The Banking Regulation Review

Seventh Edition

Editor
Jan Putnis

Law Business Research

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EDITOR'S PREFACE

Nearly eight years after the collapse of Lehman Brothers it might have been expected that fundamental questions about the business models, governance and territorial scope of large banks would have been answered clearly, but that is not yet truly the case. Debates rage on in many countries about 'too big to fail', management accountability in banks, resolution planning and conduct issues in the banking sector. What is the 'safest' form of international banking and what might shareholders in banks reasonably expect as a long-term rate of return on their investment? When is all this uncertainty going to end? Perhaps it never will for so long as large banks remain as important to the global economy as they are and the political classes throughout the world remain divided on whether this is a good thing. It is also worth remembering that the reform agenda that was born in the financial crisis of 2007–2009 established a very long implementation period – to 2019 and beyond – for many of the regulatory changes agreed upon by the G20 and the Basel Committee. So we are still in the midst of what will no doubt be seen in decades to come as the 'post-crisis' period in banking regulation.

Looking forward then, what can we see beyond the implementation of the post-crisis reforms? That depends, of course, in part on whether there is another cross-border banking crisis. It is worth noting in this context that localised banking failures remain commonplace, and with more countries around the world introducing specialised bank resolution regimes there will be further opportunities to test the uses and pitfalls of bail-in and other resolution powers.

The continuing debate about the impact of technology on banks has increased significantly in volume in much of the world in the past year. Forecasts of the eventual eclipse of banks by technology firms seem wide of the mark in the short to medium term, although there is clearly an 'adapt or die' threat to many banks in the longer term. One adaptation of sorts that we may well see more of in the next few years is banks acquiring technology firms (or otherwise entering into strategic partnerships with them).

The most obvious benefits of new technology in the banking sector concern the customer interface and market infrastructure. However, some important but less immediately obvious ways in which technology will continue to revolutionise banking arise in the context of the safety and soundness of banks. For example, some banks are looking at how innovative

uses of technology can improve their risk management, and ultimately the credibility of their recovery and resolution plans through, for example, more precise classification and management of derivative positions and counterparty relationships.

Many of the largest cross-border regulatory investigations into past conduct in the banking sector have drawn to a close over the past year. While for some that signalled the close of a painful and costly chapter in the post-crisis development of the banking sector, it remains difficult to conclude that the threat of further such investigations has gone away.

As an English lawyer it would be odd if I did not mention the June 2016 referendum in the UK on membership of the European Union, parochial though that may seem to some readers outside Europe. The legal and regulatory regime that will apply to business that banks undertake in and from London is, however, of global interest, and the result of the referendum, and its aftermath, will therefore be of very considerable importance to all large banks and many smaller ones.

This seventh edition of *The Banking Regulation Review* contains chapters provided by authors in 39 countries and territories in March and April 2016, as well as chapters on International Initiatives and the European Union. My sincere thanks, as in previous years, go to the authors who have made time to contribute their chapters despite their heavy workload.

The team at Law Business Research have, once again, tolerated the hectic schedules and frequent absences on business of many of the authors, and I would like to thank them for doing so with such good humour and understanding. Thank you also to the partners and staff of Slaughter and May in London and Hong Kong for continuing to encourage projects such as this book, and in particular to Ben Kingsley, Peter Lake, Nick Bonsall, Edward Burrows, Tim Fosh, Kristina Locmele and Helen McGrath.

Jan Putnis
Slaughter and May
London
May 2016

Chapter 40

UNITED KINGDOM

Jan Putnis, Nick Bonsall and Edward Burrows[1]

I INTRODUCTION

The UK financial regulatory framework for banks and their groups has been subject to significant reform over recent years through the implementation of various international, EU and UK-specific measures, many of which were introduced in response to the financial crisis of 2007–2009 (and subsequent general and specific events of concern to policymakers).

A fundamental reform of the UK financial regulatory framework saw the dismantling of the United Kingdom's previous primary financial regulator (the Financial Services Authority (FSA)), and the creation of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA). The new regime is now more than three years old and the approaches of the new authorities are apparent. The PRA's judgment-led approach to supervision has led to a significant focus on governance arrangements and resolution planning in respect of the largest banking groups. The FCA has pursued a strong enforcement agenda, most notably as regards LIBOR and foreign exchange manipulation. A common theme across both regulators is an increased focus on individual accountability, including measures to increase awareness of accountability of senior managers in banks.

Two key areas of focus during the past year for many of the larger UK banking groups are the introduction of a new 'senior managers' regime for the regulation of senior individuals in banking groups and the development of retail banking ring-fencing planning arrangements, the requirements for which were introduced through the Financial Services (Banking Reform) Act 2013 (the Banking Reform Act). The 'senior managers' regime replaced the 'approved persons' regime on 7 March 2016 with the intention of increasing individual accountability of senior staff in banks. It was accompanied by a new 'certification' regime for other important bank staff and a new set of conduct rules. The 'ring-fencing' regime will require certain UK banking groups with significant retail and small and medium-sized

1 Jan Putnis and Nick Bonsall are partners, and Edward Burrows is an associate at Slaughter and May.

enterprise (SME) banking operations, with effect from 1 January 2019, to 'ring fence' certain core deposit-taking activities for retail and SME depositors in a legal entity that will not be permitted to carry on certain specified wholesale and investment banking activities. Compliance with these requirements will involve significant business model, operational and legal reorganisations, which will need to be carried out in the time available (and therefore largely over the period to mid-2018).

At the same time, UK banks are preparing for various other significant reforms, including the gradual implementation of requirements under EMIR and MiFID II/MiFIR (for further information, see the European Union chapter), the introduction of new remuneration rules for senior individuals in banking groups, and enhancements to the recovery and resolution planning arrangements for banking groups (including a bail-in tool and measures requiring a minimum amount of total loss absorbing capital).

The top five UK banking groups by market capitalisation[2] are HSBC Holdings plc, Lloyds Banking Group plc, Barclays plc, Standard Chartered plc and Royal Bank of Scotland Group plc. These banks (other than Standard Chartered) plus Santander UK plc (the UK subsidiary of the Spanish banking group) dominate the UK personal and business banking markets, although the market share of smaller 'challenger' banks continues to develop.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i The UK regulatory framework for banks

Regulatory and supervisory responsibility for UK banks is divided principally between the PRA (a subsidiary of the Bank of England) and the FCA. The Bank of England Financial Policy Committee (FPC) has a macro-supervisory mandate to identify imbalances, risks and vulnerabilities in the UK financial system, and can direct the PRA and the FCA to take certain action to mitigate those risks. The Bank of England and Financial Services Bill 2015-16 proposes reforms to certain regulatory governance arrangements. It will end the PRA's status as a subsidiary of the Bank of England and establish a new 'Prudential Regulation Committee' to exercise the function of the governing body of the PRA. The name and statutory objectives of the PRA will remain unchanged. The draft Bill is expected to come into force during the first half of 2016.

The authority of 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 PRA

The PRA is the prudential regulator of all UK deposit-taking institutions (i.e., banks and building societies), insurance companies and certain large investment firms. The conduct of business of PRA-authorised firms is regulated by the FCA, and such firms are therefore referred to as '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

2 The five largest UK banking groups ranked by market capitalisation as at 5 April 2016.

legislation made under the FSMA.[3] 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. The regulated activity of 'accepting deposits' is specified for the purposes of the FSMA 2000 (PRA-Regulated Activities) Order 2013 and, 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 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. 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) and, since 1 April 2014, certain consumer credit-related activities. The 'investments' to which these activities relate are set out in secondary legislation[4] and include shares, debentures, public securities, warrants, futures, options, contracts for differences and units in collective investment schemes.

The PRA's statutory objectives include promoting the safety and soundness of the firms it regulates (including banks). The PRA is required to advance this objective 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 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 does not operate on a 'zero-failure' basis: a core aspect of the PRA's approach to banking supervision is its focus on the establishment, maintenance and implementation of appropriate recovery and resolution arrangements.

The PRA has a general power under the FSMA to make rules that apply to the firms it regulates, and to issue related guidance, with respect to the carrying on by such firms of regulated activities, and 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.

The PRA has adopted a set of 'Fundamental Rules', which are a series of high-level prudential principles that underpin the PRA's regulatory approach to the firms it regulates. These focus on fundamental matters relating to governance, integrity, resolvability and financial resources. The fundamental rules are drafted as clear statements of principle, and include statements that 'a firm must at all time maintain adequate financial resources' and 'a

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.

firm must deal with its regulators in an open and cooperative way and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice'.

Consistent with its judgment-led approach to supervision, the PRA's supervisory approach 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 though on-site inspection by either its own supervisory staff or 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 FCA

The FCA is responsible for the regulation of conduct of business at all UK authorised firms (including banks and other PRA-authorised firms), and conduct of business in respect of wholesale and retail financial markets and market infrastructure. 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 dedicated consumer credit lenders or investment intermediaries). Firms subject to prudential and conduct of business regulation by the FCA need seek authorisation only from the FCA to carry on regulated activities (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 certain operational objectives, including in relation to consumer protection and promoting effective competition in the markets for certain financial services.

When pursuing its consumer protection objective, the FCA must have regard to, *inter alia*, 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 uses its supervisory and enforcement work, thematic reviews and market studies to further its objectives. Market studies are a recent addition to the FCA's toolkit, and the FCA has indicated that these will become more commonplace, following initial market studies in the areas of cash savings and competition in the wholesale sector.

The FCA has various powers to further its consumer protection objectives, including powers to introduce product intervention rules (pursuant to which it can ban the sale or distribution of certain products), to require the withdrawal of misleading financial promotions and to publicise the issue of a 'warning notice' (a stage in an FCA regulatory investigation, prior to any finding of guilt or wrongdoing).

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 the carrying on of regulated activities, and 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. The FCA has adopted a set of Principles for Businesses, which are high-level requirements that apply to the firms that it regulates. A key conduct principle states that 'a firm must pay due regard to the interests of its customers and treat them fairly'.

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 has power to issue macro-prudential recommendations and 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.

ii Management of banks

The Banking Reform Act introduced amendments to the FSMA that have established an enhanced regulatory framework for individuals performing certain functions at UK banks or, in certain circumstances, UK branches of foreign banks. These reforms were primarily intended to enhance individual accountability in the banking sector and to address concerns that ongoing responsibilities of senior bankers were inadequately defined. This section provides an overview of this new framework, which includes a new 'senior managers' regime (which replaced the approved persons regime for banks), a 'certification' regime (applying to other bank staff whose actions pose a risk of significant harm to the firm or its customers), and a new set of conduct rules (which replaced the previous Statements of Principle and Code of Practice for Approved Persons) enforceable by either the PRA or the FCA.

Senior managers regime

Individuals intending to carry on certain specified 'senior management functions' at regulated firms require prior approval by the PRA or the FCA (the regulator granting the approval depends on the nature of the role). These specified 'senior management functions' broadly cover roles in which persons are responsible for managing one or more aspects of the firm's affairs relating to a regulated activity and those aspects involve, or might involve, a risk of serious consequences for the firm, or for business or other interests in the UK. Senior management functions are specified by either the PRA or the FCA, a distinction which reflects the difference in scope of each regulators' objectives.

There are 20 specified senior management functions, each of which is labelled with an 'SMF' number. Of these, the functions that are most relevant to banks are the chief executive function (SMF1), chief finance function (SMF2), executive director function (SMF3), chief risk function (SMF4), head of internal audit function (SMF5), head of key business area function (SMF6), group entity function (SMF7) and compliance oversight function (SMF16). Certain non-executive directors will also require pre-approval as senior managers, including the chairman (SMF9), a senior independent director function (SMF14), and chairs of the risk (SMF10), audit (SMF11), remuneration (SMF12) and nominations (SMF13) committees. Other non-approved non-executive directors (termed 'notified NEDs') fall outside the scope of the senior managers regime, although the certification regime and conduct rules (see below) still apply.

For senior management functions specified as PRA functions, individuals are pre-approved by the PRA with the FCA's consent. For senior management functions specified as FCA functions, individuals require pre-approval by the FCA only.

There are 30 'prescribed responsibilities' specified by either the PRA or the FCA, or by both, which banks must allocate to individuals holding senior management functions. This is designed to ensure that there is individual accountability for the fundamental responsibility inherent in a particular function. Certain prescribed responsibilities are designed to be

assigned to executives, while others reflect non-executive roles. Not all of the prescribed responsibilities will be relevant to all firms – for example, certain prescribed responsibilities apply only in specific circumstances (such as where the bank carries out proprietary trading or once the ring-fencing regime comes into effect, is ring-fenced). In general, each prescribed responsibility should be allocated to one individual, although the regulators have recognised that the sharing of responsibilities may be necessary in limited circumstances (e.g., where departing and incoming senior managers work together temporarily as part of a handover).

All applications for individuals to perform a senior management function must be accompanied by a 'Statement of Responsibilities', a document which sets out the areas of business for which the individual will be responsible. Banks are also required to produce a 'Responsibilities Map', a single document that describes the firm's management and governance arrangements.

Qualifications for approval: fitness and propriety

The regulators will approve an individual only if satisfied that the candidate is a fit and proper person to perform the senior management function for which approval is sought. The PRA and the FCA both apply a 'fit and proper test', which is concerned largely with the candidate's honesty, integrity and reputation, competence and capability, and financial soundness.

Both regulators are interested in the qualifications of prospective directors of banks, and expect banks to carry out extensive referencing and due diligence before appointing new directors and other individuals performing senior management functions, including assessing suitability for the role, conducting criminal record checks and obtaining references from previous employers. The PRA and the FCA have, and exercise, the power to interview prospective directors and other individuals performing senior management functions at banks.

Duty of responsibility

The senior managers regime is designed to increase individual accountability and is supported by a duty of responsibility. In circumstances where a firm breaches regulatory requirements, there is now a greater risk of regulators investigating individuals. Broadly, the PRA or the FCA, or both, must show in any misconduct claim against an individual that the senior manager with the relevant responsibility did not take such steps as a person in the senior manager's position could reasonably have been expected to take to avoid the contravention occurring.

The regulators had originally outlined plans for a presumption of responsibility, under which the onus would have been on the senior manager to show that they took such steps as a person in their position could reasonably be expected to take to prevent the contravention occurring. However, the regulators' original proposal was replaced in October 2015 by the 'duty of responsibility'.

Certification regime

The 'certification' regime applies to individuals employed in positions where they could pose a risk of significant harm to the firm or its customers. The PRA or the FCA will not pre-approve these individuals, but banks are required to certify that the individuals are fit and proper for their roles, both at the point of recruitment and on an ongoing basis (at least

annually). Where it believes that an individual within the scope of the regime fails to meet the requisite standards, a bank must refuse to renew that individual's certificate of fitness and propriety.

Conduct rules

The FCA and the PRA have each issued new sets of conduct rules, which replaced the previous rules for approved persons. The FCA's conduct rules apply to all individuals approved as senior managers or covered by the certification regime, as well as all other employees (other than ancillary staff who perform a role that is not specific to the financial service business of the firm). The PRA's conduct rules apply only to individuals approved as senior managers or covered by the certification regime.

The conduct rules are high-level and reflect core standards expected of those within their scope, including requirements relating to integrity, acting with due care, skill and diligence, observing proper standards of market conduct, and dealing openly and cooperatively with regulators.

Both the FCA and the PRA's conduct rules are split into two tiers, namely, those that apply to all individuals within the scope of the conduct rules, and those that apply only to senior managers. Additional 'second tier' rules applying to senior managers include disclosing to regulators any information of which they would reasonably expect notice, and taking reasonable steps to delegate responsibilities and oversee the delegation of responsibilities to an appropriate individual.

Relevant individuals who fail to comply with a conduct rule, or are 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 senior manager who has breached a conduct rule that it has issued, irrespective of whether it has approved the individual. The Bank of England and Financial Services Bill 2015-16 proposes to extend the power of regulators to take enforcement action against non-executive directors who are not senior managers. Both regulators also have the power to withdraw approval from individuals, or to issue a general or specific prohibition order prohibiting an approved person from carrying on any senior management function, or both.

Reckless misconduct in the management of a bank

The Banking Reform Act introduced a new criminal offence that applies in respect of misconduct by a senior manager that leads to the failure of a bank. The offence is relevant where – upon the failure of a UK bank or PRA-authorised investment firm – it is established that such an approved individual:

a took, or agreed to the taking of, a decision by or on behalf of the bank or investment firm as to the way in which the business of the bank or investment firm, or another bank or PRA-authorised investment firm in its group, was to be carried on, or that individual failed to take steps that they could take to prevent such a decision being taken;

b at the time of the decision, the individual was aware of a risk that the implementation of the decision could cause the failure of the relevant group bank or PRA-authorised investment firm;

c in all the circumstances, the individual's conduct in relation to the taking of the decision fell far below what could reasonably be expected of a person in that individual's position; and

d the implementation of the decision causes the failure of the relevant group bank or PRA-authorised investment firm.

The offence applies to a decision that causes a UK bank or PRA-authorised investment firm to fail that is taken on or after 7 March 2016.

III PRUDENTIAL REGULATION

i Regulatory capital

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 EU Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD), together referred to as 'CRD IV' (for further information, see the European Union chapter). The CRR is directly applicable in the United Kingdom and, accordingly, the PRA has not made rules to implement its provisions, except in relation to certain discretions afforded. The CRD is an EU directive and, as a consequence, requires implementation in the United Kingdom (this is due to take place on a phased basis until 2019).

Under the CRR, UK banks are 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 external events.

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'. A 'building block' approach applies, whereby capital must be held against specific risks (e.g., position risk, counterparty risk, foreign exchange risk, commodities risk and large exposures risk). Transactions giving rise to more than one risk category may trigger several different capital charges. Banks can (with PRA approval) use a market risk internal model to calculate their capital requirements for market risk.

The credit risk capital charge will depend on the bank's risk-weighted assets, calculated using either the standardised approach or an 'internal ratings based approach'. The standardised approach sets capital charges for exposures to particular classes of counterparty (e.g., corporates, interbank, retail, residential mortgages), generally based on external credit ratings. Internal ratings based approaches, which are based on internal models for credit risk, can be used only if approval is given by the PRA. The PRA recognises two internal ratings-based approaches: the foundation IRB and the 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 the advanced IRB, the bank determines all the risk factors based on its own internal estimates.

The PRA would typically require a new bank to use the standardised approach and, if the bank can demonstrate to the PRA that it has sufficiently sophisticated risk-modelling methods, the PRA may grant permission to apply an internal ratings-based approach (although, under the CRD, this will not be allowed within the first three years of the bank's existence).

The PRA imposes restrictions on large exposures of banks and requires capital deductions for funding arrangements (including loans and guarantees) entered into with connected parties where those arrangements are of a capital nature.

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:

a UK banks are 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 various regulatory capital buffers (including those deriving from CRD IV, which will be phased in over the period to 1 January 2019, unless unilaterally accelerated by the UK). The capital buffers include the CRD IV combined capital buffer (which is formed of a capital conservation buffer of 2.5 per cent of risk-weighted assets, plus a countercyclical buffer that the Bank of England calibrates on advice from the FPC), certain sector-specific capital buffers calibrated by the FPC, Pillar 2 capital buffers (which the PRA has split into Pillar 2A, a capital buffer to address risks that are not adequately captured by the CRR capital requirements, and Pillar 2B, an additional capital buffer to address risks to which the bank may become exposed over a forward-looking planning horizon) and systemic capital buffers (reflecting the global or domestic systemic importance of a bank). 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);

b the base capital requirement relating to the highest quality of capital ('Common Equity Tier I' capital, which is broadly ordinary share capital and reserves) is at least 4.5 per cent of risk-weighted assets. Banks are required to satisfy the regulatory capital buffers referred to in (a) above using Common Equity Tier I capital and will, accordingly, need to maintain a Common Equity Tier I capital ratio 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 European Union and International Initiatives chapters);

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 or preference shares with no incentive to redeem and that will automatically be written down or converted into Common Equity Tier I upon the bank's Common Equity Tier 1 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); and

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 requirements on ring-fenced banks and banks that are systemically important. This additional loss absorbing capacity, the amount of which

is expected to be calibrated following completion of the Financial Stability Board's work on the adequacy of loss absorbing capital for global systemically important banks, is designed to be available for bail-in on resolution (see subsection vii, *infra*). 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

Regulatory capital requirements apply to individual banks on a stand-alone ('solo') basis and, in addition, the PRA carries out consolidated supervision of banking groups. The relevant requirements can be complex, but 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 they are regulated or not.

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 or investment firms, or that carry on broadly defined 'financial' activities. Subsidiary undertakings are required to be consolidated in full, although proportionate consolidation for non-wholly owned subsidiaries is permitted, subject to certain criteria being satisfied, with supervisory permission. Banking groups are permitted, subject to the satisfaction of certain prescribed conditions and haircuts, to recognise on a consolidated basis the minority interest that arises in respect of non-wholly owned subsidiaries that are fully included within the consolidation. Banking groups are required to include participations, on a proportionate basis, within the scope of consolidated supervision. A 'participation' is presumed to be held where there is a holding of 20 per cent or more of the share capital in another undertaking.

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 could be increased over a period of several years.

The CRR will introduce a new 'liquidity coverage ratio' (LCR) in the United Kingdom, with the new standards to be introduced on a phased basis between 1 October 2015 and 1 January 2018.

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 PRA 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.

The CRR also contemplates the introduction of a 'net stable funding ratio', measuring liquidity over a longer period of time than the LCR, although the implementation of this requirement is not currently expected until 1 January 2018.

v Leverage ratio

Given the number of systemically important banks in the UK and the relative size of the UK banking system, the FPC directed the PRA in 2015 to introduce a leverage ratio in the UK ahead of any internationally agreed standard. The PRA has implemented the FPC's proposals in relation to UK global systemically important banks and other major UK banks from January 2016, which include:

a a minimum leverage ratio requirement of 3 per cent;

b a supplementary leverage ratio buffer set at 35 per cent of the firm's systemic risk buffer; and

c a countercyclical leverage ratio buffer set at 35 per cent of the firm's countercyclical buffer.

Subject to its review on international progress, expected in 2017, the FPC envisages that the minimum leverage ratio requirement will be applied to remaining UK banks from 2018 (in line with binding standards under the CRR).

vi Ring fencing

The Banking Reform Act introduced the legal framework for the 'ring fencing' of core banking services that are critical to retail and small enterprise clients. This requirement will, once brought into full force and effect, result in the core deposit-taking business of UK banks being carried out through entities that are legally and financially independent of other banking services that carry on various wholesale or investment banking activities. Key details on the scope of the ring-fencing requirements and the restrictions applying to ring-fenced entities are, or in due course will be, set out in a combination of relevant secondary legislation[5] and regulatory rules. There remain a variety of points of detail, including key regulatory rules relating to intra-group arrangements, which are currently under consultation. It is expected that affected banks will be required to organise themselves to comply with the requirements by 1 January 2019 at the latest.

Broadly speaking, the ring-fencing requirements will apply to banks that carry out the activity of accepting 'core deposits'. For these purposes, 'core deposits' will include all deposits except:

a deposits made by large organisations (undertakings that are not SMEs) and their group members;

b deposits made by 'relevant financial institutions';

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

d deposits taken by branches of an affected UK bank outside the EEA.

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 also be exempt.

5 The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (SI 2014/1960) and the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (SI 2014/2080).

Ring-fenced banks will be subject to significant restrictions on their banking activities, including a prohibition (subject to exceptions) on exposures to 'relevant financial institutions' (e.g., non-ring fenced banks, global systemically important insurers and investment firms) and limitations on the types of financial products and services that ring-fenced banks may provide. Ring-fenced banks will also be prohibited from having branches outside the EEA and, subject to exceptions, participating interests (presumed to be held at a holding of 20 per cent or more of issued share capital) in undertakings incorporated or formed under the law of a jurisdiction outside the EEA.

A fundamental principle of the regime is that ring-fenced banks may not deal in investments as principal, except where narrowly drawn exceptions apply relating to matters including risk management, debt-for-equity swaps, securitisation of assets originated by the ring-fenced bank, certain simple derivative products, security over shares or other investments, and entering into transactions with central banks. The final scope and nature of the ring-fencing requirements will depend on key regulatory requirements set by the PRA and the FCA, which are due to be finalised during the first half of 2016.

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 rules on ring-fenced banks will be designed to ensure that:

a core activities of ring-fenced banks are not adversely affected by other group members;

b ring-fenced banks make commercially independent decisions;

c ring-fenced banks are not unduly reliant on resources from other group members that would not be available if those members failed; and

d ring-fenced banks are sufficiently resilient, including upon failure of a group member.

The Banking Reform Act also provides the PRA with new powers to require the restructuring or break-up of a group that, in the PRA's view, is failing to meet the ring-fencing objectives.

vii Recovery and resolution regime

The PRA requires UK banks to produce and maintain a recovery plan, describing actions that could be taken by the bank to ensure the continuity of all or part of its (or of a group member's) business in prescribed stress scenarios; and a resolution pack, containing 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 has issued supervisory statements prescribing the information and analysis that must be set out in recovery plans and resolution packs, which take into account the requirements of the EU Bank Recovery and Resolution Directive (BRRD).

The Banking Act 2009 introduced a 'special resolution regime' for UK banks, which is intended to facilitate the orderly 'resolution' of banks in financial difficulties. The Banking Act 2009 also established two new insolvency proceedings for banks that are available in respect of failed banks or residual parts of banks that are in wind-down. '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' comprise

methods for addressing the situation where a bank has encountered or is likely to encounter financial difficulties, and can be summarised as the transfer of all or part of the business of the bank to a private sector purchaser, a 'bridge bank' wholly owned by the Bank of England or an asset management vehicle; the bail-in option; and taking the bank into temporary public ownership.

Exercise of the stabilisation options is subject to certain strict conditions prescribed under the Banking Act 2009. The PRA (having consulted with the Bank of England) must be satisfied that the relevant bank is failing, or is likely to fail, and the Bank of England (having consulted with HM Treasury, the PRA and the FCA) must be satisfied 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 cease to be failing or likely to fail. The Bank of England must have regard to certain 'special resolution objectives', and must be satisfied that the stabilisation option is necessary having regard to the public interest in the advancement of one or more of these objectives; and that one or more of the objectives would not be met to the same extent by the winding up of the bank. Each stabilisation option is subject to additional specific controls to ensure it is used only 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 amended the Banking Act 2009 to introduce a bail-in tool as a stabilisation option, and this tool came into effect on 1 January 2015. Broadly speaking, the bail-in tool enables 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, through write down or conversion into different forms of liability (e.g., equity). The bail-in tool, as implemented, is intended to reflect the powers required under the BRRD, and its use would be subject to a 'no creditor worse off principle' (i.e., affected creditors must not be left worse off under bail-in than they would otherwise have been under ordinary insolvency proceedings).

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

viii FSCS

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

The FSCS, which is funded by levies on regulated firms imposed on different sectors (and therefore is free to consumers), protects certain retail 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 £75,000 per depositor in respect of all of the depositor's accounts held at a bank.

Deposits protected by the FSCS are regarded as 'preferential debts' in the event of a bank's insolvency and, accordingly, rank ahead of the claims of most other unsecured creditors.

IV CONDUCT OF BUSINESS

The FCA is responsible for the conduct of business regulation and supervision of banks in the United Kingdom. There are certain overarching legal and regulatory principles that UK banks must consider in the context of the conduct of their businesses. Banks are subject to the FCA's Principles for Businesses, which include a principle that firms must treat their customers fairly (TCF principle). The TCF principle applies to services provided to retail and professional clients, although it is recognised that these client types require different levels of protection, and extends beyond the direct treatment of those customers to all of the activities of regulated firms that affect customer outcomes.

UK banks must also be aware that UK consumer protection legislation will render 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, certain duties or liabilities that they may otherwise have to customers.

The Financial Ombudsman Service operates an independent alternative dispute resolution service for certain customers of PRA and FCA authorised firms.

The Banking Conduct of Business Sourcebook, introduced in 2009, contains a set of reasonably high-level FCA rules that apply in relation to deposit-taking activities, and relate to matters including communications with customers, financial promotions, post-sale requirements and cancellation rights in relation to banking products.

i Mortgage regulation

The Mortgage and Home Finance Conduct of Business Sourcebook (MCOB) contains FCA rules in respect of activities associated with regulated mortgage contracts. These rules apply to banks (and other entities) that carry on regulated activities associated with mortgages, including entering into regulated mortgage contracts as lender, and administering, arranging and advising on such contracts. A regulated mortgage contract is, broadly, a loan secured by first legal mortgage 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'). MCOB sets out regulatory requirements relating to, *inter alia*, 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.

The EU Mortgage Credit Directive was implemented in the UK on 21 March 2016. This moved the regulation of second charge mortgages from the FCA's consumer credit regime to its regulated mortgage regime (bringing second charge mortgages within the scope of the provisions in MCOB) and granted the FCA additional supervisory powers in respect of buy-to-let mortgages.

ii Consumer credit

Responsibility for consumer credit regulation in the UK was transferred to the FCA on 1 April 2014. The regulatory framework is split between requirements of the Consumer Credit Act 1974 (as amended) (CCA) and the FCA's own consumer credit rules. As a result of the transfer, 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, once fully authorised by the

FCA, the approved persons regime. Firms that carried on regulated consumer credit activities prior to the transfer of consumer credit regulation to the FCA were required to submit their applications for full FCA authorisation by 31 March 2016.

iii Investment business

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, hold appropriate authorisation from the PRA (which would consult with the FCA, as appropriate). These activities are also subject to their own detailed conduct of business rules, including the rules in the Conduct of Business Sourcebook and the Principles for Businesses referred to above.[6]

iv Payment services

The United Kingdom has implemented the EU Payment Services Directive (PSD)[7] substantially through the UK Payment Services Regulations 2009 (PSRs). 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).

The PSRs 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.

A revised EU Payment Services Directive (PSD2) came into force on 12 January 2016 and must be transposed into national law by 13 January 2018. PSD2 widens the scope of the existing PSD and also contains enhanced security measures to be implemented by all payment service providers, including banks.

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.

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.

6 The United Kingdom 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.

7 2007/64/EC.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Acquisitions of control: the FSMA regime

Outline of the UK regime

Under the UK change in control framework, which is set out under the FSMA and reflects requirements introduced through the EU Acquisitions Directive,[8] any person who decides to acquire or increase control of a UK-authorised person must first obtain the approval of the appropriate regulator (i.e., for banks, the PRA).

Where the PRA is the appropriate regulator, 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 the suitability of the proposed controller and the financial soundness of the acquisition; the likely influence that the proposed controller would have on the UK-authorised person; and 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.

The PRA has an 'assessment period' of 60 working days, commencing on the date on which it acknowledges receipt of a complete change in control application, to make its determination. The PRA may, no later than the 50th working day of the assessment period, request further information to complete its assessment, and can interrupt the assessment period 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). The process can be completed well within the maximum time allowed, but it can never be assumed that this will be possible.

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 (although no formal consent is required for such reduction).

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.

Meaning of 'control'

The term 'control' is broadly defined, such that a person (A) will have 'control' over a UK bank (B) for the purposes of the regime if A holds 10 per cent or more of the shares or voting power in B or a parent undertaking (P) of B; or 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 appropriate), 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, threshold steps occur at 20, 30 and 50 per cent and upon becoming a parent undertaking.[9]

8 2007/44/EC.

9 Although certain shareholdings may be disregarded to a specified extent, including those held by a UCITS management company (or its parent), a custodian or its nominee or, subject to

For these purposes, a controller's (or proposed 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 the EU and UK have issued guidance indicating, broadly, that persons will be acting in concert when each of them decides to exercise his or her rights linked to shares acquired in accordance with an explicit or implicit agreement made between them. The EU guidance on acting in concert is currently being reviewed by the European Supervisory Authorities.

The UK regulatory approach to change in control of a bank

The PRA's assessment of a change in control application must take into account the suitability of the acquirer and the financial soundness of the acquisition to ensure the sound and prudent management of the UK bank. The assessment should have regard to the likely influence that the acquirer will have on the UK bank, but must disregard the economic needs of the market.

The PRA may object to an acquisition of a bank only if there are reasonable grounds for doing so on the basis of prescribed assessment criteria or if the information provided by the applicant is incomplete. Broadly speaking, the assessment criteria include:

a the reputation and experience of the acquirer and persons who effectively run the business of the acquirer;

b the financial soundness of the acquirer;

c the expected ability of the UK-authorised person to comply with prudential requirements following the acquisition of control;

d whether the acquisition could adversely affect the PRA's ability to perform effective supervision of the UK-authorised person; and

e whether there are reasonable grounds to suspect financial crime.

The PRA may impose conditions on its approval where it would otherwise object to the acquisition, but may not impose conditions requiring a particular level of holding to be acquired. The FCA can, where it has reasonable grounds to suspect financial crime, direct the PRA to object to an acquisition of control, or not to approve an application for the acquisition of control unless it does so subject to conditions that the FCA specified.

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 referred to as a 'banking business transfer scheme' in Part VII of the FSMA is, broadly speaking, (1) a scheme whereby the whole or part of the business carried on by a UK bank is to be transferred to another entity, and (2) the whole or part of the business to be transferred includes deposits.

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certain conditions, an underwriter of a securities offering (in each case acting in its capacity as such).

In relation to the second condition, deposits must form an integral part of the business to be transferred under a banking business transfer scheme but need not be the sole or predominant business carried on.

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 the court proceedings required to sanction the scheme. The court may require assurance that such persons have been fairly treated. Both the PRA and the FCA are entitled to be heard in the proceedings.

Implementation procedure

A prescribed procedure exists for the implementation of Part VII transfers. This can be summarised as follows:

a High Court application: an application to the Court can be made by the transferor, the transferee or both. The court procedure involves two hearings;

b preliminary hearing: 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 this order is granted, notices (approved by the PRA) regarding the scheme must be published in the London, Edinburgh and Belfast Gazettes, as well as in two national newspapers in the United Kingdom;

c scheme document: the terms of the Part VII transfer are documented in a scheme document, which must be lodged in support of the application to Court. The scheme document must include specific details of the transfer and provisions regarding particular categories of asset or liability being transferred;

d scheme statement: a statement explaining, and setting out the terms of, the scheme document must be prepared and 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;

e regulatory approval: although not a legal requirement, as a practical matter the approval (or confirmation of no objection) of both the PRA and the FCA should be sought before the final hearing;

f final hearing: the Court is requested to sanction the scheme at the final hearing. Any person who alleges that he or she would be adversely affected by the carrying out of the scheme has the right to object. If the Court is so minded, the scheme will be sanctioned by a final court order. The PRA and the FCA have the right to attend the final hearing, and representatives from at least one of them would usually be expected to do so.

The Court may sanction the scheme if:

a the PRA certifies that the transferee possesses (or will possess before the Part VII transfer takes effect) adequate financial resources, taking the Part VII transfer into account;

b the transferee has the necessary authorisation to carry on the business being transferred in the United Kingdom;

c at least 21 days have elapsed since the PRA was given copies of the application and the statement; and

d 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 scheme 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.

Ring-fencing transfer schemes

The Banking Reform Act amended the FSMA to introduce a modified version of the banking business transfer scheme specifically for ring-fencing purposes, referred to as a 'ring-fencing transfer scheme'. Broadly, a scheme carried out by a UK banking group will be a ring-fencing transfer scheme where:

a the whole or part of the business to be transferred is carried on by a UK authorised person, or by a 'qualifying body' (a body incorporated in the UK that is in the group of a UK authorised person but that is not itself authorised); and

b the purpose of the scheme is either to enable the person transferring the business, or the person to whom it is transferred, to carry on 'core activities' in compliance with the FSMA and the PRA's ring-fencing rules; or to assist in the corporate restructuring of a group, which includes the transferor or the transferee, in order to enable one or more members of the group to become ring-fenced banks, while one or more other members of the group remain as non-ring-fenced banks.

Ring-fencing transfer schemes do not require the transfer of deposit-taking business. Accordingly, a ring-fencing transfer scheme could be used, for example, to transfer activities that cannot legally be carried on by a ring-fenced bank (e.g., certain derivatives or traded commodities positions) to a third party.

Ring-fencing transfer schemes require additional administrative steps to banking business transfer schemes, including a requirement for a report from an independent expert whom the PRA must approve as having the necessary skills to provide a report on the scheme. The purpose of the report is to set out whether persons other than the transferor are likely to be adversely affected by the scheme, and if so, whether the adverse effect is likely to be greater than reasonably necessary in order to achieve the purpose of the scheme.

A court application relating to a ring-fencing transfer scheme may be made only with the consent of the PRA, and the PRA must have regard to the scheme report when deciding whether to give consent.

VII REMUNERATION

On 1 July 2015, the FCA and the PRA introduced five new Remuneration Codes primarily aimed at strengthening the alignment of long-term risk and reward. The new Remuneration Codes apply to over 3,000 banks, building societies and investment firms in the United Kingdom. Banks are subject to two of these codes, namely the PRA's CRR Remuneration Code and the FCA's Dual-Regulated firms Remuneration Code.

The provisions of these two Remuneration Codes affect certain senior and risk-taking individuals in UK banks, staff engaged in control functions, and those earning in the same remuneration bracket as senior management and risk takers. In addition, UK banks are required to apply the provisions of the Remuneration Code to their subsidiaries and other members of their consolidation group, including such entities that are established in countries or territories outside the EEA.

A central focus of the Remuneration Codes 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').

The rules provide, *inter alia*, that:

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

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;

c a discount rate (up to 25 per cent) may be applied to total variable remuneration, provided that it is paid in instruments that are deferred for a period of not less than five years;

d at least 50 per cent of variable remuneration must consist of shares or equivalent interests in the relevant firm or (where appropriate) capital instruments that reflect that firm's credit quality;

e 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;

f 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; and

g the variable remuneration component must be subject to *malus* or clawback arrangements, which must cover specific criteria for application (such as a failure to meet appropriate standards of fitness and propriety).

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

Additional remuneration rules apply in relation to senior managers, including a mandatory deferral of bonus payments for at least seven years (for senior managers) or five years (for risk managers). The clawback period for bonuses paid to senior managers will also be extended to 10 years if, at the end of the seven-year period, there are outstanding investigations that could lead to clawback.

The board of a bank must adopt and periodically review the bank's remuneration policy, and is responsible for its implementation. The remuneration policy should be subject to central and independent internal review for compliance. A bank that is 'significant in terms

of its size, internal organisation or activities' (essentially, all large UK banks and investment firms that engage in proprietary trading) must establish a remuneration committee for this purpose.

Certain smaller banks, building societies and investment firms are not subject to the full range of restrictions in the Remuneration Codes; for example, smaller investment firms and asset managers have the ability to disapply the requirement to maintain ratios between fixed and variable remuneration.

In the event of a breach of the Remuneration Codes, the PRA or the FCA, or both, 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 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 a significant and welcome focus on developing, finalising and implementing some of the fundamental changes to the regulatory framework that have been in development over recent years.

i Ring-fencing regime

Ring-fencing planning was a key focus during 2015 for many of the larger UK banking groups, with an important milestone being the delivery of near-final ring-fencing plans to the PRA and the FCA by 29 January 2016. The PRA stated that these plans should ideally include the provisional UK holding company and UK regulated entity balance sheets and profit and loss statements, a project plan showing how banks will transition to the preferred legal and operation structures and details of any new authorisations, permissions or waivers likely to be required and any Part VII transfers requiring regulatory attestations.

The full scope and nature of the ring-fencing requirements remain under development and, accordingly, banks' ring-fence planning arrangements will continue to evolve over the next 18 to 24 months. It is likely that the first ring-fencing transfer schemes will occur over the course of 2017 and 2018 as banks prepare for the new regime.

ii Senior managers regime

In addition to ring-fencing planning, UK banking groups carried out significant work during 2015 prior to the implementation of the senior managers regime on 7 March 2016. Among other things, banks were required to examine their internal governance structures in order to produce a 'Responsibilities Map' describing their management and governance arrangements. By 8 February 2016, banks had to carry out a grandfathering exercise to ensure that staff authorised under the previous regime were transitioned across to the senior managers regime, as appropriate.

Over the coming months, UK banks will also have to ensure that they have adequate systems in place to comply with the new certification regime. The deadline for banks to issue certificates for individuals under the certification regime is 7 March 2017.

iii Remuneration

The issue of bankers' remuneration, and in particular bankers' bonuses, has been a politically charged issue during recent years. In addition to the introduction of the bonus cap by CRD IV, the periods of deferral and clawback of senior managers' bonuses have been extended in the past year.

As the regulatory emphasis shifts towards the accountability of senior management for conduct and culture, senior managers at UK banks will increasingly be at risk of bonus cancellations and clawback claims. Prior to this, banks may have been reluctant to seek to recover the bonuses of employees who have been dismissed. However, the new rules mean that banks will be under increased regulatory and reputational pressure to claw back bonuses where they may not have done so previously.

iv Conduct investigations

The impetus for banking reform in recent years has been fuelled by a number of controversies affecting the banking sector.

The most high-profile development during the past year was the conviction in August 2015 of one individual (a former UBS and Citigroup yen derivatives trader) for conspiring to manipulate LIBOR. He was initially sentenced to 14 years' imprisonment, which was later reduced to 11 years by the Court of Appeal. However, in the subsequent trial of certain alleged co-conspirators, no further individuals were convicted.

The criminal trial of 10 individuals accused of manipulating EURIBOR is due to begin in September 2016. It remains to be seen whether regulators will turn their attention to the setting of additional benchmarks, such as those used in commodities markets.

v Fair and Effective Markets Review

The Fair and Effective Markets Review, announced in July 2014 and comprising the Bank of England, HM Treasury and the FCA, launched a consultation on 27 October 2014 on the fairness and effectiveness of the fixed income, currency and commodity (FICC) markets.

The Review issued its final report on 10 June 2015, setting out 21 recommendations to help restore trust and improve standards in FICC markets. The recommendations fall under the following four headings:

a Raising standards, professionalism and accountability of individuals;

b Improving the quality and clarity and market-wide understanding of FICC trading practices;

c Strengthening the regulation of FICC markets in the UK; and

d Launching international action to raise standards in global FICC markets, particularly the spot FX market.

The recommendations are fairly wide-ranging. A number of the recommendations are for domestic implementation, by public authorities and market participants, while others require international discussion and coordination with national and international authorities.

The Review's co-chairs will provide a full implementation update report to the Chancellor and the Governor of the Bank of England by June 2016.

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 more fragmented and ever-evolving 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.

Given this supervisory environment, and taking into account the focus of the largest UK banking groups on ring-fencing reorganisations, the extent of mergers and acquisitions involving or creating systemically important UK banking groups is likely to be limited. Where such banking groups are involved in mergers or acquisitions, it is to be expected that regulators will require compelling evidence that adequate due diligence has been carried out, and will apply close scrutiny to the proposed arrangements. Together with competition concerns, these points are likely to have an all-but-fatal effect on any immediate prospects for major domestic 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 'challenger banks'.

The introduction of the new senior managers regime is consistent with the increased focus of the PRA and the FCA on banking governance arrangements and the individual accountability of senior managers in banking groups. It remains to be seen whether the regulators will pursue a greater degree of enforcement action against senior individuals at banks under the new regime.

Potentially the most significant development likely to shape the UK banking sector in future years will be the implementation of the ring-fencing requirements for the largest UK retail banking groups, and how these proposals will be affected by international developments. The intense focus and debate on the design and implementation of the ring fence has already begun, and can be expected to continue over the next year as banks continue to engage with the regulators and to develop their proposals for legal and operating structures under the new regime. The ring-fencing regime 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 to which the regime will apply.

All of this will, over the next year, develop against the backdrop of perennial banking sector issues, including the remuneration paid to senior bankers. There seems little prospect of the banking sector stepping out of the political and media spotlight in the near future.

Appendix 1

ABOUT THE AUTHORS

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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 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.

NICK BONSALL

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Nick Bonsall has been a partner in the financial regulation group at Slaughter and May in London since May 2016. He advises on the supervision and regulation of banks, investment firms, 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 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.

EDWARD BURROWS

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Edward Burrows is an associate in the financial regulation group at Slaughter and May in London. He qualified as a solicitor in England and Wales in 2013. His practice incorporates

advisory, transactional and contentious work for a broad range of financial institutions. During his time at Slaughter and May, he has advised on various aspects of the supervision and regulation of banks, in particular regulatory capital, remuneration, governance arrangements, the senior managers regime and outsourcing. Before becoming a solicitor, he graduated with a law degree and obtained a postgraduate commercial LLM from the University of Cambridge.

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