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REGULATORY FRAMEWORK

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

The coalition government announced in June 2010 proposals to abolish the FSA and establish a new framework for financial services regulation by 2013. This is considered in the ‘Update and trends’ box. The banking sector is currently regulated by the Financial Services Authority (the FSA). The FSA is required, so far as is reasonably possible, to act in a way that is compatible with specified regulatory objectives. These objectives are:

- maintaining confidence in the market system;
- protecting and enhancing the stability of the UK financial system;
- securing the appropriate degree of protection for consumers; and
- the reduction of financial crime.

The Financial Services Act 2010 established the Consumer Financial Education Body which is tasked with enhancing the understanding and knowledge of members of the public of financial matters, and the ability of members of the public to manage their own financial affairs. Formerly, this had been a responsibility of the FSA.

In discharging its functions the FSA must have regard to:

- the need to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised persons;
- the principle that a burden or restriction should be proportionate to the benefits;
- the desirability of facilitating innovation;
- the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
- the need to minimise adverse effects on competition;
- the desirability of facilitating competition between those subject to regulation; and
• the desirability of enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system).

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

The primary statute governing banking is the Financial Services and Markets Act 2000 (FSMA 2000). Under FSMA 2000 it is a criminal offence for a person to engage in 'regulated activities' in the United Kingdom unless he is authorised to do so or is exempt from the authorisation requirement. Regulated activities are defined in secondary legislation.

Accepting deposits is a regulated activity where such deposits are lent to third parties, or where any other activity is financed wholly or to a material extent out of capital or interest on deposits. Banks must therefore obtain authorisation under FSMA 2000 to accept deposits.

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

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

The Banking Act 2009 introduced a new special resolution regime for banks to facilitate the orderly resolution of banks in financial difficulties. The act also established a new bank insolvency regime as well as formalising the Bank of England’s supervisory role in respect of inter-bank payment systems. A parallel insolvency regime applies to investment banks (including banks carrying on investment banking business) under the Investment Bank Special Administration Regulations 2011.

3. Which regulatory authorities are primarily responsible for overseeing banks?

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

4. Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

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

Under changes that came fully into effect on 31 December 2010:

• the maximum amount payable to any claimant was increased to £85,000;
• the eligibility criteria for claims have been simplified;
• ‘fast payout’ of claims is required with a target of payment within seven days;
compensation is calculated on a gross basis (thereby ignoring any debts a depositor owes to the bank); and

firms are required to put in place systems to enable them to provide a single customer view (SCV).

The European Commission adopted a proposal to amend the EU Deposit Guarantee Directive in July 2010. The proposal (which is currently being negotiated by the European Council and Parliament) would confirm the existing level of coverage (€100,000), require reimbursement within seven days and facilitate repayment of depositors where the deposit is held with a branch outside of the bank’s home member state. Member states will be permitted to provide temporary protection of higher balances, for example, in connection with real estate transactions. The council has proposed 20 working days for payments to be made and objected to the commission’s proposal to introduce a framework for national deposit guarantee schemes to be able to borrow from each other.

5. Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an ‘affiliate’ for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

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

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

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

- a single counterparty;
- connected counterparties; or
- a group of connected clients.

Large exposures must be reported periodically to the FSA. Exposures of more than 25 per cent of a bank’s capital are prohibited. This limit may, however, be exceeded in respect of intra-group transactions only where the excess arises in respect of trading activity and the bank holds additional capital. A similar exemption for third party transactions was abolished on 31 December 2010.

GOVERNMENT RECAPITALISATION OF THE BANKING SECTOR

The UK government adopted emergency measures in response to the crisis in the banking sector, including liquidity assistance, recapitalisations and an asset protection scheme. Major UK banks were required to increase their tier 1 capital significantly. RBS Group PLC (RBS) and Lloyds Banking Group (Lloyds), which were unable to raise the additional capital externally, received government capital injections. RBS benefited from a second injection at the time of its accession to the UK government’s asset protection scheme in 2009.

The government currently holds 90.6 billion shares in RBS, including 51 billion non-voting shares. This is equivalent to 70 per cent of the voting share capital and 84 per cent of the total share capital. The government currently holds a total of 27.6 billion ordinary shares in Lloyds. This is equivalent to 41 per cent of the total share capital. The government also nationalised failed mortgage lenders Northern Rock and Bradford & Bingley which are wholly publicly owned. The government is committed to selling these ownership interests when market conditions permit.
A person is a connected counterparty if:

- he or she is closely related to the bank;
- he or she is an associate of the bank;
- the same persons significantly influence the governing body of that person and the bank; or
- the bank has an exposure that was not incurred for the clear commercial advantage of the bank, or its group, and that is not on an arm's-length basis.

The application of these rules is adjusted where a bank forms part of a core UK group (a group or subgroup of wholly owned UK companies that satisfy certain requirements) or a non-core large exposures group. The effect is to relax the limits on intra-group transactions provided that certain conditions are met. A waiver is required from the FSA to apply either of these regimes which are more restrictive than the pre-2011 UK integrated group and wider integrated group regimes. In particular, the FSA now applies a 100 per cent limit on exposures between members of a core UK group and members of the non-core large exposures group.

There are no specific restrictions on the types of business that a bank can undertake, although if a bank wishes to engage in activities that are regulated under FSMA 2000 (see question 2) it must obtain permission from the FSA, which would require it to satisfy the FSA that it could meet the relevant regulatory requirements. A bank may not carry on insurance business as EU directives restrict writing insurance to firms authorised to do so and prohibit them from carrying on any other activity. A bank may, however, own an insurance subsidiary.

6. What are the principal regulatory challenges facing the banking industry?

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

The implementation of Basel III from 1 January 2013 will significantly increase the amount of capital and liquidity resources that a bank is required to hold. New requirements in respect of remuneration were introduced on 1 January 2011 (see question 17). We have already referred to the UK government’s proposals to reform the structure of financial regulation by 2013.

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

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

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

Measures to implement these proposals are currently in the process of being adopted.

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

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

• principles of self-sufficiency and adequacy of liquidity resources;

• enhanced systems and control requirements, which implement the Basel Committee’s updated Principles for Sound Liquidity Risk Management and Supervision;

• quantitative requirements, coupled with a definition of liquid assets to meet such requirements; and

• detailed and frequent reporting to the FSA.

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

The FSA has stated that it will implement the new regime gradually. Initial low-level individual guidance and floors will be provided to firms as they migrate to the new regime. This will be followed by a gradual raising of liquidity standards over time, paced according to wider macroeconomic developments. Meanwhile, the FSA continues to work with firms most affected by the new regime focusing on the steps they are taking to mitigate liquidity risk and on the impact of progressively tightening requirements over time.

Restrictions on bank bonuses and other discretionary payments to staff were implemented on 31 December 2010 following adoption of EU Directive 2001/76/EU (known as CRD 3), together with guidelines published by the European Banking Authority (EBA). Changes have also been made to governance requirements.

The EBA was established on 1 January 2011, and replaced the Committee of European Banking Supervisors (CEBS). The functions of the EBA include:

• developing technical standards to facilitate the creation of a single EU rulebook. Such standards will need to be adopted by the commission to become binding;

• on its own initiative, or at the request of one or more national supervisors, or the commission, investigating cases of the misapplication of EU law by national supervisors and, where necessary, adopting a recommendation for action. If the recommendation is not complied with, the European Commission may take a decision requiring the national supervisor to take specific action or to refrain from action;

• in exceptional situations, adopting a decision addressed to banks requiring them to respect certain provisions of community law;

• again in exceptional circumstances, requiring national supervisors to take specific action; and

• mediating disputes between national regulators.

The intention is that the EBA will play an active role in developing a common European supervisory culture, and in promoting regulatory convergence throughout the European Union. It remains to be seen to what extent this will happen. However, the establishment of the EBA may significantly reduce the role of national supervisors, such as the FSA, in interpreting and applying EU banking regulation.
The government’s proposals to restructure the regulatory framework in the United Kingdom are considered in the ‘Update and trends’ box.

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

Changes are being driven by the need to respond to the financial crisis. The Basel Committee on Banking Supervision (the Basel Committee) published the Basel III Capital Accord on 16 December 2010. This is summarised in question 17.

In June 2010 the UK government announced its intention to abolish the FSA and replace it with a new structure for financial regulation. This is considered in the ‘Update and trends’ box.

SUPERVISION

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

Banks are supervised by the FSA. Supervision is carried out through the Advanced Risk-Responsive Operating Framework (ARROW), which seeks to identify the main risks to the FSA’s statutory objectives, measure the importance of those risks, mitigate them where their size justifies this and monitor and report on progress.

The FSA accepts that risks cannot be eliminated and does not apply a zero failure regime. Examples of risks taken into account under ARROW include the failure of a firm, mismanagement, fraud, market abuse and money-laundering. Potential problems are scored, based on the likelihood of the problem occurring, and the impact if it does occur. The FSA has four categories within the ARROW framework: low, medium low, medium high and high. The main focus of FSA supervision is on firms within the latter two categories which are subject to regular visits by the FSA.

The FSA allocates individual banks to one of three categories: small firms, ARROW light and full ARROW. Banks falling into the latter two categories will have an FSA supervisor responsible for supervision.

Under the full ARROW approach the FSA carries out a full risk assessment of risks within the firm. The supervisory team has discretion to investigate any areas to the extent they see fit. ARROW light involves a reduced-scope risk assessment covering certain core areas and sectorally important issues. Small firms do not have a relationship manager and are not subject to firm-specific assessments.

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

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

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

If the FSA identifies a breach of its rules or principles it may bring enforcement proceedings. Sanctions include withdrawal of authorisation, fines, banning orders and public disclosure of non-compliance (naming and shaming). Where a person has committed criminal offences (e.g. insider dealing, market manipulation, carrying on a regulated activity without authorisation) the FSA may initiate a criminal prosecution. The Coroners and Justice Act 2009 enhanced the ability of the FSA to prosecute financial crimes including protection for whistleblowers and powers to engage in plea bargaining. In March 2009 the FSA brought its first successful prosecution for insider dealing. Further successful prosecutions have followed and as of January 2011 12 prosecutions for insider dealing were pending. The FSA has also brought successful prosecutions for acquiring control over an authorised person without obtaining prior FSA consent. In July
2010 the Supreme Court confirmed that the FSA may also prosecute money-laundering offences.

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

Most issues are resolved between the FSA and banks as part of the ARROW framework, thereby avoiding the need for enforcement action. However, recent themes in enforcement have been failings in systems and controls in respect of the pricing of financial products, deficiencies in the segregation of client money and errors in transaction reporting to the FSA. Examples of recent enforcement action are set out below.

In January 2011 Barclays Bank plc was fined £7.7 million for failing to take reasonable care to ensure that investment advice provided to retail customers in respect of funds was suitable. Product brochures and documentation were potentially misleading and did not set out relevant risks and internal training was inadequate.

Barclays Capital Securities was fined £1,127,559 in January 2011 for breaches of the FSA client money rules. Barclays failed to segregate sterling client money held in sterling money market deposits on an intra-day basis. The FSA regarded the failing as particularly serious due to Barclays’ leading market presence in the United Kingdom and globally. JP Morgan Securities Ltd was also fined £33.32 million in May 2010 for failings concerning the protection and segregation of client money within its futures and options business.

Royal Bank of Scotland plc was fined £2.8 million in January 2011 for deficiencies in its complaints-handling process in respect of its retail branch network. Internal monitoring at branch level was ineffective in assessing whether customers were treated fairly and complaint handlers did not properly review complaints.

In December 2010 DB UK Bank Limited was fined £840,000 for serious failings in its lending policy and practices as well as its treatment of mortgage borrowers who were in arrears. DB UK Bank failed to obtain information in relation to interest-only mortgage borrowers as to where they would live when the mortgage came to an end and failed, in relation to self-certified mortgages, to offer a different mortgage product with a lower cost if the customer’s circumstances indicated that they might have qualified for such a product.

Goldman Sachs International was fined £17.5 million in September 2010 for failing to inform the FSA of an investigation by the SEC into a synthetic collateralised debt obligation marketed from the United Kingdom. Goldman Sachs also failed to inform the FSA of the SEC’s decision to recommend enforcement action for serious violations of US securities law committed by a UK-approved person when working for Goldman in the United States.

Société Générale was fined £1.575 million in August 2010 for failing to submit accurate transaction reports in respect of approximately 18.8 million transactions representing 80 per cent of its reportable transactions. The failings affected the ability of the FSA to detect potential market abuse and occurred during a period of heightened awareness around transaction reporting issues as a result of the implementation of MiFID. Commerzbank AG was fined £595,000 in April 2010 for failing to submit correct transaction reports in respect of approximately 1.03 million transactions representing an estimated 94 per cent of the firm’s reportable transactions over a period of two years. Credit Suisse was also fined £1.75 million for failing to submit accurate transaction reports in respect of approximately 40 million transactions.

Royal Bank of Scotland plc and other members of its group were fined £5.6 million in August 2010 for failing to establish and maintain appropriate and risk-sensitive policies with regard to customer due diligence and internal controls to prevent money-laundering. RBS failed to screen transactions against the UK Treasury list of persons and entities subject to financial sanctions. Other failings included not recording sufficient information relating to directors and beneficial owners of corporate customers and inadequate review and monitoring of the “fuzzy matching” capabilities in its screening software.

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

In November 2009 the FSA fined Nomura International plc (Nomura) £1.75 million for serious failings in relation to the book marking within its international equity derivatives (IED) business. The systems and controls around marking the IED book fell far short of those expected for a business trading in complex and high-risk financial products.

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

The FSA has implemented changes to its supervisory policy as part of the Supervisory Enhancement Programme. The government’s proposals to replace the FSA are described in the ‘Update and trends’ box. This involves:

• a significant increase in resources devoted to the supervision of high-impact firms and, in particular, to complex banks;

• a shift in supervisory style to focus on key business outcomes and risks, and on the sustainability of business models and strategies;

• emphasis on technical skills as well as probity in assessing approved persons;

• an increase in supervisory resources devoted to sectoral and firm comparator analysis, to better identify firms that are outliers in terms of risks and business strategies, and to identify emerging sector-wide trends that may create systemic risk; and

• a much more intensive analysis of information relating to key risks.

The FSA has placed increased reliance in recent years on ‘skilled person’ reports commissioned by the FSA, but paid for by firms, on areas such as capital adequacy, governance and complaint-handling.

13. Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Regulatory capital requirements are derived from the EU Capital Requirements Directive (CRD), which applies to all UK-authorised banks. This implements the Basel II Capital Accord.

The FSA requires banks to hold capital on initial authorisation and also capital against risks. The former represents a minimum, although for most banks the capital they are required to hold against risks will be significantly in excess of the authorisation minimum.

On authorisation, banks must hold capital resources of €5 million. Thereafter, a bank must hold capital equal to the sum of its requirements for credit risk, market risk and operational risk.

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

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

FSA requirements for market risk follow a ‘building block’ approach, identifying particular risks against which capital must be held. It follows that if a transaction gives rise to more than one type of risk it may trigger several capital charges. Capital is required to be held in respect of position risk, counterparty risk, foreign exchange risk and commodities risk.

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

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

Forthcoming changes to the capital adequacy framework are described in question 17.

The FSA does not require UK banks to issue contingent capital although it is possible that contingent capital may play a role in the regulation of systemically important financial institutions. This issue is being considered further by the Financial Stability Board and the Basel Committee.

14. How are the capital adequacy guidelines enforced?

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

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

The bank will need to agree with the FSA a remedial programme to bring it back into compliance. The terms of such programme will depend on the circumstances, and cannot be described in generic terms, but are likely to include raising new capital, a reduction of exposures, or both. If a bank is unable to agree with the FSA how to remedy the situation the FSA may revoke the bank’s authorisation. Additional powers to deal with failing banks have been enacted in the Banking Act 2009 and, for banks carrying on an investment banking business, the Investment Bank Special Administration Regulations 2011 (see question 16).

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

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

The stabilisation options are:

- the transfer of all or part of a bank to a private sector purchaser (PSP);
- the transfer of all or part of a bank to a 'bridge bank' owned by the Bank of England (Bridge Bank); and
- the transfer of a bank or a bank holding company into temporary public ownership (TPO).

These powers apply only to a UK bank or bank holding company. They do not apply to overseas banks with a branch in the UK. Such branches may be wound up in the United Kingdom if this is permitted under EU law.

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

- the bank is failing, or is likely to fail, to satisfy the threshold conditions for authorisation under FSMA 2000; and
- having regard to timing and other relevant circumstances it is not reasonably likely that action will be taken to satisfy those conditions.
In exercising any of the stabilisation powers, or the [new] insolvency procedures, the authorities must have regard to specified objectives. These are the protection and enhancement of the stability of the UK financial systems, the stability of the UK banking systems, protecting depositors, protecting public funds and avoiding unjustified interference with property rights. These objectives are to be balanced as appropriate in each case. The Treasury is required to publish a code of practice about the use of the powers, although this code is not legally binding. This was published in February 2009.

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

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

The stabilisation powers are supplemented by a broad range of powers to transfer shares or property (including foreign property) as well as overriding contractual rights that could interfere with the transfer.

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

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

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

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

Other insolvency proceedings remain possible (eg, administration or liquidation), although no application can be determined until the FSA has decided not to apply for a bank insolvency order. A resolution for voluntary winding-up has no effect without prior approval of the court.

The Banking Act 2009 introduced a new bank administration regime. This may be used where part of the business of a UK bank is sold to a commercial purchaser, or is transferred to a Bridge Bank, under the stabilisation powers. The purpose of bank administration (which should not be confused with administration under the Insolvency Act 1986) is principally to ensure that the non-sold or transferred part of the bank continues to provide services to enable the purchaser or Bridge Bank to operate effectively. Once the Bank of England notifies the bank administrator that the residual bank is no longer required, the bank will proceed to a normal administration where the objective is either to rescue
the residual bank as a going concern or, if this is not possible, to achieve a better result for the bank’s creditors as a whole than in a winding-up.

Additional insolvency procedures for banks carrying on an investment banking business were introduced by the Investment Bank Special Administration Regulations 2011. These are special administration (bank insolvency) and special administration (bank administration).

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

Yes. The first set of amendments (CRD 2) was adopted in September 2009 and came into force on 31 December 2010. This directive:

- tightened requirements on banks’ large exposures. The former exemption from large exposure limits for inter-bank loans of less than one year has been abolished;

- introduced harmonised requirements for tier 1 hybrid capital (preference shares and perpetual subordinated debt). Hybrid capital is capped at 50 per cent of tier 1 after deductions, and there are separate non-cumulative sub-limits for:
  - innovative and dated instruments (15 per cent);
  - other non-innovative hybrid capital (35 per cent); and
  - quasi-equity (50 per cent);

- requires tier 1 hybrid capital debt to include a feature enabling the instrument to be written down or converted to ordinary shares in specified circumstances;

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

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

Further changes (CRD 3) were agreed in November 2010 in respect of trading book capital, resecuritisation and remuneration. The requirements on employee remuneration came into force on 1 January 2011 and place limits on the percentage of staff bonuses that can be paid in cash. The other changes (which come into force on 31 December 2011) include:

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

- extending the capital charge for default risk in the trading book to capture mark to market losses caused by changes in creditworthiness (ie, ratings downgrades). Such downgrades were a major source of loss on traded debt positions during the financial crisis;

- introducing new (and higher) capital charges for resecuritisations (such as CDO of ABS); and

- aligning the capital charges for securitisation positions that are held in a bank’s trading book with those in the non-trading book. Previously many banks had treated trading book securitisation positions as straightforward debt positions.

These changes are expected to more than triple the amount of capital required on average to be held in respect of banks’ trading books.

The Basel Committee published the Basel III Capital Accord in December 2010. This will be implemented into EU law through the CRD 4 directive which is expected to be published in the second quarter of
2011. Basel III is due to be implemented in stages starting on 1 January 2013, with lengthy transitional arrangements.

The main changes include:

- improving the quality of capital through new definitions of core tier 1 capital, non-core tier 1 capital and tier 2 capital;
- raising the minimum core tier 1 capital ratio to 4.5 per cent and imposing a further capital conservation buffer of 2.5 per cent resulting in an effective minimum core tier 1 ratio of 7 per cent;
- increasing the tier 1 capital ratio (including the capital conservation buffer) from 4 to 8.5 per cent and the minimum total capital ratio (including the same buffer) to 10.5 per cent;
- abolishing innovative tier 1 capital and tier 3 capital. Tier 2 capital will be simplified based on lower tier 2 capital;
- adopting a harmonised approach to deductions from capital, with most deductions being made from common equity;
- introducing new and more stringent requirements in respect of counterparty credit risk on derivatives, repos and securities financing transactions;
- adopting a leverage ratio as a non-risk-based measure to curtail the growth in banks’ balance sheets;
- enabling regulators to impose an additional capital buffer in case of excessive credit expansion where local conditions justify this;
- introducing two new liquidity standards: a liquidity coverage ratio (LCR) designed to enable banks to withstand a short-term liquidity stress, as well as a net stable funding ratio (NSFR) requiring banks to have a minimum amount of stable funding based on the liquidity characteristics of a bank’s assets and activities over a one-year horizon; and
- addressing the risks posed by financial institutions that are systemically important.

The commission is also considering reducing the number of national discretions in the CRD.

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

The FSA also requires banks to carry out stress tests to ensure that they hold adequate capital in the event of plausible adverse economic conditions. In its 2010 business plan the FSA stated that it will be carrying out annual stress tests for all major financial institutions. The current Pillar 2 anchor scenario models a 2.3 per cent fall in UK GDP from mid-2010 to the beginning of 2012, a 23 per cent decline in house prices, a 34 per cent decline in commercial property prices and an increase in unemployment to 13.3 per cent. This scenario is designed to guide firms on the appropriate severity of scenarios used for their own capital planning stress tests.

In December 2010 the FSA introduced new requirements in respect of reverse stress-testing. Reverse stress tests require firms to identify and assess scenarios most likely to render their business models unviable. This is different to general stress-testing which tests for outcomes arising from changes in circumstances. Reverse stress-testing is not designed as a means of introducing a ‘zero-failure’ regime or as a way of directly influencing a firm’s capital requirements. However, if a firm’s reverse stress-testing identifies business model vulnerabilities that have not previously been considered, the firm may be required to hold a different amount or quality of capital.
OWNERSHIP RESTRICTIONS AND IMPLICATIONS

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

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

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

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

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

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

19. Are there any restrictions on foreign ownership of banks?

No (apart from sanctions imposed by the United Nations, the European Union and the United Kingdom on specified persons and countries).

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

There are no restrictions on the business activities of a parent or acquirer of a UK bank, or on those of affiliates of a UK bank, although such activities will be taken into account as part of the FSA’s assessment of the acquisition. A bank may be owned or acquired by a company whose business is wholly non-financial in nature. As a result of changes in August 2009 the directors, officers and employees of a holding company of a UK bank whose decisions or actions are regularly taken into account by the governing body of the bank must be approved by the FSA.

The FSA carries out the consolidated supervision of banking groups. Consolidated supervision applies at the level of the highest EEA group company whose subsidiaries and participations (basically, a 20 per cent holding), are banks or engage in broadly financial activities. The FSA will not normally undertake worldwide supervision of a group headed by a parent outside of the European Economic Area.

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

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

- limits on large exposures will apply.

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

Where a banking group is subject to consolidated supervision the FSA will apply its prudential rules to the group as a whole (see question 20). It will not, however, directly regulate non-authorised entities in the group.
Each regulated firm (including banks) will need to meet the regulatory requirements applicable to it on a stand alone basis. This includes, but is not limited to, capital adequacy and liquidity. Beyond this, the entities and individuals that control a bank are not subject to particular requirements. There is no legal obligation on a parent to provide additional capital if a subsidiary bank becomes undercapitalised. However, in this case, unless the bank is able to rectify the situation by raising capital elsewhere, or by reducing its exposures, then it will cease to meet the authorisation criteria and will lose its authorisation. In addition, the authorities may invoke the stabilisation powers under the Banking Act 2009 (see question 16).

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

Banks are required by the FSA to draw up recovery and resolution plans (referred to as ‘living wills’). A recovery plan might include provision for group support in specified circumstances. The European Union published a communication on crisis management in October 2010. The commission is considering the possibility of requiring intra-group support arrangements as part of a recovery plan although no concrete proposals have yet been made.

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

We have referred in question 16 to the pre-insolvency stabilisation powers as well as the new bank insolvency procedure and bank administration and similar procedures for banks that carry on an investment banking business.

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

**UPDATE AND TRENDS**

The new UK coalition government announced its intentions to reform the structure of financial services regulation in June 2010. Under the proposals the FSA will be abolished, with its responsibilities for the prudential supervision of banks and certain other financial institutions passing to the Prudential Regulation Authority (PRA), which will be a wholly owned subsidiary of the Bank of England. Responsibility for the supervision of market conduct will pass to a new Financial Conduct Authority (FCA). A Financial Policy Committee will be set up within the Bank of England to ensure financial stability through the exercise of macro-supervisory powers and discretions. It is intended that the new regulatory architecture will be established by 1 January 2013. The government published its second consultation document on the new regime in February 2011. Prior to the introduction of the new regime, the FSA has announced its intention to reorganise itself into two business units tracking the functions of the new regulatory authorities.

Of primary importance to banks will be the PRA. According to the consultation document, the PRA’s strategic objective will be contributing to the promotion of the stability of the UK financial system. The PRA’s operational objective will be promoting the safety and soundness of PRA-authorised persons. This includes seeking, in relation to each PRA-authorised person, to minimise any adverse effect that the failure of that
person could have on the UK financial system. The government envisions the PRA adopting a judgment-based supervisory approach with supervision, and enforcement action, based on judgments, in some cases in place of specific rules. This is likely to lead to an intensification of the style of supervision developed in recent years by the FSA in response to the financial crisis.

The FCA will have as its core purpose protecting and enhancing the confidence of all consumers of financial services. The FCA's strategic objective will be protecting and enhancing confidence in the UK financial system. Its operational objectives will be facilitating efficiency and choice in the market for financial services, securing an appropriate degree of protection for consumers and protecting and enhancing the integrity of the UK financial system. Banks will be supervised by the FCA in respect of the conduct of all aspects of their business.

Under the reforms banks will need authorisation from both the PRA and the FCA. The PRA's authorisation process should enable it to assess whether the firm will be capable of managing its business prudently and to evaluate the soundness of an applicant's proposed business model. The FCA's authorisation process will be aimed at ensuring that all new entrants to the financial services market meet the necessary conduct and consumer protection requirements. Both regulators will have the powers currently enjoyed by the FSA to vary or remove permissions on grounds falling within their respective scope. However, the PRA will have a power of veto over the FCA's exercise of such power where, in the judgement of the PRA, there may be systemically threatening results. Both regulators will have their own rule-making powers, although the government envisages coordination between the PRA and FCA to avoid inconsistencies for dual-regulated firms.

The government has decided that change-of-control consents will primarily be a matter for the PRA. However, the PRA will be obliged to consult the FCA. It is proposed that the PRA, as a consolidated supervisor, could veto change-of-control approvals given by the FCA as a solo supervisor of a firm on systemically prudent grounds.

**Transactions at an Undervalue**

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

**Preferences**

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

**Fraud on Creditors**

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

**Shadow Directorship**

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

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

DISQUALIFICATION

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

PIERCING THE CORPORATE VEIL

The courts may pierce the corporate veil, so as to impose liability on a parent company for the debts of its insolvent subsidiary, in limited circumstances. These include where the subsidiary was used as a device or facade, thereby avoiding or concealing any liability of the company’s controllers. In Ben Hashem v Ali Shayif [2008] EWHC 2380 Munby J said: ‘The common theme running through all the cases in which the court has been willing to pierce the veil is that the company was being used by its controller in an attempt to immunise himself from liability for some wrongdoing which existed entirely dehors the company.’

CHANGES IN CONTROL

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

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

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

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

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

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

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

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

26. Describe the required filings for an acquisition of control of a bank.

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

- corporate controllers form, for a controller that is a limited company or a limited liability partnership;
- partnership controllers form, for a controller that is a partnership;
- individual controllers form, for an individual controller;
- fund manager form for acquirers that are an investment manager acquiring the shares in the course of investment management activity; and
- trust controllers form for a trustee settlor or beneficiary of a trust.

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

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

The FSA has 60 working days to approve an acquisition, although the process may be shortened where the controllers are already known to the FSA. It facilitates approval for the acquirer to discuss a proposed acquisition with the FSA informally in advance. This enables the FSA to identify potential issues and request any further information before the formal notification is submitted. If approval is granted, the prospective controller must complete the acquisition within one year, or such shorter period as the FSA specifies.