULATION

i Regulatory capital

The package of European Union legislation known as CRD IV (comprising the Capital Requirements Regulation (CRR) and the Capital Requirement Directive (CRD)) introduces in the EU the prudential supervisory standards set out in Basel III. CRD IV replaces and recasts the previous prudential regime for banks and, in accordance with Basel III, makes a number of important enhancements. The detail of the CRD IV package is discussed in more detail in the European Union chapter.

It is important to recognise that the legislative basis for the CRD IV package is different from its predecessor regime. Many of the detailed rules regarding the application of prudential supervision by competent authorities and in relation to regulatory capital adequacy are contained within the CRR, which, as an EU Regulation, is directly applicable in the United Kingdom. Consequently, the PRA has not made rules to implement the provisions of the CRR, except in relation to certain discretions that it is afforded. The CRD is an EU Directive and, as a consequence, requires implementation in the United Kingdom (albeit that, in accordance with the terms of the CRD, this is due to take place on a phased basis until 2019). Where appropriate, the PRA has implemented provisions of the CRD using the PRA Rulebook and amendments to its Handbook.

Under the CRR, UK banks and required to hold capital in respect of credit risk, market risk and operational risk. Credit risk is, broadly, the risk that a debtor will not repay a loan at maturity, or that a counterparty will not perform an obligation due to the bank. Market risk measures the risk of a bank suffering losses as a result of changes in market prices where it has invested in debt or equity securities, or in derivatives or physical commodities. Operational risk can be described as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Whether a particular exposure is subject to the rules on credit risk or market risk normally depends on the bank’s intention in entering into the transaction. The rules on market risk apply to trading activity where the bank’s purpose is to make a profit,
or avoid a loss, from short-term changes in market prices (i.e., proprietary trading). Such trading positions constitute the bank’s ‘trading book’. All other exposures and investments are addressed under the credit risk framework. This includes ordinary bank lending. Investments made to generate an income stream, or to benefit from increases in their value over the medium to long term, are normally subject to the requirements in respect of credit risk.

In respect of credit risk, banks have a choice between a ‘standardised approach’ and ‘advanced approaches’. The standardised approach sets capital charges for exposures to particular classes of counterparty (e.g., corporates, interbank, retail, residential mortgages, etc.). The capital charge generally depends on the external credit rating of the counterparty. The PRA requires capital to be held in respect of both assets and also off-balance sheet exposures. For the latter, a formula applies to convert off-balance sheet exposures into a notional on-balance sheet amount, which is then subject to capital requirements.

Banks may obtain PRA approval to use internal models to calculate their capital requirements for credit risk. The PRA recognises two such ‘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 determined based on supervisory estimates, which are then fed into a formula to determine the capital charge for such exposures. Under advanced IRB, banks themselves determine all the risk factors based on their own internal estimates. Banks that use their own internal models may also use such models to calculate the capital requirements for off-balance sheet liabilities.

The actual amounts of capital that will be required depend on the bank’s risk-weighted assets, calculated using either the standardised approach or an advanced approach. The PRA may require that a new bank start by using the ‘standardised approach’ mentioned above, which is the most formulaic method of calculating risk-weighted assets. If a bank can demonstrate to the PRA that it has sufficiently sophisticated risk-modelling methods then the PRA may allow the bank to move to a PRA-approved IRB model, although, under the CRD, this will not be allowed within the first three years of the bank’s existence.

PRA requirements for market risk follow a ‘building block’ approach, identifying particular risks against which capital must be held. If a transaction gives rise to more than one type of risk it may trigger several different capital charges. Capital is required to be held in respect of position risk, counterparty risk, foreign exchange risk, commodities risk and large exposures risk. Banks can (with PRA approval) use an internal model to calculate their capital requirements for market risk. This is a different type of model to that used for determining capital requirements for credit risk.

The PRA also imposes restrictions on large exposures of banks.

### ii Types of capital

Under the CRR, bank regulatory capital is classified according to the scheme promulgated by the Basel Committee on Banking Supervision. In summary:

- **Banks established in the United Kingdom** will be required under the CRR to hold base regulatory capital of at least 8 per cent of risk-weighted assets plus additional capital in respect of regulatory capital buffers that will be phased in over the next few years. The capital buffers comprise the CRD combined capital buffer (which
is formed of a capital conservation buffer of 2.5 per cent of risk-weighted assets, plus a counter-cyclical buffer that the Bank of England will calibrate on advice from the FPC, certain sectoral specific capital buffers to be calibrated by the FPC, Pillar 2 capital buffers (which the PRA has split into: (1) Pillar 2A, a capital buffer to address risks that are not adequately captured by the CRR capital requirements; and (2) Pillar 2B, an additional capital buffer to address risks to which the bank may become exposed over a forward-looking planning horizon) and any systemic capital buffers (reflecting the global or domestic systemic importance of a bank). In practice, this means that UK banks will ultimately be required to hold regulatory capital of an amount that is significantly in excess of 10.5 per cent of risk-weighted assets (being the 8 per cent base requirement plus the 2.5 per cent capital conservation buffer). In accordance with Basel III, however, full implementation of the increased capital requirements will be phased in over the period to January 2019 (unless the EU, or the UK acting unilaterally, decides to accelerate implementation).

b During the financial crisis of 2007–2009, both investors and banking regulators focused on how much ‘core Tier I’ capital was held by banks. The CRR applies a stricter definition for the highest-quality element of capital, and the base capital requirement relating to this ‘common equity Tier I’ capital (broadly, ordinary share capital and reserves) will be increased to at least 4.5 per cent of risk-weighted assets. In addition, banks will be required to satisfy all regulatory capital buffers referred to in (a) above using common equity Tier I capital. Accordingly, banks will in practice be required to hold common equity Tier I capital of an amount that is significantly in excess of 4.5 per cent of risk-weighted assets. The PRA will have the power to restrict the payment of distributions (in the form of dividends or staff bonuses) by UK banks unless this and certain other capital buffers are satisfied (further details of these reforms are set out in the separate chapters on the European Union and ‘International Initiatives’).

c Subject to specified limits, banks are permitted to hold other types of capital instrument to satisfy their total capital requirement, with these instruments categorised as additional Tier I (broadly, perpetual subordinated debt instruments with no incentive to redeem and that will automatically be written down or converted into common equity Tier I upon the bank’s capital ratio falling below a specified level of at least 5.125 per cent) and Tier II (broadly, subordinated debt instruments with an original maturity of at least five years).

d In addition to the regulatory capital requirements under CRD IV, the Banking Reform Act introduces a framework for regulators to impose non-capital primary loss-absorbing capacity (PLAC) requirements on ring-fenced banks and banks that are systemically important. The PLAC requirement is designed to be relevant in the context of the bail-in resolution tool (as to which see the section on the recovery and resolution regime below), with PLAC essentially comprising unsecured debt that would be available for use in the recapitalisation of a failing bank. The levels of PLAC required are yet to be confirmed, although the government has suggested a requirement of at least 17 per cent of risk-weighted assets. The requirements are likely to be applied on a sliding scale depending on the bank’s size and associated level of systemic risk.
iii Group supervision

The requirements for credit risk, market risk and operational risk apply to individual banks on a stand-alone, or ‘solo’, basis. In addition, the PRA carries out consolidated supervision of banking groups. The relevant requirements are complex. However, the basic principle is that banking groups must hold prescribed minimum amounts of capital, on a group-wide basis, to cover the risk-weighted assets and off-balance sheet liabilities of members of the group, whether or not they are regulated.

Under the CRR, consolidated supervision generally applies at the level of the highest parent undertaking incorporated in the European Economic Area (EEA) together with its subsidiary undertakings that are banks, investment firms, or which carry on broadly defined ‘financial’ activities. Subsidiary undertakings are consolidated in full. In addition, banks are required to include within the scope of consolidated supervision ‘participations’. A ‘participation’ is, broadly, a holding of 20 per cent or more of the share capital in another undertaking. Participations are consolidated on a proportionate basis.

iv Liquidity

The financial crisis demonstrated the importance of both capital and liquidity adequacy for banks. Rather than waiting for the Basel III measures in relation to liquidity adequacy to be introduced at an EU level, the FSA introduced its own rules on liquidity with effect from December 2009. Recognising, however, that imposing strict new rules on liquidity in an unstable financial market could have had an adverse effect on banks’ stability, the FSA decided to impose relatively low-level quantitative liquidity standards that can be increased over a period of several years.

The CRR will introduce a new ‘liquidity coverage requirement’ in the United Kingdom, but these new standards are not expected to come into effect until 2015. In the interim, the PRA continues to apply the liquidity adequacy regime that was originally developed by the FSA.

The PRA’s liquidity adequacy regime broadly requires UK banks to be self-sufficient for liquidity purposes: banks may only rely on other members of their group if they obtain a rule modification from the FSA and comply with stringent requirements. The PRA is unlikely to grant this modification to a UK bank that is seeking to rely on liquidity from non-UK subsidiaries. The liquidity standards in the new rules require that banks have adequate liquidity resources in certain specified stressed scenarios.

v Ring fencing

The Banking Reform Act introduced a requirement for certain UK banking groups broadly to ‘ring fence’ their core banking services that are critical to retail and small and medium-sized enterprise (SME) clients from wholesale and investment banking services. This requirement will, once brought into full force and effect, implement a key recommendation of the ICB that the core deposit-taking business of banks be carried out through entities that are legally and financially independent of other banking services that

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5 The European Economic Area comprises the Member States of the European Union together with Iceland, Liechtenstein and Norway.
United Kingdom

are seen as being more risky. The details on the scope of the ring-fencing requirements and the restrictions applying to ring-fenced entities will be set out in secondary legislation that is expected to be finalised later in 2014 with the affected banks required to organise themselves to comply with the requirements by a date in 2019 to be confirmed.

Broadly speaking, the ring-fencing requirements will apply to banks that carry out the activity of accepting 'core deposits'. Under drafts of the secondary legislation (which has not yet been finalised at the time of writing), ‘core deposits’ will include all deposits except:

a deposits made by large organisations (undertakings that are not SMEs) and financial institutions;

b deposits made by certified, consenting high net worth individuals and closely related persons; and

c deposits taken outside the EEA.

The draft secondary legislation provides that banks whose core deposits do not exceed £25 billion will be exempt from the ring-fencing requirements. This threshold will be calculated taking into account all UK banks in a group. It is proposed that building societies, insurance firms, credit unions and industrial and provident societies will similarly be exempt.

Banks that are subject to the ring-fencing requirements will be prohibited from carrying on certain other excluded activities and will be subject to a number of general prohibitions. Most notably, the draft secondary legislation proposes that ring-fenced banks will, subject to certain exceptions, be prohibited from having exposures to any ‘relevant financial institutions’ (including non-ring-fenced banks, insurers and investment firms). Ring-fenced banks will also be prohibited from having branches or subsidiaries outside the EEA (again with certain exceptions).

The Banking Reform Act specifically provides that ring-fenced banks may not carry out the regulated activity of dealing in investments as principal, except in defined circumstances specified in secondary legislation. The permitted circumstances are expected to be narrowly drawn, but are likely to enable banks to carry on such activities in the following contexts:

a risk management: a ring-fenced bank may deal in investments as principal for the purpose of limiting its exposure to specified risks, for example, by entering into derivatives to limit exchange rate risk;

b debt-for-equity swaps: a ring-fenced bank may acquire equity in a company for the purposes of a debt restructuring;

c securitisation of own assets: ring-fenced banks may (subject to appropriate capital requirements) securitise their own assets and retain the related notes. The securitisation vehicle concerned must only hold assets acquired from the ring-fenced bank; and

d simple derivatives: ring-fenced banks may sell certain specified derivative products to their customers. This activity is, however, likely to be limited in the types of product that may be sold, the nature of the underlying risk, and the size of the derivative portfolio. It is currently expected that ring-fenced banks will be permitted only to sell derivatives that are highly liquid and that relate to either commodity prices, interest rates or foreign exchange rates.
The Banking Reform Act also makes provision for the PRA to make rules in certain broad areas pertaining to ring fencing and ring-fenced banks.

The Banking Reform Act creates a framework for the secondary legislation to define other excluded activities, performance of which by a ring-fenced bank will be prohibited. One such additional excluded activity that the draft secondary legislation specifies is dealing in commodities. Beyond the excluded activities and the other restrictions stated above, it is expected that there will be flexibility in the activities that ring-fenced banks may carry on, although the content of the PRA rules on ring fencing is not yet known at the time of writing.

The role of the PRA
The Banking Reform Act will amend the PRA’s statutory objectives under the FSMA to include an objective of ‘ensuring the continuity of the provision of core banking services’. These ‘core banking services’ are broader than the core activity of accepting deposits and extend to facilities for making payments from, and overdrafts in connection with, deposit accounts.

The PRA will be required to make rules governing ring-fenced banks ensuring that: (1) their core activities are not adversely affected by other group members; (2) they are able to make commercially independent decisions; (3) that they do not depend on resources provided by other group members that would not be available if those members failed; and (4) that they would be able to carry on their core activities if another member of its group were to fail. At the time of writing, the PRA has yet to publish policy statements on these rules.

The Banking Reform Act also provides the PRA with new powers to require the restructuring of a group that, in the PRA’s view, is failing to meet the four objectives described above. Such a restructuring may involve requiring a parent undertaking to dispose of its shares in the ring-fenced bank, or requiring the disposal of specified property by a member of the banking group.

Recovery and resolution regime
The Banking Act 2009 introduced a ‘special resolution regime’ for UK banks and is intended to facilitate the orderly ‘resolution’ (i.e., wind-down) of banks in financial difficulties. This legislation also established two new insolvency proceedings for banks that can be used in circumstances where a bank does, in fact, fail. ‘Failure’ for these purposes includes insolvency, bankruptcy or administration of the bank concerned or the exercise of resolution powers under Part I of the Banking Act 2009 (the latter are referred to as ‘the stabilisation options’) in relation to that bank. The ‘stabilisation options’ currently comprise three methods for addressing the situation where a bank has encountered or is likely to encounter financial difficulties. These are:

- **a** the transfer of all or part of the business of the bank to a private sector purchaser;
- **b** the transfer of all or part of the business of the bank to a company wholly-owned by the Bank of England, referred to as a ‘bridge bank’; and
- **c** taking the bank into temporary public ownership.
The Banking Act 2009 imposes strict controls on the circumstances in which the powers to invoke stabilisation options may be exercised. These controls include the need for the PRA (having consulted with HM Treasury, the Bank of England and the FCA) to be satisfied that the relevant bank is failing, or is likely to fail, to satisfy the threshold conditions for authorisation under the FSMA and that, having regard to timing and other relevant circumstances, it is not reasonably likely that (aside from the stabilisation options) actions will be taken by or in respect of the bank that will enable the bank to satisfy those threshold conditions. Additional specific controls apply in respect of each stabilisation option to ensure that the stabilisation option is only invoked where the relevant authority considers it necessary having regard to relevant circumstances, such as the public interest in the stability of the UK financial system.

The Banking Reform Act introduces a bail-in tool as a fourth stabilisation option. The government is consulting on secondary legislation that will define the scope and application of the bail-in tool, and this tool is intended to be implemented during the course of 2014. The bail-in tool is intended, once implemented, to reflect the powers that are expected to be agreed under the EU Bank Recovery and Resolution Directive (RRD). The RRD is expected to provide a transitional period for implementation of the bail-in resolution tool, with the effect that Member States will not be required to implement this requirement into national law until 1 January 2016. Notwithstanding this, the government, the Bank of England and the PRA view the bail-in tool as an important resolution measure that should be introduced as soon as practicable.

The intention of the bail-in option is to enable the Bank of England, during a stabilisation period of a failing bank, to impose losses on shareholders and, subject to limited exceptions, unsecured creditors of a bank as if that bank were insolvent, while also ensuring the bank continues to operate and provides essential services. The bail-in option includes the power to cancel or modify terms of contracts, and liabilities may be written down or converted into different forms of liability (including equity). Any write-down or conversion would be subject to the ‘no creditor worse off principle’, with the effect that affected creditors must not be left worse off under the application of the bail-in than they would otherwise have been under ordinary insolvency proceedings.

Certain liabilities (such as deposits protected under the Financial Services Compensation Scheme, the UK’s deposit guarantee scheme) are excluded from the scope of the bail-in power.

Following bail-in, the Bank of England also has the power to require that a business reorganisation plan is drawn up to set out a plan for addressing a bank’s failings. From 1 January 2014, banks have been required to produce and keep up to date an effective recovery plan. A recovery plan, in this context, describes the actions that could be taken to ensure the continuity of all or part of the business of the bank (or of another member of its group) in prescribed circumstances. The PRA specified certain key elements that must be covered by the resolution plan in a supervisory statement published in December 2013. At that time, the PRA acknowledged that the RRD may result in the implementation of binding EU technical standards, and that the PRA’s supervisory statements may need to be amended to bring them in line with the EU requirements.

Similarly, the PRA requires banks to produce and keep up to date ‘resolution packs’. A bank’s resolution pack is designed to contain information and analysis that would assist the regulator with any action it needs to take in the event that the bank is
likely to, or does in fact, fail. The PRA specified certain details of the information to be provided in a bank’s resolution pack in its supervisory statement of December 2013. In particular, the PRA describes two phases in which it will request information: (1) phase 1, in which the PRA will request certain basic information from all firms to inform the regulators’ decision on a preferred resolution strategy for the firm; and (2) phase 2, where necessary, and dependent on the information provided in phase 1, the PRA will request tailored information taking into account the specific risks that the firm poses. As with its statement on recovery plans, the PRA stresses that the content of its supervisory statement and its approach to resolution will likely evolve over time.

vii Financial Services Compensation Scheme

Certain deposits held at UK-authorised banks are covered by the Financial Services Compensation Scheme (FSCS). The FSCS is managed and administered by a limited company (the Financial Services Compensation Scheme Limited) established under the FSMA. This body is independent from, but is accountable to, both the PRA and the FCA for the effective operation of the FSCS. The PRA and the FCA are jointly responsible, under the FSMA, for ensuring that the body is capable of discharging its functions.

The FSCS is free to consumers and protects certain deposits (primarily those of private individuals and small businesses) as well as claims relating to certain investment products and certain types of insurance policies. The maximum current level of protection for bank deposits is £85,000 per depositor in respect of all of the depositor’s accounts held at a bank.

The responsibility for determining the rules within which the FSCS operates, including the persons eligible to claim and the level of compensation payable, is split between the PRA and the FCA. The PRA is responsible for such rules in relation to bank deposits and all contracts of insurance, while the FCA is responsible for such rules in relation to all other covered products and types of financial activity. The FSCS is funded by levies on regulated firms imposed on different sectors.

Prior to the financial crisis, the practical involvement of the FSCS in the resolution process had been confined to the customers of only smaller authorised firms and had not been the subject of much attention in the media or among policymakers. The collapse or near-collapse of a number of deposit-taking institutions and the receipt of substantial taxpayer support by some banks has meant that the FSCS is now an essential part of the plans of the UK government, the PRA and the FCA to ensure that where firms do collapse, this does not have a detrimental impact on retail customers. This dovetails with the PRA’s objectives, which effectively recognise that banks should be capable of orderly failure, and the related work undertaken for the ‘special resolution’ regime for banks introduced under the Banking Act 2009, which is intended to facilitate orderly ‘resolution’ (i.e., wind-down) of banks in financial difficulties (see above).

Once the Banking Reform Act comes fully into force and effect, deposits protected by the FSCS will be regarded as ‘preferential debts’ in the event of a bank’s insolvency. This will result in these deposits ranking ahead of the claims of most other unsecured creditors, thereby mitigating the risk of compensation being paid under the FSCS.
IV CONDUCT OF BUSINESS

As explained above, the FCA is responsible for the conduct of business regulation and supervision of banks in the United Kingdom. Banks’ deposit-taking activities have been subject to detailed conduct of business regulation only since 2009, when regulation in this area was introduced by the FSA. Consumer credit activities generally have, however, been regulated for a considerably longer period by the OFT under the Consumer Credit Act 1974 (as amended) and are now regulated by the FCA under the FSMA. Moreover, conduct of business in respect of certain residential mortgage lending and related activities has been regulated in the United Kingdom since 2004.

There are certain overarching legal and regulatory principles that UK banks must consider in the context of the conduct of their businesses. The Principles for Businesses mentioned above, including in particular the principle that firms must treat their customers fairly (the TCF principle), apply to banks as they do to other regulated firms. The TCF principle is primarily concerned with retail customers, although it also applies to the treatment of professional clients (e.g., large corporate entities and certain financial sector firms). It extends beyond the direct treatment of those customers to all of the activities of regulated firms that affect customer outcomes.

Another important point of concern for UK banks is the existence of legislation that renders void or unenforceable certain unfair or unreasonable terms in consumer and certain other contracts. There are also restrictions in the FCA’s rules that effectively prevent regulated firms from seeking to exclude or restrict, or to rely on any exclusion or restriction of, any duty or liability that it may have to a customer in relation to certain business unless it is reasonable to do so and the duty or liability does not arise under the FSMA or rules made by the FCA or the PRA.

i Banking conduct of business rules

The Banking Conduct of Business Sourcebook (BCOBS), which was introduced in 2009 under the FSA’s regulatory regime, now contains FCA rules on matters such as communications with customers, financial promotions, post-sale requirements and cancellation rights in relation to banking products. These rules currently form a relatively ‘light-touch’ regime of conduct of business regulation when compared with the regimes that apply to insurers and investment firms in the United Kingdom. To a large extent these rules codify a set of non-binding requirements that were set out in the former Banking Code.

ii Mortgage regulation

The Mortgage and Home Finance Conduct of Business Sourcebook (the MCOB) contains FCA rules in respect of activities associated with regulated mortgage contracts. These rules apply to persons (whether or not they are banks) carrying on regulated activities associated with mortgages, including entering into regulated mortgage contracts as lender, and administering, arranging and advising on such contracts. These contracts are broadly loans secured by first legal mortgages on land in the United Kingdom where at least 40 per cent of that land is used, or intended to be used, as or in connection with a dwelling by the borrower where the borrower is an individual or a trustee (‘regulated
mortgage contracts). The rules in the MCOB relate to such matters as advising and selling standards, disclosure obligations (both at the pre-application and offer stages of the negotiation of a regulated mortgage contract), arrears and repossessions, and equity release products. Following the introduction of the EU Mortgage Credit Directive (MCD), the FCA has stated that it will be consulting on amendments to MCOB in mid-2014. The MCD introduces enhanced disclosure requirements on mortgage lenders that the United Kingdom is required to implement by 2016.

As with consumer credit more generally (for which, see below) the regulation of second charge residential mortgages has, from 1 April 2014, been transferred from the OFT to the FCA. However, in light of the upcoming implementation of the MCD, the FCA has not proposed significant new rules in relation to such mortgages for the interim.

iii Consumer Credit Act 1974 (as amended)

Until 1 April 2014, most consumer lending in the United Kingdom was governed and regulated solely under the CCA. Persons, including banks, carrying on activities to which the CCA applied could do so only if they had an appropriate licence from the OFT. Credit agreements subject to the CCA were unenforceable if they did not comply with the detailed requirements set out in the secondary legislation made under the CCA.

From 1 April 2014, the regulation of consumer credit has been transferred from the OFT to the FCA. While much of the CCA has been retained, the FCA has also made a number of its own consumer credit rules to replace certain provisions. The key change to the regime is that activities regulated under the CCA (which include consumer lending, credit brokerage and debt collection) have now become regulated activities under the FSMA. Firms carrying out these activities are, as a result, now subject to a broader range of regulatory requirements, including the FCA’s Principles for Businesses and the approved persons regime. Firms that held CCA licences prior to 1 April 2014 can benefit from an ‘interim permission’ regime, which will enable such firms to continue their business pending successful applications for full FCA authorisation, but firms seeking to commence a consumer credit business since 1 April 2014 have had to apply to the FCA for authorisation under FSMA.

iv Investment business

As noted above, performance of investment business in the United Kingdom is a regulated activity under the FSMA. ‘Investment business’, in this context, includes activities such as dealing in investments (both as principal and as agent), managing investments and providing investment advice. Where a bank intends to carry on these regulated activities it must, under the FSMA, obtain prior authorisation from the PRA (which is required to consult with the FCA before granting such authorisation). These activities are also subject to their own detailed conduct of business rules, including, most notably, the rules in the Conduct of Business Sourcebook and the Principles for Businesses referred to above.6

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6 The United Kingdom has implemented the EU Markets in Financial Instruments Directive (MiFID) (2004/39/EC) and its EU implementing measures by means of legislation and rules of the PRA and the FCA.
v Payment services

The United Kingdom has implemented the EU Payment Services Directive (PSD)\(^7\) substantially through the Payment Services Regulations 2009 (PSRs).\(^8\) There are also a small number of payment services-related rules in the FCA Handbook. The PSRs came into force on 1 November 2009.

The FCA is the ‘competent authority’ for the conduct of business aspects of the PSD in relation to all payment service providers (including banks), and for the prudential aspects of the PSD in relation to authorised payment institutions (as defined below). In addition, the Financial Ombudsman Service (FOS) provides a dispute resolution service in relation to the PSRs. Furthermore, HM Revenue and Customs is responsible for supervising the anti-money laundering compliance of money service businesses under the Money Laundering Regulations 2007.

The PSRs:

a set out an authorisation and prudential supervisory regime for payment service providers that are not banks, building societies or e-money issuers (each of which are required to be authorised under separate legislation); such businesses are known as ‘authorised payment institutions’ or ‘authorised PIs’ and are able to passport their payment services to other EEA Member States;

b allow payment service providers operating beneath a certain average monthly turnover threshold to be registered instead of obtaining authorisation; such ‘small payment institutions’ or ‘small PIs’ are not permitted to passport payment services into other EEA Member States;

c exempt certain payment service providers (for example, banks, and authorised and small e-money issuers) from the authorisation and registration requirements;

d set out conduct of business requirements; in this context, this means requirements for information to be provided to payment service users, and specific rules on the respective rights and obligations of payment service users and providers; these requirements are applicable to all payment service providers, whether they are payment institutions, banks, building societies, e-money issuers or any other category of firm; and

e stipulate that rules governing access to payment systems should be non-discriminatory, subject to certain exemptions.

V FUNDING

UK banks raise funding from a number of different sources. In addition to deposits, interbank lending and wholesale funding, it is expected that receipts from securitisations will gradually become more important as the securitisation market continues to recover following the financial crisis, although this recovery is proving to be slow.

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\(^7\) 2007/64/EC.

\(^8\) SI 2009/209, as amended by the Payment Services (Amendment) Regulations 2009 (SI 2009/2475).
The ability of UK banks to rely on sources of funding from within their group to meet liquidity requirements is limited under the PRA's rules as noted in Section III, supra.

The Bank of England also makes available certain liquidity facilities to UK banks, in particular through its discount window facilities and open market operations.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Outline of the UK regime

The United Kingdom has implemented the EU Acquisitions Directive,9 which concerns the prudential rules and evaluation criteria for the assessment of acquisitions and increases of holdings in the financial sector. Under the implementing provisions, which are set out in the FSMA, any person (whether acting alone or in concert with one or more other persons) who decides to acquire or increase control of a UK-authorised person must first obtain the approval of the appropriate regulator.

A ‘UK-authorised person’ for these purposes is a body incorporated in, or an unincorporated association formed under the law of, any part of the United Kingdom that is permitted to carry on regulated activities in the United Kingdom (i.e., regulated by the PRA and the FCA, or by the FCA only). The ‘appropriate regulator’ is the PRA in respect of dual-regulated firms including banks, and the FCA in respect of all other UK-authorised persons.

Where the PRA is the appropriate regulator, as would be the case in respect of the change in control of a UK bank, the PRA is required to consult with the FCA before finalising its determination in respect of the change of control, and the FCA is permitted to make representations to the PRA in respect of matters including (1) the suitability of the proposed controller and the financial soundness of the acquisition; (2) the likely influence that the proposed controller would have on the UK-authorised person; and (3) whether there are reasonable grounds to suspect, or suspect an increased risk of, money laundering or terrorist financing in relation to the proposed change in control.

As described in more detail below, for the purposes of the UK control regime, ‘control’ includes a shareholding or voting rights of 10 per cent or more in the bank or its parent undertaking. Completion of such an acquisition without prior approval from the appropriate regulator is a criminal offence, and may also result in the acquirer’s shareholding rights being restricted or a court ordering the sale of the shares.

An existing controller of a UK-authorised person that decides to reduce its control over the UK-authorised person, cease to be its parent undertaking, or cease to be a controller of that bank altogether, is required to give notice of such intention to the appropriate regulator. It is a criminal offence in the United Kingdom to fail to notify the appropriate regulator of such a reduction or disposition of control, although no approval is, per se, required for such a transaction. Clearly, however, the person acquiring the interest disposed of may require prior approval from the appropriate regulator.

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9 2007/44/EC.
Moreover, every UK bank is required to take reasonable steps to keep itself informed about the identity of its controllers, and to notify the PRA as soon as it becomes aware that any person has decided to acquire control or to increase or reduce control of the bank.

Scope of the UK regime
The FSMA change of control regime applies to all UK-authorised persons. Consequently, all UK banks, insurance companies and firms carrying on investment business (which includes dealing and arranging deals in investments, managing investments and providing investment advice) that are incorporated in the United Kingdom are within the scope of the regime. Overseas firms operating through branches in the United Kingdom are subject to different requirements.10

It should also be noted that, in addition to acquisitions or disposals of banks and their parent undertakings, the FSMA change of control regime may also be relevant in relation to:

a. stakebuilding exercises in actual or potential public bid situations where the target or one of its subsidiary undertakings is a UK-authorised person;
b. joint ventures involving UK-authorised persons;
c. group reorganisations involving UK-authorised persons (even where there is no change in the ultimate parent company);
d. taking security over shares in UK-authorised persons or shares in companies that are controllers of such authorised persons; and
e. certain investment management, custody and stock-lending arrangements.

Meaning of ‘control’
For the purposes of the FSMA change in control regime, ‘control’ is broadly defined. A person (A) will have ‘control’ over a UK bank (B) for the purposes of the regime if A:
a. holds 10 per cent or more of the shares in B or a parent undertaking (P) of B;
b. holds 10 per cent or more of the voting power in B or P; or
c. holds shares or voting power in B or P as a result of which A is able to exercise significant influence over the management of B.

A will be treated as increasing his or her control over B, and requiring further approval from the PRA (or the FCA, as relevant), if the level of shareholding or voting power in B or, as the case may be, P increases through any threshold step. In addition to 10 per cent, the threshold steps occur at 20, 30 and 50 per cent.11

10 It should be noted that general insurance brokers and other insurance intermediaries, mortgage intermediaries, building societies, friendly societies and certain other businesses, are also subject to a change in control approval regime despite such firms not being covered by the Acquisitions Directive (‘non-directive firms’). Non-directive firms are subject to a slightly modified version of the change of control regime, which we do not consider further here.

11 Certain shareholdings may be disregarded in certain circumstances to a specified extent, for example where the acquirer is a credit institution, an investment firm (or its parent), a
In determining the level of a controller’s or potential controller’s shareholding or voting power for these purposes, the controller’s shareholdings or voting power are aggregated with those of any person with whom he or she is ‘acting in concert’. There is no statutory definition of ‘acting in concert’ for these purposes although guidance on the interpretation of this expression has been issued both at EU and UK level.12

**The UK regulatory approach to change in control of a bank**

In accordance with the requirements of the Acquisitions Directive and its implementation in the United Kingdom, when it receives an application for approval of an acquisition of ‘control’ (or an increased level of ‘control’) of a UK-authorised person that is a bank, the PRA must:

- consider the suitability of the acquirer and the financial soundness of the acquisition in order to ensure the sound and prudent management of the UK bank;
- have regard to the likely influence that the acquirer will have on the UK bank; and
- disregard the economic needs of the market.

If there are any regulated institutions within the acquiring group, the PRA must consult any appropriate home state regulators before completing its assessment.

The PRA may object to an acquisition of a bank only if there are reasonable grounds for doing so on the basis of the assessment criteria listed below, or if the information provided by the applicant is incomplete. If contemplating raising an objection, the PRA may also take into account whether the applicant has cooperated with any information requests that it has made, or requirements that it has imposed.

The assessment criteria are:

- the reputation of the acquirer;
- the reputation and experience of any person who will direct the business of the UK-authorised person as a result of the proposed acquisition;
- the financial soundness of the acquirer, in particular in relation to the type of business that the UK-authorised person pursues or envisages pursuing;
- whether the UK-authorised person will be able to comply with its prudential requirements (including the threshold conditions for authorisation in relation to all of the regulated activities for which it has or will have permission);

12 The Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) issued ‘Guidelines for the Prudential Assessment of Acquisitions and Increases in Holdings in the Financial Sector’ (3L3 Guidelines) aimed at setting out a standardised approach across the EU. These provide that ‘persons are ‘acting in concert’ when each of them decides to exercise his or her rights linked to the shares he or she acquires in accordance with an explicit or implicit agreement made between them’, but some uncertainty still remains. Moreover, the FSA issued guidance, which has been adopted by both the FCA and the PRA, on the manner in which the regulator will interpret ‘acting in concert’.
if the UK-authorised person is to become part of a group as a result of the acquisition, whether that group has a structure which makes it possible to:
• exercise effective supervision;
• exchange information among regulators; and
• determine the allocation of responsibility among regulators; and

whether there are reasonable grounds to suspect that, in connection with the proposed acquisition:
• money laundering or terrorist financing is being or has been committed or attempted; or
• the risk of such activity could increase.

The appropriate regulator may impose conditions on its approval where it would otherwise object to the acquisition. However, it may not impose conditions requiring a particular level of holding to be acquired. Where, as is the case for all UK banks, the PRA is the appropriate regulator, the FCA has powers in certain limited circumstances to direct the PRA (1) to object to an acquisition of control; or (2) not to approve an application for the acquisition of control unless it does so subject to conditions that the FCA specified. These FCA powers are exercisable only if the FCA considers there to be reasonable grounds to object to the acquisition of control on the basis of money laundering or terrorist financing being or having been attempted, or the acquisition increasing the risk of such activity.

The FSMA change of control regime in practice
The appropriate regulator has an ‘assessment period’ of 60 working days (plus any permitted interruption period) from the date upon which it acknowledges receipt of an application for approval to decide whether or not to approve a change of control. The appropriate regulator may, no later than the 50th working day of the assessment period, ask for further information to complete its assessment, and may interrupt the assessment period no more than once for up to 20 working days while this information is provided (30 working days if the notice-giver is situated or regulated outside the EEA, or is not subject to supervision under certain EU financial services directives).

As noted above, if there are any regulated institutions within the acquiring group, the appropriate regulator must also consult any appropriate home state regulator before completing its assessment, which may have an impact on the timetable.

Although, in many cases, the process can be completed well within the maximum time allowed, it can never be assumed that this will be possible.

Further reform
Article 6 of the Acquisitions Directive required the European Commission to review the Directive’s application and to submit a report to the European Parliament and the Council in respect of that review, together with any appropriate proposals. In February 2013, the European Commission published its report on the Acquisitions Directive. The report concluded that the Directive is working satisfactorily, although it has only been applied since 2009. The Commission stated, however, that it would ask the European Supervisory Authorities to update the 3L3 Guidelines (see further, footnote 12, supra) on how to apply the proportionality principle, deal with indirect holdings, apply the time
limits and ensure that the assessment criteria are interpreted and applied consistently in member states and cross-sectorally. Revised guidelines have yet to be published.

Other UK issues
The description of the change in control process for banks set out above deals only with issues arising under the FSMA. It should be noted that, in addition to the FSMA requirements, change of control over a UK bank may also give rise, *inter alia*, to issues under the City Code on Takeovers and Mergers, the Data Protection Act 1998, the CCA, the Pensions Act 2004 and the rules of any exchange of which the bank is a member. Competition law may also be relevant.

It will also be necessary in some cases to consider other aspects of the FSMA, in particular the requirements for individuals performing controlled functions within an authorised firm to be approved in advance by the appropriate regulator, and regulatory capital requirements.

ii Transfers of banking business
It is possible to transfer a banking business in the United Kingdom by way of a court-sanctioned banking business transfer scheme under Part VII of the FSMA (a ‘Part VII transfer’). This does not, however, prevent the use of other mechanisms for the transfer or assumption of assets and liabilities relating to banking businesses by other means, such as assignments or novations.

Part VII transfers
A Part VII transfer of banking business is referred to as a ‘banking business transfer scheme’ in Part VII of the FSMA, and is defined as a scheme that:

a satisfies one of the conditions in Section 106(2) of the FSMA. The conditions in Section 106(2) include a condition that ‘the whole or part of the business carried on by a UK authorised person who has permission to accept deposits […] is to be transferred to another body […]’; it is also possible to undertake a Part VII transfer under which ‘the whole or part of the business carried on in the UK by an authorised person who is not a UK-authorised person but who has permission to accept deposits […] is to be transferred to another body which will carry it on in the UK […]’;

b is one under which the whole or part of the business to be transferred includes the accepting of deposits; and

c is not an excluded scheme as defined by the FSMA.

The business to be transferred must include deposit-taking activities carried on in the United Kingdom. These activities must form an integral part of that business, but need not be the sole or predominant business carried on. The Banking Reform Act will, however, amend the FSMA to remove this requirement where, broadly, the transfer is taking place in connection with the creation of the ring fence required by the Banking Reform Act.

A banking business transfer scheme takes effect without the consent of the depositors or other counterparties, although any person who alleges that he or she would be adversely affected by the carrying out of the scheme may be heard in court
proceedings, which are required to sanction the scheme,\textsuperscript{13} and the court may require assurances that such persons have been fairly treated. Both the PRA and the FCA are entitled to be heard in the proceedings.

**Implementation procedure**

The following procedure needs to be followed in order to implement a Part VII transfer of banking businesses:

\textbf{a} The Part VII transfer process is initiated by the submission of an application to the High Court. Under Section 107(2) of the FSMA, the application can be made by the transferor, the transferee or both. The court procedure involves two hearings.

\textbf{b} At a preliminary hearing, typically before a registrar, the court is requested to grant a preliminary order sanctioning the publication of notices (see below) and setting a date for the final hearing. Once the application for the Part VII transfer has been made to the court, notices (approved by the PRA) stating that fact (and containing the address from which the statement mentioned below may be obtained) must be published in the London, Edinburgh and Belfast Gazettes, as well as in two national newspapers in the United Kingdom.

\textbf{c} The terms of the Part VII transfer are documented in a scheme of transfer (the scheme document), which must be lodged in support of the application to court. The scheme document must include details of the transfer itself and any specific provisions in relation to particular categories of asset or liability being transferred, together with provisions setting out the precise nature of what is (and is not) to be transferred pursuant to the scheme document.

\textbf{d} A statement explaining, and setting out the terms of, the scheme document (the statement) should be prepared, and must be given free of charge to anyone who requests it. A copy of the court application and the statement must be provided to the PRA, which would share such documents with the FCA.

\textbf{e} Although not a legal requirement, as a practical matter the approval (or at least confirmation of no objection) of both the PRA and the FCA to the Part VII transfer will need to be sought before it may proceed.

\textbf{f} At the final hearing, typically before a High Court judge, any persons who allege that they would be adversely affected by the carrying out of the Part VII transfer have the right to raise objections and, if the court is so minded, the Part VII transfer will be sanctioned by a final court order. The PRA and the FCA have the right to attend that court hearing, and representatives from at least one of them would be expected to do so.

\textbf{g} The court may sanction the Part VII transfer by the final court order if:

- appropriate certificates have been provided by the PRA certifying that the transferee possesses (or will possess before the Part VII transfer takes effect) adequate financial resources, taking the Part VII transfer into account;
- the transferee has the necessary authorisation to carry on the business being transferred in the United Kingdom;

\textsuperscript{13} Section 110 of the FSMA.
• at least 21 days have elapsed since the PRA was given copies of the application and the statement; and
• the court is satisfied that, in all the circumstances of the case, it is appropriate to sanction the Part VII transfer.

The court has wide-ranging powers to make the transfer effective, including providing for the transfer to the transferee of the whole or any part of the undertaking concerned and of any right, property or liability of the transferor (whether or not the transferor has the capacity to effect the transfer in question).

Where any property or liability included in the order is governed by the law of a country or territory outside the United Kingdom, the final court order may require the transferor, if the transferee so requires, to take all necessary steps for securing that the transfer of that property or liability is fully effective under the law of that country or territory.

The Part VII transfer takes effect as provided in the scheme document and this normally happens shortly after the final court order is made.

The Banking Reform Act will make certain modifications to these arrangements where, broadly, the transfer is taking place in connection with the creation of the ring fence required by that Act, including the introduction of a requirement for an independent expert’s report on the transfer.

**VII REMUNERATION**

The CRD IV package restated and extended the remuneration requirements that were introduced in 2011 by the CRD III package (and that were implemented in the United Kingdom in the PRA’s ‘Remuneration Code’). The PRA’s Remuneration Code has been updated to implement the CRD IV requirements, and applies to approximately 2,600 banks, building societies and investment firms in the United Kingdom. The provisions of the Remuneration Code affect certain senior and risk-taking individuals in UK banks. In addition, UK banks are required to apply the provisions of the Remuneration Code to their subsidiaries and other members of the consolidation group, including such entities that are established in countries or territories outside the EEA.

A central focus of the Remuneration Code is the amount and nature of variable remuneration payments (i.e., bonuses). In general, firms must have a clear distinction between their criteria for setting basic fixed remuneration (to reflect relevant experience and responsibility) and for setting variable remuneration (to reflect a ‘sustainable and risk-adjusted performance as well as performance in excess of that required to fulfil the employee’s job description as part of the terms of employment’).

More specifically, the Code provides that:

a guaranteed variable remuneration is not consistent with sound risk management and is accordingly prohibited, except in exceptional circumstances when hiring new staff;

b the variable remuneration component must not exceed 100 per cent of the fixed component (i.e., the ratio is capped at 1:1) unless shareholder approval above a prescribed threshold is given to extend it; this approval may not extend the ratio above 2:1;
at least 50 per cent of variable remuneration must consist of shares or equivalent interests in the relevant firm or (where appropriate) capital instruments which reflect that firm’s credit quality;

at least 40 per cent of variable remuneration must be deferred over a period of between three to five years, rising to 60 per cent if the variable remuneration exceeds £500,000 or is paid to a director; and

the proportion of variable remuneration to be paid in shares or equivalent instruments mentioned above applies to both the deferred and non-deferred aspects of variable remuneration.

Regulatory guidance clarifies, however, that these revised rules will not generally apply if: (1) an individual’s variable remuneration is 33 per cent or less of his or her total remuneration; and (2) his or her total remuneration is not more than £500,000.

The board of a bank must adopt and periodically review the bank’s remuneration policy and is responsible for its implementation. A bank must ensure that remuneration of senior officers in risk management and compliance functions is directly overseen by the board (or a remuneration committee) and the remuneration policy should be subject to central and independent internal review for compliance, with remuneration policies adopted by the board at least annually. A bank which is ‘significant in terms of its size, internal organisation or activities’ must establish a remuneration committee for this purpose – in practice it is expected that all major UK deposit-taking banks and firms that engage in proprietary trading will be required to establish remuneration committees. Banks must ensure that employees who perform risk management, compliance monitoring and audit ‘control functions’ are independent of the business units they oversee. Staff performing control functions at firms subject to the Remuneration Code must be remunerated adequately to attract qualified and experienced staff and in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control. The Remuneration Code rules include proportionality measures that seek to align the remuneration policies and practices of a bank with its risk profile, risk appetite and risk strategy. In summary, these measures mean that certain smaller banks, building societies and investment firms are not subject to the full range of restrictions in the Remuneration Code; for example, smaller investment firms and asset managers have the ability to disapply the requirement to maintain ratios between fixed and variable remuneration. The eligibility for this relief depends on the prudential category of the relevant firm.

In the event of a breach of the Remuneration Code the PRA may (depending on the provision breached) prohibit a firm from remunerating its staff in a certain way; make void any provision of an agreement that contravenes such a prohibition; and/or provide for the recovery of payments made, or property transferred, in pursuance of such a void provision.

VIII THE YEAR IN REVIEW

The past year has seen few entirely new UK financial regulatory reform initiatives in comparison with past years, but there has been a significant and welcome focus on
finalising and implementing some of the most important and fundamental changes to
the regulatory framework that have been in development since the financial crisis.

The new UK regulatory architecture is now just over a year old, with the PRA and
the FCA increasingly showing greater signs of independence of approach. In the build
up to the replacement of the FSA by the FCA and the PRA, much was said and written
about the expected approaches of the new regulators and the impact that this might have
on the market. One year on, both the market and the regulators have had time to settle
into the new framework and trends can begin to be observed.

For the PRA, the overhaul of its Handbook, and its role in the ongoing reforms
under the Banking Reform Act, have underlined its ‘judgement-based’ approach
to regulation. The proposed replacement of its Principles for Businesses with new
Fundamental Rules provides further evidence of the PRA distinguishing its supervisory
approach from that of the FCA.

The FCA has demonstrated its commitment to pursuing an agenda focused on
consumer protection and promoting competition in financial services. This is evident
from the increase in its enforcement actions and thematic reviews over the past year, its
very real focus on senior management responsibility, and the market studies that it has
carried out and intends over the next year to perform.

The introduction, from 1 January 2014, of the new prudential supervisory regime
under the CRD IV package has been a key change over the past year. The detail of the
CRD IV package is discussed in the separate chapter on the European Union, but the
market now has a much clearer understanding of how the supervisory regime under that
framework will operate.

The Banking Reform Act has now been passed into law, marking a key milestone
in the implementation of the recommendations made by the ICB and the PCBS. Much
of the detail behind the implementation of the Banking Reform Act will be set out in
secondary legislation and rules that have not yet been made, but drafts of some of these
measures have been published.

The impetus for banking reform in recent years has been fuelled by a number of
high-profile controversies affecting the banking sector. The past year has, unfortunately,
been marred by further controversies.

i Review of interest rate benchmarks
Regulatory concerns around misconduct in respect of various interbank benchmarks,
including LIBOR, continues. On the enforcement side, the FSA and the FCA imposed
significant financial penalties on three banks during 2013 and issued warning notices
ahead of further enforcement action to certain individuals.

The recommendations of the Wheatley Review into the misconduct (which
were presented to the government in September 2012) have now been implemented.
Two new categories of significant influence function for individuals managing
teams responsible for calculating and corroborating benchmark submissions and for
individuals managing teams responsible for submissions to LIBOR have been added
to the approved persons regime. Two new regulated activities relating to benchmarks
(although, currently only applicable to LIBOR) have also been introduced. The FCA’s
new rules in relation to benchmark administrators (contained in Chapter 8 of the FCA’s
market conduct sourcebook, and in its ‘General Guidance on Benchmark Submission and Administration’) have come into effect.

ii  Global investigation into the foreign exchange market

The FCA confirmed in October 2013 that it was conducting investigations, alongside several other agencies, into a number of firms relating to alleged collusion and rate rigging in the foreign exchange market. In February 2014, during a parliamentary hearing, Martin Wheatley described the foreign exchange investigations as comparable in seriousness with those that were conducted into LIBOR. A number of banks have suspended employees and put bonuses for foreign exchange traders on hold, but, at the time of writing, no bank has yet been issued with a financial penalty.

The Bank of England is also facing scrutiny over whether its officials may have been aware of the behaviour of traders who face allegations of foreign exchange rate manipulation. In this connection, the Bank of England launched an internal investigation in February 2014 and has suspended one official.

iii  Payday loans cap

The ‘payday loans’ sector came under mounting criticism in 2013 as political leaders accused lenders of encouraging consumers to take on unsustainable debt burdens. In an unexpected move, the Chancellor of the Exchequer, George Osborne, announced in November 2013 that the overall cost of payday loans would be capped. This captures not just interest rates, but also associated fees such as arrangement fees and penalty fees. The FCA had an existing power under the FSMA enabling it to cap the cost of payday loans, but the Banking Reform Act will amend the FSMA to impose a duty on the FCA to make rules to cap the cost of credit in relation to high-cost short-term credit agreements. The FCA will be required to make these rules with a view to securing appropriate protection for consumers, and to report on the use of this power in its annual report. The relevant section of the Banking Reform Act has yet to come into force, but the FCA’s rules should take effect no later than 2 January 2015.

IX  OUTLOOK AND CONCLUSIONS

The continuing reform of the United Kingdom’s financial regulatory framework through the phased implementation of various reform initiatives will continue to present challenges for regulated firms, and particularly banks, in the United Kingdom. Banks are required to understand and comply with the rules of a new, more fragmented regulatory regime. They are likely to find challenges in the interventionist role played by the PRA, in its close scrutiny of banks’ systems, controls and governance, and by the FCA as it looks to intervene at an earlier stage in product life cycles to prevent and combat perceived consumer detriment.

It is to be expected, in this supervisory environment, that mergers and acquisitions involving or creating systemically important UK banking groups will be subject to intense regulatory scrutiny. It seems unlikely that the PRA (or the FCA) would countenance a transaction on the scale of the acquisition of ABN AMRO by RBS in 2007 in the future without being provided with compelling evidence that adequate due diligence had been
carried out and without intensive involvement of the UK and EU regulators in the acquisition process. Together with competition concerns, this is likely to have an all but fatal effect on the prospects for major consolidation or acquisition activity in the banking sector in the United Kingdom. Indeed, recent government policy has been directed at encouraging competition from new market entrants and so-called ‘challenger banks’. The FCA’s specific operational objective of promoting effective competition in the interests of consumers is relatively new, but already the FCA has indicated that it intends to take significant steps to demonstrate its furtherance of this objective.

Potentially the most significant development likely to shape the UK banking sector in coming years will be the implementation of the ring-fencing requirements for the largest banks that take deposits from individuals and SMEs, and how these proposals will be affected by developments internationally. The intense focus and debate on the design of the ring fence, including what activities will be permitted to be carried on within it, has already begun and can be expected to continue over the next year. Regardless of how the ring fence is eventually designed, it presents a fundamental challenge to the universal banking model and it is not yet clear what effect this may have on the competitiveness of the UK banking groups that become subject to the ring-fencing requirement.

All of this will, over the next year, develop against the backdrop of perennial banking sector issues, including the remuneration paid to senior bankers, which is likely to remain subject to intense scrutiny regardless of whether it is compliant with the PRA’s Remuneration Code.

In short, there seems little prospect of the banking sector stepping out of the political and media spotlight in the near term.
Appendix 1

ABOUT THE AUTHORS

JAN PUTNIS
Slaughter and May

Jan Putnis has been a partner at Slaughter and May in London since 2003. His practice focuses on financial regulation, with particular emphasis on international corporate and commercial transactions. Mr Putnis acts for a broad range of financial institutions, including banks, insurance groups and asset managers, on strategic regulatory matters and investigations, cross-border and domestic mergers and acquisitions and on outsourcings. His work involves extensive advice on regulatory capital and on capital structures of new businesses as well as capital structures to facilitate acquisitions and group reorganisations. Mr Putnis qualified as a solicitor in 1996. In a previous life, he graduated with a degree in physics from Oxford University in 1992.

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Benjamin Hammond is a senior associate at Slaughter and May in London. After qualifying as a solicitor in England and Wales in 2006, he practised for several years in the field of corporate tax before focusing on regulatory law. His practice now encompasses transactional and non-transactional work for a variety of financial and non-financial institutions, including a number of insurers, banks, investment firms and credit rating agencies.

NICK BONSALL
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Nick Bonsall is an associate in the financial regulation group at Slaughter and May in London. He advises on the supervision and regulation of investment firms, banks, payment institutions, insurance companies and building societies. Recently, his work has involved advising on various financial regulatory aspects of the acquisition and disposal of banking businesses, including through the FSMA banking business transfer regime, and
on various matters relating to bank recovery and resolution plans. He has also advised on financial services outsourcings, the UK electronic money and payment services regimes and on agreements for the distribution of retail investment products. He graduated from the University of Edinburgh with a degree in mathematics and statistics and qualified as a solicitor in England and Wales in 2009.

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