Banking Industry Regulatory Update

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The business of relationships.

Banking Industry Regulatory Update

INTRODUCTION

International regulatory bodies, working alongside their regional and national counterparts, have spent over three years attempting to mend the global financial system by strengthening its stability and resilience. In 2011, the stream of regulations does not appear to be slowing.

This banking industry regulatory update, the fifth in the series, sets out the key banking industry reforms, and proposals for reform, in the international, European and UK spheres. This paper sets out the position as at September 2011. It should be noted that, as this is an ever changing regulatory environment, care should be taken when reading the paper as it will become out of date relatively quickly.

CORPORATE GOVERNANCE

International – Basel Committee on Banking Supervision ("BCBS")

Internationally, there has been a continued emphasis on effective governance. This focus stems from the view that corporate governance is so fundamental to both individual banking organisations and to the international financial system as a whole, it merits targeted supervisory guidance. The BCBS published a set of 14 principles (the "**Principles**") for enhancing sound corporate governance practices in October 2010, following its consultation on those principles in March 2010.

As outlined in our September 2010 and February 2011 updates, the focus of the Principles is primarily on attributing responsibility for corporate governance, risk management/strategy and corporate values to the board and senior management (rather than to regulatory supervisors). Emphasis is also placed on the need for the board to ensure effective communication laterally and vertically (in order for risk and other issues to be adequately dealt with) and for each board member to properly know and understand the institution's structure. The sentiment that a board must establish and promote corporate values that discourage excessive risk taking pervades the Principles.

Specifically, the Principles include the following requirements:

- Appropriate practices, committees and roles must be set up to manage risk, remuneration, conflicts and auditing. Such practices must keep pace with the bank's sophistication and risk profile;
- The board of a parent company must take responsibility for overseeing corporate governance across the group;
- The board must properly understand the bank's corporate structure and the nature and purpose of any offshore or unregulated entities;
- Communication lines must be adequate to effectively report risk issues and exposures to the board;
- Compensation must be aligned with prudent risk taking;
- A bank's code of conduct must outline acceptable and unacceptable risk taking behavior and that the board should take the lead in establishing the correct 'tone at the top'.

Incidentally there been some debate over whether corporate culture/ethics can and should be regulated (in the manner attempted by the Principles), to which Hector Sants responded strongly in the affirmative in his speeches of 17 June and 4 October 2010.

The BCBS advises supervisors to establish guidance or rules in accordance with the Principles. The BCBS notes that banks' compliance with the Principles (as implemented by the bank's home country) should be proportionate to the size, complexity, structure, economic significance and risk profile of a bank, and the corporate group it belongs to (if relevant).

In June 2011, BCBS updated a framework of principles concerning operational risk management for banks and their supervisors published in 2003 called *Sound Practices for the Management and Supervision of Operational Risk (Sound Practices*), to reflect current industry practice. The framework of principles incorporates governance as an over-arching theme and, in line with the BCBS's 14 Principles, places emphasis on the role of the board of directors in assessing operational risk and overseeing the implementation of appropriate policies and procedures.

Europe

At European level, the European Commission ("**EC**") published a green paper on corporate governance in June 2010, which discussed the links between corporate governance and the financial crisis; and suggested options for reform along similar lines to the Principles. On 12 November 2010, the EC published a feedback statement on responses to its green paper which had been given by interested parties such as the FSA). While the feedback statement demonstrates the broad support of the industry to the EC's proposals (particularly in relation to the clarification of responsibility), it also notes that many respondents see corporate governance failures as due to a lack of effective implementation of existing rules rather than deficiencies in the regulatory regime.

The European Parliament adopted a resolution in response to the Green Paper on 11 May 2011, in which it:

- emphasises the need for financial institutions to establish effective governance systems, with adequate risk management, compliance, internal audit functions, strategies, policies, processes and procedures;
- calls for the establishment of mandatory risk committees or equivalent arrangements at board level for all economically significant financial institutions;
- calls for the establishment of "fit and proper persons" criteria, to be implemented by national regulators;
- calls on the European Commission to develop legislation requiring large financial institutions to submit their boards to regular external evaluation;
- encourages institutional shareholders to take a more active role in holding the board to account with a view to encouraging a culture of greater responsibility.

On 5 April 2011 the EC published another Green Paper as part of a public consultation focused on improving the corporate governance of European companies. The Green Paper is intended to prompt debate in three key areas: the functioning of boards of directors; how to enhance shareholder involvement and how to improve the effectiveness of the existing national corporate governance codes. The deadline for responses to the consultations closed on 22 July 2011.

In a related publication, the Committee of European Banking Supervisors ("**CEBS**") set out its High Level Principles for Risk Management on 16 February 2010. CEBS was replaced by the new, more powerful European Banking Authority ("**EBA**") as of 1 January 2011 which exercises a wider role than its predecessor. For example, the EBA is able to issue binding technical standards on member states and has indicated that it is keen to press for a single EU rule book. The EBA was also responsible for the Q1 2011 round of bank stress testing. The principles for risk management covered issues such as risk culture, appetite and exposure, the role of the Chief Risk Officer and a new product approval process. They were to become part of financial institutions' internal capital adequacy assessment process ("**ICAAP**"), and of supervisors' review framework under Pillar 2 of Basel II, by 31 December 2010.

On 13 October 2010, CEBS published a consultation paper on its consolidated Guidebook on Internal Governance (the "**Guidebook**"). The Guidebook consists of 30 principles covering corporate structure and organisation, management, risk management, internal controls, systems and continuity and transparency, and consolidates all CEBS guidelines specifically aimed at internal governance (including the High Level Principles Risk Management referred to above). The Guidebook principles shall as of 30 September be part of financial institutions' ICAAP process and of supervisors' supervisory review framework. While the principles are aimed at large and complex institutions, CEBS considered they could (subject to proportionality) be adapted to any institution. As such, smaller firms shall have concluded an analysis of their existing practices in comparison with the principles in order to be in a position to either comply, or discuss proportionality with their national regulator.

In addition on 27 September 2011 the EBA published Guidelines on internal governance which apply on a "comply or explain" basis. UK banks should already be meeting the EBA Guidelines as there is nothing particularly new in them.

UK

In the UK, the government and the FSA have been responsible for a number of initiatives to strengthen corporate governance in financial services companies. These include the implementation of the Walker Review of 2009 (which set out 39 recommendations which are intended to improve the governance of UK banks and other financial institutions), through revised governance and remuneration codes, a new stewardship code, and increased supervision of individuals performing significant influence functions in regulated firms.

The Walker Review was considered by the Financial Reporting Council ("**FRC**") in early 2010. The primary conclusions drawn by the FRC can be summarised that; more attention should be paid to following the spirit of the existing Combined Code on Corporate Governance 2008 (the "**Combined Code**") as well as its letter and that the impact of shareholders in monitoring the Combined Code could be enhanced by better interaction between the boards and their shareholders. The FRC review thus led to the Combined Code being replaced by;

- the UK Corporate Governance Code 2010 (the "**Code**") which applies to listed companies (including financial institutions) for reporting periods beginning on or after 29 June 2010; and
- the UK Stewardship Code 2010 (the "**Stewardship Code**") which sits alongside and is complimentary to the Code, and which will apply to fund managers and other institutions authorised to manage assets on a discretionary basis for "professional clients" (including collective investment schemes, insurance companies and pension funds).

Both codes apply (as the Combined Code did) on a 'comply or explain' basis.

The Code

The Code consists of main and supporting principles spanning the five areas of leadership, effectiveness, accountability, remuneration and relations with shareholders. However, the Code differs in tone from the Combined Code in that it places more importance on the main principles which should guide board behaviour and which should be continually considered and reported on by the board. These are now listed separately at the front of the Code (in addition to later on together with the supporting principles). The primary differences between the Code and the Combined Code include:

- Increased emphasis on the roles and responsibilities of the Chairman, the senior independent director and non executive directors ("**NEDs**");
- New requirement that any search for board candidates should have regard to diversity, including gender diversity;
- New requirement for directors of FTSE 350 companies to be subject to annual re-election;
- New requirement that external board evaluation reviews be conducted every 3 years by FTSE 350 companies;
- New emphasis on directors' time commitments;
- New emphasis on consideration and management of risk; and
- Amendments to provisions related to performance related remuneration.

The Stewardship Code

Broadly, the Stewardship Code sets out good practice for institutional investors when engaging with UK listed companies. The seven principles of the Stewardship Code cover the establishment and, where required, disclosure of practices relating to collective action with other investors, monitoring investee companies, voting policy and disclosure, enhancing shareholder value and the management of conflicts of interest. Adherence to the Stewardship Code is not compulsory, however, the new FSA rule in COBS 2.2 (in force from 6 December 2010) makes disclosure of a regulated firm's commitment to the code (or lack of) mandatory. The alternative to compliance is to explain why the firm's alternative business model makes compliance inappropriate. While certain of the requirements will already be part of a firms' practice, the net effect of compliance with the Stewardship Code is that a regulated firm must make public arrangements and policies that previously remained confidential.

The British Bankers' Association ("**BBA**") published a response to the Department for Business Innovation and Skills' ("**BIS**") call for evidence "A Long-Term Focus for Corporate Britain" in January 2011, which states that it views the Stewardship Code as a step in the right direction and is supportive of the FRC in its endeavours to promote it. The call for evidence, published on 25 October 2010, was the first stage of a review into corporate governance and economic/board 'short-termism' in capital markets. BIS published the outcome of the consultation on 28 March 2011.

In June 2011, BIS commissioned an independent review of the effect of UK equity markets on the competitiveness of UK businesses (the "**Kay Review**"). Professor John Kay, who chairs the review, launched a call for evidence on 15 September 2011. His speech emphasised that the subject of the review was corporate decision making and performance rather than corporate governance. The deadline for submissions is 18 November 2011.

Approved Persons

The FSA confirmed in its Business Plan for 2011/12 that corporate governance remains a key area of focus in the coming months. The publication of FSA policy statement PS10/15 on effective corporate governance in September 2010 highlighted the extent of the work being done in relation to significant influence and controlled functions.

Under PS10/15 and the corresponding amendments to the FSA handbook:

- A new framework of classification of controlled functions is being created including: parent entity SIF (CF00), chairman (CF2a), senior independent director (CF2b), chairman of risk committee (CF2c), chairman of audit committee (CF2d) and chairman of remuneration committee (CF2e).
- Three new systems and controls functions are being introduced: finance function (CF13), risk function (CF14) and internal audit function (CF15). The current systems and controls function (CF28) will be deleted.
- The scope and definition of the already existing director (CF1) and non-executive director (CF2) controlled functions are being reduced.

These amendments were due to come into force on 1 May 2011. However, in March 2011, the FSA announced that implementation would be postponed until a later date.

- Guidance is provided on the role to be played and time commitments to be made by NEDs, while guidance on the limits of liability of NEDs in SYSC 2.1.2G and 4.4.4G is to be deleted.

This part of the new regime came into force on 1 May 2011.

REMUNERATION

International

As mentioned in our September 2010 update, the FSB's Principles for Sound Compensation Practices (the "**FSB Principles**") were endorsed at the G20 summit in April 2009. The G20's commitment to implementing these new standards was re-iterated on 12 November 2010 at its Seoul summit, where the G20 also called for international assessments and peer reviews by the FSB to be continued and enhanced in order to ensure consistent implementation. The FSB published its *Thematic Review on Compensation – Peer Review Report* in March 2011.

The BCBS implemented the FSB Principles into its risk management guidance and set out a methodology to help supervisors assess firms' compliance with the FSB Principles and related implementation standards.

On 14 October 2010, the BCBS published a consultative document on the range of methodologies for risk and performance alignment of remuneration. The report provides an overview of practices currently used by banks intended to align remuneration with risk. The report also analyses the issues

that may reduce the effectiveness of banks' methodologies. The aim of the report is to help converge and spread best practices in the sector. The comment period closed on 31 December 2010 with comments by the BBA acknowledging that the BCBS appears committed to proportionality and the tailoring of methodologies to a firm's specific characteristics.

The BCBS issued its final publication on Pillar 3 disclosure requirements for remuneration on 1 July 2011. Banks will be required to disclose qualitative and quantitative information about their remuneration practices and policies covering a wide range of areas:

- governance/committee structures;
- the design/operation of remuneration structures and frequency of review;
- the independence of remuneration for risk/compliance staff;
- risk adjustment methodologies;
- the link between remuneration and performance;
- long-term performance measures; and
- types of remuneration.

The BCBS expects banks to comply with these Pillar 3 requirements from 1 January 2012 and expects publication of disclosures at least annually or as soon as practicable after the information is available.

Europe

The amended Capital Requirements Directive (*2006/48/EC* and *2006/49/EC*) ("**CRD3**") was adopted by the European Council on 11 October 2010. With regard to remuneration, CRD3 requires that an institution's policies include caps on cash bonuses, bonus deferrals and new bonus/salary ratios, the recurring aims being to better align remuneration with the long term interests of the institution. It is also intended that the amendments will bring down the disproportionate role played by bonuses in the financial sector. The deadline for implementation of the CRD3 remuneration requirements in Member States was 1 January 2011. This has been implemented in the UK through amendments to the UK's remuneration code (see below).

Since its high-level principles for remuneration policies were published on 20 April 2009, CEBS has published; a report on the implementation of the principles in June 2010; a consultation paper on draft guidelines on remuneration policies and practices ("**CP42**") on 8 October 2010 (as required by CRD3) and; the final version of the Guidelines on Remuneration Policies and Practices on 10 December 2010, together with a feedback document summarising the main issues arising from CP42. The guidelines address high-level remuneration policies, and the day-to-day practice of making

remuneration decisions. They came into force on 1 January 2011, in line with the deadline for implementation of CRD3.

In order to benchmark remuneration practices across Europe, the EBA has requested certain data from national regulators about individual firms. On 28 July 2011, the EBA published a consultation (CP46) on draft guidance, along with a template, on the information to be supplied to national regulators as part of the exercise. On the same day the EBA published a separate consultation (CP47) on guidance specifically relating to the supply of information about high earners. The deadline for responses to both papers closed on 2 September 2011.

In accordance with the proposals outlined in the EC's Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies published on 2 June 2010, the recently adopted and published Alternative Investment Fund Managers Directive, amendments to the UCITS IV Directive (*2009/65/EC*) (UCITS IV) and the Solvency II Directive (*2009/138/EC*) contain provisions on remuneration in the investment fund and insurance context.

UK

Changes to the UK's existing Remuneration Code were proposed by the FSA in July 2010, in consultation paper CP10/19, following the passing of the Financial Services Act 2010 (which empowers the FSA to make rules on remuneration and recover payments which are not compliant) and the approval of the CRD3 text. On 10 November 2010, the FSA also published a consultation paper on remuneration disclosure (CP10/27) in accordance with CRD3. CRD3 requires firms to disclose information on their remuneration policies and pay-outs on an annual basis.

On 17 December 2010, the FSA published its policy statements on revising the remuneration code (PS10/20) and remuneration disclosure (PS10/21). The policy statements were delayed slightly so that the FSA could take into account the final guidelines on remuneration published by CEBS (referred to above). The revised remuneration code (the "**Revised Code**") and disclosure requirements have been inserted into the FSA handbook by the Senior Management Arrangements, Systems and Controls (Remuneration Code) (No 2) Instrument 2010 and Prudential Sourcebook for Banks, Building Societies and Investment Firms (Remuneration Disclosures) Instrument 2010.

The rules on disclosure require a firm to disclose, on an annual basis, its remuneration policy and details in respect of senior management and members of staff whose actions have a material impact on the risk profile of the firm. The disclosure may form part of the firm's annual report and accounts provided the disclosure meets the relevant requirements.

The most significant amendments made to the existing remuneration code by the Revised Code are as follows;

- Scope: The FSA's existing code applies to the largest banks, building societies and broker dealers. The revised code will catch a much larger group of around 2,700 firms, including all banks and building societies and CAD investment firms;

- Bonus ratios: Appropriate ratios must be set between fixed and variable remuneration.

- Limit on cash bonuses: at least 50% of both upfront and deferred variable remuneration must be settled in shares or other instruments.

- Deferrals: at least 40% of a bonus must be deferred over a period of at least three years for code staff. For staff earning more than £500,000, the deferral rule rises to at least 60% of bonus. Both upfront and deferred equity awarded must be subject to a retention period before sell on is permitted.

- Prohibition on guaranteed bonuses: the prohibition will apply to all staff. For 'non-Code Staff', guaranteed bonuses will be completely prohibited, and for 'Code Staff' they will only be permitted in exceptional circumstances.

Other provisions of the code make the establishment of a remuneration committee compulsory for certain firms, and deal with performance adjustment mechanisms, pensions and golden parachutes. All provisions have in mind the primary requirement of CRD 3 that an institution "must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management."

Proportionality

The UK changes listed above have resulted in what has been called the 'most stringent code of practice of any financial centre in the world' by Chancellor of the Exchequer George Osbourne in January 2011. However, despite the strong political rhetoric, in practice the FSA has identified four "tiers" of firm (by reference to the type of firm and the level of capital resources required to be held) in relation to which certain levels of 'proportionate' compliance only, are expected. The tiers are broadly as follows;

- Tier one: Banks and building societies with regulatory capital exceeding £1bn and full scope BIPRU firms with capital resources of over £750m;

- Tier two: Banks and building societies with regulatory capital between £50m and £1bn, full scope BIPRU firms with capital resources between £100m and £750m;

- Tier three: Any bank, building society, full scope BIPRU firm that does not fall into any of the other tiers;

- Tier four: All limited license and limited activity firms (including third country BIPRU firms with such permissions) e.g. fund managers.

Tier four firms will not be required to have, for example, a remuneration committee, set ratios between fixed and variable remuneration; award a percentage of variable remuneration in shares or defer variable remuneration over an appropriate period as these requirements are considered overly

burdensome for smaller firms. However, such firms will still be required to comply with other new, less detailed requirements including that variable remuneration does not limit the firm's ability to strengthen its capital base (amongst others).

The revised remuneration code came into force on 1 January 2011 in respect of 2010 performance with an extension period until 1 July 2011 for firms newly within its scope. The new disclosure rules came into effect on 1 January 2011. The FSA requires firms to make their first disclosure in relation to 2010 remuneration as soon as practicable, but no later than 31 December 2011.

Following a consultation in April 2011, the FSA published finalised guidance (FG11/11) on the Revised Code in August 2011. The guidance is targeted at banks, building societies and Capital Adequacy Directive ("**CAD**") investment firms (which generally corresponds with firms subject to MiFID). Specific guidance is provided on the Revised Code's rules on retention periods and guaranteed variable remuneration. It also includes guidance on Frequently Asked Questions and templates which tier 2, 3 and 4 firms should use in order to assess their compliance with the Revised Code (Remuneration Policy Statements). In August the FSA also published two "Dear CEO" letters as part its consultation on the Revised Code. The two letters are targeted at Tier 1 and Tier 2, 3 and 4 firms respectively. They set out the ways in which firms are expected to comply with the Revised Code and how the FSA intends to monitor their compliance. The annexes to the letter contain guidance on the definition of "code staff", long-term incentive plans (**LTIP**s) and the structure of alternative investments. The 4-week window for the submission of responses to the guidance closed on 2 September 2011.

Since the implementation of the Revised Code, although the much feared exodus of bankers has not yet materialized, concerns have been expressed about the eventual effect of the Code on the labour market. From the institution perspective, the EU's (and consequently the UK's) prescriptive approach has been contrasted with the more flexible approach of the United States, Japan and Canada and frustration has been expressed that firms may be subject to different but overlapping requirements, meaning more time spent monitoring compliance. On a more practical note, it is clear that organisations will need to be prepared for a much closer relationship between their HR and compliance functions when it comes to pay, which will again, take organisation.

FINANCIAL TRANSACTIONS TAX

On 7 October 2010 the EC issued a Communication called Taxation of the Financial Sector together with a staff working document, press release and set of questions and answers on the topic. The Communication put forward a two pronged approach, based on the premise that "the financial sector needs to make a fair contribution to public finances, and that governments urgently need new sources of revenue," which includes both a financial transactions tax ("**FTT**"), which the EC believes should be implemented at a global level, and a financial activities tax ("**FAT**") (to be imposed on financial institutions) to be introduced within the EU only.

In early March 2011, members of the European Parliament voted in the adoption of the "Podimata report" (an innovative financing resolution drafted by Anni Podimata) by 529 votes in favour to 127 votes against, which proposed the promotion of the introduction of a FTT. Later, on 29 June 2011, the EC published a proposal for a Council Decision on the system of own resources of the EU. This proposal highlighted the FFT as a key element in creating additional revenue for the EU which could reduce the contributions made independently by Member States. The EC has proposed the

introduction of an FFT from 1 Jan 2018 at the latest and stated that the "*EU initiative will constitute a first step towards the application of a FFT at global level."*

It has been argued that a global FTT would be more difficult and take longer to implement than an EU FFT. Unsurprisingly an EU FFT has also received criticism. For example, on 9 June 2011, Simon Lewis the chief Executive of the Association for Financial Markets in Europe ("**AFME**") argued that the "*real impact of a possible transaction tax needs to be understood.*" He explained, using foreign currency trading as an example, that a tax would significantly increase costs in this sector at the expense of economic growth. He also noted that a FFT should be considered against "*the backdrop of several significant new taxes or levies already being introduced by individual Member States…we have already called upon the* [EC] *to conduct a thorough study into the tax contribution made by the financial services sector*."

It appears that FFT may now be used by, for example Germany, as a condition to providing more ECB support to assist Greece. The UK is likely to argue against the requirement as it will have a large impact on the UK where most financial transactions take place.

RETAIL BANKING AND PAYMENT SERVICES

Payment Services

As mentioned in our September 2010 and February 2011 updates, the EU Payment Services Directive ("**PSD**") provides the legal foundations for the Single Euro Payments Area initiative. It introduces a new licensing regime to encourage non-banks to enter the payments market, sets common standards for terms and conditions with a focus on high levels of transparency, and establishes maximum execution times for payments in euro and other EU/EEA currencies. The PSD also seeks to encourage the adoption of more efficient payment types and, for some Member States, introduce a shift in liability between providers and customers in the interests of consumer protection. The EC is continuing to publish questions and answers on the PSD on its website, the most recent set of answers being posted in July 2011. The EC is expected to review the implementation of the PSD and its impact on Member States before 1 November 2012.

In June 2011, the EC published revised guidelines on passport notifications under the PSD as well as new guidelines on the second Electronic Money Directive ("**2EMD**") which is discussed further below. The PSD passport notification guidelines are a voluntary code of conduct which was first published in November 2009. They are intended to allow EU competent authorities to cooperate and exchange information to ensure an efficient passport notification process for electronic money ("**e-money**") institutions.

2EMD aims to encourage the growth of the e-money market and was implemented in the UK on 1 May 2011 through the Electronic Money Regulations 2011 ("**EMR**") which introduce new conduct requirements for all e-money issuers. In addition, EMR introduce new authorisation/registration and prudential standards for e-money institutions ("**EMIs**"). Among other changes which 2EMD makes, authorised EMIs are subject to a reduced initial and minimum ongoing capital requirement and all EMIS must safeguard funds received from customers for e-money so that should the EMI become insolvent the funds are protected from other creditors' claims.

The FSA's Banking and Payment Services conduct regime comprises the Banking Conduct of Business sourcebook ("**BCOBS**") (the final provisions of which came into force on 1 May 2010) together with the Payment Services Regulations 2009 ("**PSR**"), which implement the PSD with effect from 1 November 2009. The PSRs broadly require certain information to be provided to the customer before and after execution of a payment transaction and deal with the rights and obligations of both payment service provider and customer in relation to payment transactions. The obligations for the former include registration as a payment service provider. In brief the BCOBS contains rules and guidance on communications with banking customers and financial promotions, the speed of customer payments (e.g. from 1 January 2012 all payments into a customer account will have to be made by close of play on the business day after the instructions are received), post-sale requirements and cancellation.

The UK Payments Council originally published guidance on the BCOBS in December 2009 and has since been updated twice, first in May 2010 and most recently in January 2011. The guidance has been granted industry guidance status by the FSA until 31 December 2012.

The Board of the UK Payments Council has announced a target date of the 31 October 2018 for closing the cheque clearing system, provided (only) that alternative forms of payment are developed by 2016. However concerns have been aired by the Treasury Committee and the charity sector that the number of donations, particularly from older donors would go down if cheques were abolished, although it is unlikely that these will affect the timetable for reform.

The UK Domestic Cheque Guarantee Card Scheme closed on 30 June 2011. This concludes a decision made by the Payments Council in 2009 to abolish the use of cheque guarantee cards due to a decline in usage of the guaranteed cheque.

Consumer Credit

1 February 2011 marked the end of the transitional period for the implementation, in the UK, of the Consumer Credit Directive ("**CCD**") by numerous sets of regulations and amending regulations. The CCD adapts the European consumer credit regime so it is able to deal with more modern forms of credit. It is also designed to bring a greater level of consistency to the regulation of consumer credit across Europe, and to increase consumer protection through, amongst other things, increased transparency.

The regulations (the most significant of which are the Consumer Credit (EU Directive) Regulations 2010) contain a number of important changes to the existing Consumer Credit Act 1974. The regulations restrict the availability of the useful "high net worth" exemption under the Consumer Credit Act, introduce a fundamental requirement on lenders to make detailed pre-contractual credit information available in a prescribed form, oblige lenders to assist consumers in assessing the suitability of a range of credit agreements and to make their credit agreements conform with the requirements of the amended Act.

Lenders and those involved on the periphery of consumer borrowing e.g. credit intermediaries should ensure they are aware of the new requirements.

CAPITAL

International

Following the publication of its three papers on enhancing the existing bank capital framework: Enhancements to the Basel II framework, Revisions to the Basel II market risk framework, and Guidelines for computing capital for incremental risk to the trading book, the Basel Committee on Banking Supervision ("**BCBS**") stated that it expected all firms to comply with its revised Pillar 1 (minimum capital) and Pillar 3 (market discipline) requirements on risk weighting and disclosure and its associated Pillar 2 guidance, by the 31 December 2010.

New trading book rules also took effect at the end of 2010, which introduce higher capital requirements to capture the credit risk of complex trading activities. They include a stressed value at risk requirement which the BCBS believes will help dampen the cyclicality of the minimum regulatory capital framework. In July 2010, the G20 announced in a progress report that, following its 2009 package of reforms relating to trading book risks, the BCBS has started a fundamental review of the trading book. This was confirmed by the BCBS in October 2010 in a report to the G20 on the financial crisis. In his January 2011 speech, Nout Wellink, BCBS Chairman, announced that the review would take "a very close look" at how banks determine their exposure measures, how they risk-weight their assets and how they engage in risk mitigation activities. The review is expected to be completed in second half of 2011.

The BCBS announced additional proposals in December 2009 under two consultative documents: Strengthening the Resilience of the Banking Sector and International Framework for Liquidity Risk Measurement, Standards and Monitoring. The documents cover areas including raising the quality, consistency and transparency of the capital base, strengthening capital risk coverage, introducing a leverage ratio and measures promoting a countercyclical capital framework and introducing a global minimum liquidity standard for internationally active banks.

Following discussions on the reform of capital requirements in July 2010, the BCBS published an Annex containing the outcome of the discussions. The main point to note from these discussions is the timescale for implementation of the Net Stable Funding Ratio (which is a measurement of a bank's vulnerability to liquidity changes) has been extended; it will now be introduced in 2018 rather than 2013.

On 12 September 2010, the BCBS agreed the minimum level of common equity and Tier 1 capital that banks will be required to hold by 1 January 2019. Over a five year period, the core Tier 1 capital minimum will be raised from the current 2% of risk weighted assets, to 4.5% by 2015, with the overall Tier 1 capital minimum being incrementally increased to 6%. The BCBS has also agreed to introduce a 2.5% "capital conservation buffer" of common equity, designed to further cushion banks against potential losses. The buffer will be phased in from January 2016 and will become fully effective in January 2019. The combination of requirements will result in banks being required to hold a minimum of 7% common equity and 8.5% Tier 1 capital by 2019.

In addition to the above, the BCBS agreed that national regulators (such as the FSA) should be empowered to impose a counter-cyclical buffer of up to 2.5% of assets, if they consider there to be excess credit in the system, which may result in loan losses later on. The idea being that the buffer will act as a shock absorber, should losses be incurred after the burst of the perceived credit bubble. Any bank which fails to keep it's capital ratio above the imposed buffer, may incur restrictions on payouts such as dividends, share buybacks and bonuses. The UK has stated that it intends to impose the full 2.5 per cent cushion. It has also said that it may impose higher capital requirements than those proposed by the Basel Committee. In addition to being potentially harmful to competition, however, it is questionable whether the UK will be able to impose higher capital requirements when the Capital Requirements Directive 4 reforms are implemented (see below).

The text of the new regime, known as Basel III was published on 16 December 2010, together with an impact assessment which tested the above proposals assuming full implementation as of year end 2009. No phase in period was permitted. A total of 263 banks from 23 committee member jurisdictions participated in the assessment, including a set of ‘Group 1’ banks (i.e., those that have Tier 1 capital in excess of €3bn, are well diversified and are internationally active) and a set of ‘Group 2’ banks (i.e., other banks). The assessment found that the average common equity Tier 1 capital ratio of Group 1 banks was 5.7 per cent, as compared with the new minimum requirement of 4.5 per cent. For Group 2 banks, it was 7.8 per cent. While Nout Wellink described the Basel III Framework as "a landmark achievement that will help protect financial stability and promote sustainable economic growth,” it appears to many that the agreed core tier one ratio is not high enough to cope with another similar downturn and that the implementation periods are too long. Indeed, the Bank of England (“**BoE**”), in its January 2011 paper: “Optimal Bank Capital,” has said a capital adequacy ratio at least twice as large as that agreed in Basel would take the banking sector closer to an optimal position and urges banks to raise more equity capital.

One point that is agreed, is that in implementing Basel III, banks are going to have to provide more accurate and timely information on their capital position at any given time and this will involve increased and more efficient data management.

The oversight body of BCBC, the Group of Governors and Heads of Supervision (**“GHOS”**), agreed a consultative document which sets out measures for globally systemically important banks (**“G-SIBS”**) in its meeting of 25 June 2011. The measures are intended to improve the resilience of G-SIBS and create strong incentives for them to decrease their systemic importance.

The proposed measures include the methodology for assessing systemic importance, the additional capital required and the arrangements by which the measures will be phased in. The assessment methodology takes an indicator- based approach which comprises five categories: size; interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity. A Common Equity Tier 1 (**“CET1”**) capital requirement ranging from 1%-2.5% depending upon systemic importance will be used to address additional loss absorbency requirements. An additional 1% surcharge is proposed as a disincentive for banks which may be increasing materially their global systemic importance.

Higher loss absorbency requirements will be introduced alongside the Basel III capital conservation and countercyclical buffers, between 1 January 2016 and the end of 2018, becoming effective in 1 January 2019. The consultative document will be submitted to the Financial Stability Board (“**FSB**”) which is coordinating the overall set of measures in respect of G-SIBS. The consultation period began in July 2011 following the release by the FSB of the consultative document, *The Effective Resolution of Systemically Important Financial Institutions* on 19 July 2011. The FSB invited responses to the consultation up to 2 September 2011.

Europe

In light of the Basel III proposals, European Commission (“**EC**”) has published a series of proposals on amending the Capital Requirements Directive (“**CRD**”), which applies to banks, building societies and certain types of investment firm. The amendments to the Directive aim to maximise the effectiveness of the capital rules in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting consumers.

A new Directive amending the CRD (labelled “**CRD2**”) was adopted in September 2009 and Member States were required to transpose the Directive by 31 October 2010 (see below for the UK). CRD2 seeks to strengthen the supervision of cross-border banking groups by requiring close coordination between the supervisor of the member state where the parent undertaking is located, and the

supervisors of its subsidiaries with regard to risk assessment and additional capital requirements. Reporting requirements will be fully harmonised at European level by 2012 and colleges of supervisors, chaired by the supervisor of the parent undertaking, will be established for all cross-border groups. The role of CEBS (now the EBA) has been strengthened and the mandates of national supervisory authorities are given a European dimension.

The Directive also seeks to improve the framework for securitisation practices by obliging originators to retain significant interests in risks transferred onto investors. The classification of hybrid instruments has been harmonised and a central role has been given to CEBS in ensuring greater uniformity of supervisors' practices. New rules on liquidity risk management have been introduced, in particular with regard to the setting up of liquid asset reserves, conducting liquidity stress tests and establishing contingency plans. The supervision of exposures to single counterparties, whatever their nature, have been tightened (in all cases, the limit is 25% of banks' own funds).

A second set of amendments to the CRD ("**CRD3**") was adopted in October 2010. Its provisions relate to capital requirements (re-securitisations, disclosure of securitisation risks and trading book, as prescribed by Basel III) which will take effect no later than 31 December 2011, and to remuneration (as discussed above).

On 28 April 2011, the EBA announced revisions to the Common Reporting Framework ("**COREP**") templates - namely: Capital and Group solvency Details, Credit Risk, Market Risk and Operational risk - in order to incorporate amendments made to the CRD by CRD3. The COREP framework is used by credit institutions and investment firms when reporting their solvency ratio to supervisory authorities under CRD. The changes will apply from 31 December 2011, as above.

Legislative proposals for a regulation and a directive which comprise the package of reforms known as CRD4 were published on 20 July 2011 by the EC. The versions currently published are provisional but final versions are expected soon. It is proposed that the new regulation and directive will repeal the Banking Consolidation Directive (2006/48/EC) and the Capital Adequacy Directive (2006/49/EC) which together currently comprise the CRD. Aligned with the timelines envisaged by the BCBS for Basel III implementation, the proposed directive and regulation are intended to be in force on 1 January 2013, with full implementation expected by 1 January 2019.

CRD4 will implement the Basel III reforms agreed in December 2010 but the content of the new regulation and directive does not exclusively contain Basel III reforms - there are a number of reform proposals in the areas of corporate governance, supervision and sanctions for instance, which go beyond Basel III. It also sets out the EC's proposals for a single set of harmonised prudential rules, known as the single rule book. In terms of coverage, CRD4 will apply Basel III to a broader range of firms including MiFID investment firms which is beyond the remit intended by Basel III.

The proposed regulation comprises detailed quantitative requirements and has direct effect, thus restricting the discretion of national supervisors when applying the provisions. The regulation contains provisions which relate largely to the single rule book such as: quality of capital, quantity of capital, counterparty credit risk, leverage and liquidity.

The new directive is less prescriptive and reflects the necessary interaction of the proposed reforms with respective national laws. It covers areas such as: authorisation of credit institutions and their

passporting rights; corporate governance; sanctions and reforms relating to capital buffers covered by Basel III.

AFME published a pack of explanatory materials on Basel III and CRD4 on 21 June 2011.

UK

The FSA has implemented CRD2 and CRD3 primarily through amendments to the GENPRU and BIPRU sections of its Handbook, with all such amendments coming into force before 1 January 2011 in accordance with the required time frame. The amendments include those related to remuneration discussed above.

The FSA or its successor will be responsible for managing the implementation of CRD4. The FSA has indicated that it expects to publish a consultation paper in respect of the implementation of CRD4 in Q1 2012 which will be followed by a policy statement in Q2 2012.

The FSA has also outlined proposals to amend the rules relating to the capital planning buffer under the Prudential Sourcebook for Banks, Building Societies and Investment Firms ("**BIPRU**"). The FSA expects the capital planning buffer to be set at levels that enables firms to meet their relevant capital ratios at all economic cycle stages. The FSA may specify that elements of the capital planning buffer be held in particular forms of capital. The draft amendments to BIPRU are set out in the schedule to the consultation paper, which can be found by clicking here. Policy statement 10/14 on capital planning buffers for credit institutions, was published on 24 September 2010 which gives feedback on consultation paper 09/30 and sets out the final rules which came into effect immediately on publication on September 24, 2010. It has been said that the rules do not effect any major Handbook amendments, but that they clarify the FSA's approach in practice to setting capital planning buffers.

Although the FSA is responsible for implementing the majority of the amendments to the CRD, HM Treasury is responsible for transposing provisions on supervisory arrangements and new EU regulations on Credit Rating Agencies. In October 2010 HM Treasury published the Capital Requirements (Amendment) Regulations 2010 (SI2010/2628) together with an explanatory memorandum which set out the CRD2 rules on the recognition of credit ratings agencies and its response to issues arising from its January 2010 consultation on the topic.

The FSA consultation paper CP11/9 "Strengthening Capital Standards 3 further consultation on CRD3" was published in May 2011. The deadline for comments in respect of chapters 2-4 closed on 11 July 2011 and for chapter 5 on 11 June 2011. This paper is an update to CP09/29 which set out the FSA's proposals for implementing the changes to CRD made by CRD2 and CRD3. As already mentioned, the deadline for transposition of CRD3 requirements is 31 December 2011. The FSA expects to provide feedback and a Policy Statement confirming the final rules in Q2 2011.

In February 2010, the AFME published good practice guidelines on the CRD securitisation disclosure requirements. The guidelines are proposed to ensure adequate and consistent compliance with the CRD requirements, and the AFME are recommending firms adopt these guidelines when making disclosures from the period beginning 1 January 2011.

The FSA has indicated that it wishes to have discretion to impose more strict capital requirements than under CRDIV. In addition under its recent ICB report it is requiring retail banks to hold more capital. It is arguable whether the FSA will be successful in doing this.

LIQUIDITY REQUIREMENTS

International

The BCBS published a set of frequently asked questions on the Basel III liquidity framework in July 2011. This is a response to interpretation questions which they received following the December 2010 publication of the Basel III regulatory frameworks for capital and liquidity. The production of answers to frequently asked questions is part of BCBS's approach to ensure consistent global implementation of Basel III.

Europe

The EC will implement the Basel III reforms on liquidity requirement through CRD4.

UK

A tough new liquidity regime came into force in the UK in December 2009 (the policy for which is contained in the FSA's Policy Statement PS09/16 "Strengthening liquidity standards" October 2009). The regime introduced new liquidity reporting and quantitative requirements, coupled with a narrower definition of liquid assets. The build up of liquidity buffers will only be implemented once the economy has stabilised. The new rules discourage reliance on short-term wholesale funding, enhance systems and controls requirements, which implement the Basel Committee's updated Principles for Sound Liquidity Risk Management and Supervision, and increase the quality and quantity of liquid asset buffers. Whilst most elements of the regime are to be phased in gradually, the systems and controls requirements came into effect on 1 December 2009.

The FSA initially aimed to phase in tightened quantitative liquidity standards in the years following the introduction of the regime. However, in March 2010, the FSA published a statement stating that it would be "premature" to increase the liquidity requirements at that time as it was continuing to "work with firms that are most affected by the new regime focusing on the steps they are taking to mitigate liquidity risk", as well as contributing to the international debate on liquidity. On 18 November 2010 the FSA published a statement stating that the Basel Committee has moved further towards introducing minimum global liquidity requirements that would be implemented through EU law and that the FSA will consider how best to calibrate the UK regime once these international proposals have been finalised.

In Quarterly Consultation Paper no. 27 published on 6 January 2011 (CP11/1), the FSA proposed minor amendments to BIPRU. This contained proposals in relation to transitional provisions for simplified firms (ILAS BIPRU firms - which are any firms within the scope of BIPRU 12). The proposals extend the transitional period to be allowed to ILAS BIPRU firms by 15 months, (currently until 1 October 2013) to reach 100% of their simplified buffer requirement. Via proposed amendments to the liquid assets buffer scalar, ILAS BIPRU firms would be required to hold: 30% of their simplified buffer requirement until 28 February 2012; 50% until 30 June 2013; 70% until 31 December 31 December 2014 and 100% thereafter at which point the transitional period would cease to apply.

In the same publication, the FSA also proposed amending the definition of "low frequency liquidity reporting firm" to allow branches' reporting frequency to depend on balance sheet assets attributable to the UK branch, rather than the size of the balance sheet of the firm as a whole (which is currently determined by a balance sheet of a size less than £1bn and requires monthly rather than weekly reporting). The FSA expects the effect of this proposal to increase the number of branches which

report monthly rather than weekly. The deadline for comments on these proposals closed on 17 February 2011 and the FSA confirmed in March 2011 in its Handbook Notice 108 that it would be proceed with these proposals but further extended the transitional period for simplified firms to 31 December 2015.

More recently, the FSA has consulted on further minor amendments to the liquidity regime in Quarterly Consultation Paper No. 29 published on 6 June 2011 (CP11/11). The proposed amendments cover, among other things, the reporting requirements related to firms' sterling, US dollar and euro-denominated wholesale liabilities and the associated guidance; amendment to the definition of "DLG by default"; and corrections and amendments to the simplified ILAS approach.

In Consultation Paper 30 (CP11/18), which was published in September 2011, the FSA consulted on further proposed amendments to the liquidity regime, namely: a change to the treatment of collateral held with a central bank in excess of requirements; an amendment to the definition of small and medium-sized enterprise (SME) deposit; and an amendment to certain reporting guidance in SUP (FSA's supervision sourcebook) relating to securities issued by group entities. Comments are accepted on these amendments up to 6 November 2011.

The FSA indicated in its business plan for 2011/12 that it would focus on implementing the liquidity regime for firms through its intensive supervisory approach rather than negotiating and developing policy.

STRESS TESTING

Europe

Following its publication of the results of the 2010 EU stress tests (referred to in our September update) CEBS went on to publish its final guidelines on stress testing. The guidelines are intended to assist institutions in designing and implementing stress testing programmes with a robust governance structure, meaningful senior management engagement and effective infrastructure. The guidelines will also assist supervisors in their assessments of institutions' stress testing. CEBS expected its members to apply the guidelines from 31 December 2010. .

The EBA published the results of its EU wide stress test for 2011 on 15 July 2011. The 2011 stress test, which was applied to 9- banks, comprised the following key features:

- new consistent capital benchmark of 5% core tier 1 capital. The capital threshold for 2011 will be focused on a definition of core tier 1 capital which is more restrictive than that used in 2010;
- common baseline and adverse scenario by the EC and ECB. The 2011 adverse scenario has been designed to be more severe than 2010 CEBS exercise in terms of deviation from baseline forecast and probability that it materialises;
- a quality assurance and peer review process was conducted by the EBA and ESRB between March and June this year;
- the results include clear disclosure of credit and sovereign exposures.

Ahead of this stress test, banks were given an incentive to strengthen their capital positions as the EBA allowed specific capital increases made in the first four months of 2011 to be taken into account.

Further, on the basis of the 2011 stress test results, the EBA issued its first formal recommendation that national supervisory authorities should require banks to remedy promptly any capital shortfall below the 5% core tier 1 capital threshold. The EBA also recommended that banks with a core tier 1 capital ratio above but close to 5% which also had significant exposure to sovereigns under stress, should strengthen their capital position. The EBA will produce progress reports in respect of these recommendations in February and July 2012.

UK

Under the FSA's stress test policy, published in December 2009, firms are expected to implement robust and effective stress testing programmes (including reverse stress testing) which assess their ability to meet capital and liquidity requirements in stressed conditions. The FSA will also stress test a number of firms on a periodic basis to assess their ability to meet minimal capital levels throughout a stress period. The FSA updated its stress testing website in August 2010 to remind firms to submit their implementation plan templates, and to list a number of surgeries held in September and October 2010, which provided feedback on stress testing issues and case studies.

The FSA published Frequently Asked Questions in relation to reverse stress testing on its website on 18 May 2011.

CLIENT MONEY

As we touched on in our September 2010 and February 2011 alerts, the FSA has upped its monitoring of firms' compliance with the existing Client Assets Sourcebook ("**CASS**") regime.

In March 2009, the FSA wrote to firms' compliance officers reminding them of the CASS requirements to protect client money and assets, and announced it was embarking on visits to authorised firms to further assess their compliance with CASS. During its firm visits in 2009 the FSA identified a number of particular failings by firms, including inadequate management oversight and control, unclear arrangements for segregation of client money, lack of establishment of trust status for segregated accounts, limited due diligence and review of banks, credit institutions or qualifying market funds used for holding client money, and incomplete or inaccurate records, accounts and reconciliations. In June 2010, the FSA issued its largest ever fine to JP Morgan Securities Ltd (£33 million) for failing to segregate client money appropriately.

Partially in response to its firm visits, a number of initiatives have been undertaken by HM Treasury and the FSA to address what are perceived as serious failings in firms' handling of client money, and weaknesses in the current client assets regime. The initiatives include the following:

- CF10: creating a new 'controlled function' for client assets oversight by 1 October 2011. This will be known as control function CF10a and applications for individual approval will be possible from 1 May 2011;

- CMAR: re-introducing a client money and asset return (the "**CMAR**"). The CMAR must be reviewed and authorised by the individual holding the CF10a controlled function (when established), on a monthly basis for medium and large firms, and bi-annually for small firms, based on the FSA's proposed firm classification framework. Firms were obliged, under CASS 1, to categorise themselves as small, medium or large by 31 January 2011 and notify the FSA of their client money figures.

On 10 February 2011 the FSA published a consultation paper (CP11/04) on the operational implementation of the CMAR which is to be submitted via GABRIEL, the FSA's online information gathering system. The period for comment closed on 10 April 2011 and the FSA issued a policy statement on the topic on 27 May 2011 (PS11/06). This policy statement reports on the main issues arising from the consultation and publishes final rules for CASS medium and large firms. Proposals in relation to CASS small firms reporting arrangements and their related final rules were published slightly earlier in FSA Handbook Notice on 3 May 2011.

The FSA will adopt a phased approach to the implementation of the CMAR, the new rules for medium and large firms will now come into force on 1 October 2011, whereas those for small firm reporting began on 1 June 2011. CASS small firms are not yet required to complete the CMAR but were instead required to provide the FSA with their highest client money balance and value of client assets in the previous six months by 21 July 2011.

- TTCA: from December 1 2010 the FSA has restricted the use of title transfer collateral arrangements in relation to margin payments held by CFD and speadbetting market-makers (under which a client agrees that monies or assets should be treated as collateral in respect of the firm's arrangements and that full ownership of such monies or assets is transferred unconditionally to the firm) to non-retail clients;
- The FSA has provided further guidance on 'money due and payable' provisions in CASS 7.2.9R, aimed at firms providing contracts for difference or spread betting services specifically;
- From 1 June 2011 the FSA restricted the amount in client bank accounts held with institutions within the same group, to 20% of the firm's total client money.
- As from 1 March 2011, re-hypothecation transparency and disclosure requirements apply to prime brokerage clients. These proposals apply only to UK authorised prime brokers at the moment. However, the FSA intends to consider whether these proposals should be applied more broadly to other market participants who enter into "rights of use" arrangements to ensure a level playing field.
- HM Treasury proposals on client money and assets. These proposals are part of the Treasury's work on establishing effective resolution arrangements for investment banks. The proposals deal particularly with how client assets and monies are treated on the insolvency of the bank. The government has introduced the Investment Bank Special Administration Regulations 2011 and the Investment Bank (Amendment of Definition) Order 2011 into parliament. One of the objectives of this legislation is to ensure that client assets and money held on trust by an investment firm can be returned by an administrator as quickly as possible in the event of the investment firm's insolvency.

FINANCIAL REPORTING

In October 2009 the FSA published a discussion paper on enhancing financial reporting disclosures by UK credit institutions. The paper proposes addressing disclosure issues by either requiring the use of specified disclosure templates or by the application of a voluntary code for financial reporting disclosure. A draft code on financial reporting disclosure, developed by the BBA, is included amongst the annexes to the discussion paper.

The FSA are focusing on the transaction reporting requirements, and taking enforcement actions when firms have not complied. In April 2010 the FSA fined six companies, including four companies in the Credit Suisse group, a total of £4.2m for such compliance issues. Firms therefore need to ensure that their transaction reporting policies are comprehensive so that any errors arise early on. In addition firms that rely on third parties to report their transactions should take steps to follow up with the third party to ensure that it is correctly reporting the transactions.

The FSA published feedback statement 09/03 in September 2010 which outlines issues raised as a result of the consultation, an assessment of current compliance with the draft BBA code and changes to the final BBA code made as a result. The statement also sets out the FSA's expectations for firms' 2010 financial disclosures.

On the 10 March 2011 the FSA and the Financial Reporting Council ("**FRC**") jointly published a feedback statement as a summary of their response to a joint paper discussing improving the role of auditors in prudential regulation. Among other initiatives, the FSA is developing a draft code of practice in conjunction with the BoE and is formalising cooperative arrangements between the FRC's Audit Inspection Unit and the FSA in a Memorandum of Understanding.

SPECIAL RESOLUTION REGIME

Part 1 of the Banking Act 2009, which came into force on 21 February 2009, creates a special resolution regime ("**SRR**") for dealing with UK banks that get into financial difficulty. The SRR consists of three stabilisation (pre-insolvency) options, a bank insolvency procedure and a bank administration procedure.

The three stabilisation options are the ability to transfer part or all of a failing bank or building society to a private sector purchaser, a publicly controlled bridge bank (a company wholly owned and controlled by the BoE), and to temporary public ownership (to a nominee of the Treasury).

There had been concern that the ability to transfer part of a failing bank would lead to legal uncertainty and a reduction in confidence of counterparties in doing business with such firms, especially for those counterparties entering into close-out netting arrangements.

The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (more commonly known as the Safeguards Order) protects transactions commonly found in set-off, netting and collateral arrangements from being partially transferred to another entity. The protection extends to swaps, options, futures contracts, contracts for difference and other types of derivatives contracts. Despite this protection, the general lack of clarity surrounding the partial transfer of rights may make potential counterparties more hesitant in dealing with UK banking entities. To date, the only example of the BoE exercising its powers under the Banking Act 2009 to transfer liabilities from a failing bank or building society is in the case of the Dunfermline Building Society. In this case, part of the business of the building society was transferred to a private sector purchaser, Nationwide Building Society, and part was transferred to a bridge bank.

Although the Tripartite Authorities have acknowledged that such powers may remove or adversely affect property, employment and other rights, they believe it justified in relation to the European Convention on Human Rights on "strong public interest grounds."

The Banking Liaison Panel, consisting of representatives of the Treasury, FSA, the BoE, the Financial Services Compensation Scheme ("**FSCS**") and the banking sector, together with financial law and insolvency experts has ongoing responsibilities to keep the powers and regulations of the regime under review. However, no publications have been made as yet by the panel.

SPECIAL ADMINISTRATION REGIME

On September 16, 2010 the UK Treasury published its final consultation paper seeking views on its proposals for a new Special Administration Regime for investment firms. Draft regulations were published in draft in early 2011, including changes resulting from the consultation, and on 8 February 2011, the final Investment Bank Special Administration Regulations 2011 (*SI 2011/245*) and The Investment Bank (Amendment of Definition) Order 2011 (*SI 2011/239*) came into effect. The regulations provide for a single "special administration" procedure ("**SAR**") for insolvent investment banks.

The Banking Act 2009 excludes investment banks from the new Bank Insolvency and Bank Administration procedure it provides for, to the extent they are not authorised deposit-taking institutions. However, HM Treasury retained the power to introduce future legislation modifying insolvency law in relation to investment banks. Section 232 of the BA 2009, in summary, defines "investment bank" as an institution that is authorised to carry on certain regulated activities related to investments, that holds client assets and is incorporated or formed under UK law.

In the wake of the collapse of Lehman Brothers Limited in 2008 and the ensuing confusion regarding client assets and ownership, the SAR aims to facilitate an investment bank's assets being either returned to clients, or retained if the bank can be rescued as a going concern. The following special administration objectives ("**SAOs**") will apply to an administrator appointed under the SAR regime.

- SAO 1: to ensure the return of client assets as soon as is reasonably practicable;
- SAO 2: to ensure timely engagement with market infrastructure bodies and the Authorities (being the Treasury, the FSA and the BoE); and
- SAO 3: to rescue the investment bank as a going concern, or else to wind it up in the best interests of its creditors.

An SAR administrator can be appointed by any party who would be entitled to appoint a non SAR administrator on the grounds of insolvency. The FSA has power, after consulting with the Treasury and the BoE, to direct a SAR administrator to prioritise one or more SAOs if it is in the interests of financial stability or the maintenance of public confidence to do so. Other changes from the usual administration regime include the power of the administrator to make distributions to creditors and to take action for wrongful or fraudulent trading. Such powers are currently reserved for liquidators only.

As many large banks in the UK operate both investment banking and deposit-taking arms, the Government proposes to enable both arms of such banks to be dealt with under a single insolvency procedure. As such, where an investment bank is also a deposit taking institution, the FSA may apply to court to place the bank in a modified form of bank insolvency or bank administration, where the administrator is obliged to pursue dual objectives which include the SAOs.

PRODUCT INTERVENTION

The FSA published a discussion paper (DP11/01) on product intervention on 25 January 2011, which contained controversial proposals for the FSA (through the new Financial Conduct Authority – previously called the CPMA) to have the power to pre-approve products, ban products, intervene on pricing (e.g. through fee caps) and mandate risk warnings.

The HM Treasury, in its February 2011 consultation paper entitled "*A New Approach to Financial Regulation: Building a Stronger System*" (Cm 8012), also considered the scope of the product intervention powers of the new FCA.

On 14 June 2011 the FSA published its Product Intervention feedback statement (FS11/3) in response to DP11/01. The discussion paper and the feedback statement reflect the wider debate about the regulatory philosophy to be adopted by the Financial Conduct Authority as one of the proposed successors to the FSA and the future of financial regulation in the UK as a whole. The FSA's Business Plan 2011/12 highlights the emphasis that the FSA now places on product intervention as an integral part of its consumer protection strategy. In the feedback statement, the FSA has posited the development of a single set of rules and guidance on product governance building upon existing principles, systems and control rules and TCF guidance.

OTC DERIVATIVE REFORM

International

Over the counter derivatives trading and the perceived risk surrounding the activity, continues to generate much discussion amongst regulators. The lack of public information available on the valuation of underlying assets (particularly in the context of certain bespoke credit derivative transactions), the price formulation of contracts and the potential domino effect that can result from the lack of a central counterparty, has been said to have perpetuated the financial crisis. This view led to the G20 leaders' agreement in September 2009 that:

- "all standardised OTC derivatives contracts should be traded on exchanges...and cleared through a central counterparty by the end of 2012 at the latest;
- OTC derivative contracts should be reported to trade repositories; and
- Non-centrally cleared contracts should be subject to higher capital requirements."

On 15 April 2011, the Financial Stability Board ("**FSB**") published its first progress report, based upon a survey conducted in January 2011, on the implementation of the G20 reforms of the OTC derivatives market. This was followed by a progress report published by the International Swaps and Derivatives Association ("**ISDA**") published on 13 May 2011.

Europe

Following a period of consultation ending on 10 July 2010, the European Commission (the "**EC**") published a proposal for a Regulation on OTC derivatives, central counterparties and trade repositories (COM(2010) 484/5). This is known as EMIR.

The EMIR makes the use of a central clearing party ("**CCP**") compulsory for certain OTC derivative contracts and traders (subject to threshold conditions), and attempts to improve risk and collateral management in those contracts where a CCP is not required. It also imposes an obligation on certain counterparties to report all OTC derivatives (whether or not cleared) to a registered *"trade repository",*

which will, in turn, be under a duty to make information available to the relevant member state regulators. Further provisions deal with the management and governance of the CCP's and trade repositories which will necessarily be established for the purpose of compliance with the Regulation. Due to the global nature of derivatives trading, the EMIR has been drafted with the express intention of aligning its requirements with the similar reforms proposed in the US, under the Dodd-Frank Act.

EMIR was debated during a European plenary session on 2 July 2011. However the vote on EMIR has been postponed until a plenary sitting in Autumn 2011 when it is expected that EMIR will be adopted. We are expecting the final version to be published on 19 October 2011. If agreed, EMSA will then have the task of preparing and submitting draft technical standards for EMIR to the EC; this is currently timetabled for 30 June 2012. EMIR is currently expected to apply in member states by the end of 2012 or early 2013.

Depending on the threshold conditions developed by ESMA, is likely that EMIR will increase compliance cost significantly for OTC traders.

UK

The FSA Director of Markets, Alexander Justham gave a speech on OTC derivatives in June 2011 at the International Derivatives Expo in London. He set out action points for firms and market participants which included engaging with ESMA during its drafting of detailed rules for a mandatory clearing system. He also expressed concern that inconsistencies between EMIR and the Dodd Frank Act, for example in the area of product exemption do not create arbitrage opportunities. He also urged firms to continue to prepare for the major changes which will result from the implementation of mandatory clearing, despite this still being some way off.

REVIEW OF THE MARKET IN FINANCIL INSTRUMENTS DIRECTIVE ("MiFID")

MiFID has been in force since November 2007 and is still currently under review by the EC. The Commission issued a consultation paper on 8 December 2010 on possible amendments to MiFID, the comment period for which closed (after a controversially short period) on 2 February 2011.

The Commission considers that the existing MiFID framework (which is essentially based on shares and regulated markets) must be updated to capture today's more complex market reality. Such reality is characterised by an increasing diversity in financial instruments and methods of trading. The focus, above all, is on transparency. This is a departure from the Commission's previous focus on increasing competition through the EEA.

Overall the proposals under consultation attempt to:

- establish a safer, more transparent, more responsible financial system in the wake of the financial crisis;
- target less regulated and 'more opaque' parts of the financial system e.g. instruments traded over the counter in accordance with the recent G20 consensus;
- target the commodities markets, due to the increased presence of financial investors arguably leading to excessive price increases, price dislocation and volatility, and due to recent concerns about integrity in EU energy and carbon markets;
- provide for rapid changes in market structure and technological development in EU equity markets e.g. the development of high frequency trading;

- strengthen investor protection; and
- contribute to the development of a 'single rulebook' for EU financial markets, by minimising the discretion Member States have under EU financial services regime.

The details of the review are extremely wide ranging and reforms are suggested to almost all elements of MiFID relating to market structures, transparency, conduct of business and client classification (amongst other areas). The most contentious changes involve the plans to make "dark" trading pools more transparent, the removal and narrowing of exemptions applicable to commodities firms and the granting of the power to ban certain products to the ESMA. It can be said that the increased burden on service providers may well be significant and the extent to which investors will feel the corresponding benefits considering the cost, is unknown.

A formal Commission proposal for reforming legislation was expected by 5 July 2011 but this deadline has now been revised until autumn of 2011. We are expecting a final draft on 19 October 2011.

FINANCIAL SERVICES COMPENSATION SCHEME

On 22 September 2010, the FSCS published a press release confirming that, as from 1 January 2011, the compensation limit for deposits would increase to the sterling equivalent of EUR100,000. The current limits are now £85,000 for deposits and £50,000 for investments. The increase for deposits reflects the implementation of Directive 2009/14/EC which amended the Deposit Guarantee Schemes Directive ("**DGSD**") (94/19/EC) to increase the minimum level of deposit protection to EUR100,000 by the end of 2010. As a common limit has been adopted it is unlikely that the FSA's proposals to increase the limit for temporary high deposit balances as referred to in our September update will be continued.

Further rules came into effect on 31 December 2010 to effect the implementation of the DGSD. These include fast payout rules meaning many individuals and small businesses will receive compensation within seven days and all payments within 20 days.

<u>The Banking Act 2009</u>

Part 4 of the Banking Act 2009 gives the Treasury the power to make certain changes to the FSCS, including introducing 'pre-funding' of the FSCS by allowing the FSCS to impose levies to build up contingency funds in advance of possible defaults by firms.

The Treasury is given the power to require the FSCS to contribute to the costs of applying the special resolution regime to banks and building societies facing financial difficulties, and to allow the FSCS to invest levies collected to build up contingency funds in the National Loans Fund. Broadly speaking, initially only firms whose activities fall within the same sub-class of business as the activity of the failed business which has given rise to the claims are liable to make contributions. There are 5 classes of firm, each of which is divided into subclasses.

The FSCS announced its annual levy for 2011/12 as £217m. On 16 June 2011, Southsea Mortgage and Investment Company Limited (Southsea) was placed into the Bank Insolvency Procedure. Under the fast payout process, the FSCS started paying compensation to depositors immediately and paid the majority of Southsea's customers within two days. However, the £7.3m compensation required as a result of Southsea's default was not included in the 2011/12 levy. The FSA advices that firms should use the current fee calculator based upon the £217m levy as normal but that they should calculate an additional payment of approximately £8.27m per £1m of protected deposit as at 31 December 2010 in respect of additional compensation costs for the deposit class.

COMPLAINT HANDLING

In 2010 the FSA has published the findings from its review conducted into the standards of complaints handling in banks. Although the review focused on banks, the FSA is keen to emphasise that its findings are likely to apply to all regulated sectors. Overall the FSA found that almost all banks had deficiencies in their complaints handling, noting the following aspects in particular:

- *Lack of senior management involvement* – "very low levels of senior management engagement" were found, which in turn meant that there were not effective complaint monitoring processes in place and complaints handling was very results-based in those banks, rather than focusing on achieving a fair outcome for complainants.
- *Lack of training/competency of front-line staff where two stage processes used* – in banks where complaints were initially dealt with by front-line staff, whose roles were not exclusively focused on complaint handling, there was a significant contrast with their complaints handling ability and the ability of the specialist complaints handling staff. The FSA is advocating increased training for front-line staff, so that complaints are more frequently resolved at this early stage. Good practice highlighted includes management providing support (which was updated on a regular basis) on how to deal with the most common complaints.
- *Conflict of interest for complaints handlers where amount of redress linked to salary/bonus* – two banks set targets for staff as to the amount of redress paid, which made complaints handlers more reluctant to pay redress to complainants. Good practice highlighted rewarded staff for resolving high volumes of complaints which achieved fair outcomes for complainants.
- *Inadequate amounts of redress paid* – compensation paid by banks tended not to be appropriate (including payment for inconvenience and distress), and that there were inadequate offers to undertake remedial action.
- *Poor quality investigations into complaints* – regular failures to obtain all relevant information relating to the complaint, including failures to communicate adequately with complainants with regard to the investigation and the outcome of the investigation.

Following this review the banks that the FSA investigated have agreed to remedial measures to update their complaints handling procedures.

The £2.8 million fine imposed by the FSA against the Royal Bank of Scotland plc and National Westminster Bank plc on January 7, 2011 showed the FSA's willingness to take action in this sphere and its intention to ensure fundamental changes are implemented. The fine was based on breaches of Principle 3 (management and control); Principle 6 (requiring firms to pay due regard to the interests of their customers and treat them fairly); and Rule 1.4.1R of the FSA's Dispute Resolution: Complaints sourcebook (DISP) (requiring firms to adhere to certain rules when handling complaints).

Complaints handling is a focus area for the FSA. Its consultation paper 10/21 published in December 2010, put forward several important new proposals in this area, such as requiring firms to identify a senior individual responsible for complaints handling.

On the 27 May 2011, the FSA confirmed new complaints handling rules and an increase in the Financial Ombudsman award limit to £150,000. In CP11/10, the FSA confirmed the following changes to the Dispute Resolution Complaints (DISP) sourcebook: (i) the two-stage complaints-handling process will be abolished with effect form 1 July 2012; and (ii) firms are required to identify a senior individual responsible for complaints handling and the FSA will set out guidance on how firms can meet the existing requirements relating to root-cause analysis, with effect from 1 September 2011 (a

month later than originally expected). Further minor changes to DISP based on responses to the FSA's March 2010 publication DP10/1 and in anticipation of UCITS IV took effect from 1 July 2011 in respect of UCITS IV and 1 September 2011 otherwise.

The FSA also published a report on 1 June 2011 containing its review of complaint handling in banking groups. The review found poor complaint-handling standards in most of the banks which the FSA assessed. The FSA commented that this was the result of poor governance arrangements, polices and procedures. However, a few banks demonstrated that banks could handle high volumes of complaints with consistently fair particular. Overall the FSA found that most banks had not embedded a culture of delivering fair outcomes for complainants, this was particularly due to a lack of senior management engagement with complaints handling and inadequate procedures and training. In addition, many front-line staff were found to be without inadequate support which often resulted in incorrect decisions being made and that adherence to process was too often pursued rather than quality and fairness of response. The FSA also commented that the degree and quality of root cause analysis varied between banks. HERE

INTER-BANK PAYMENT SYSTEMS

Part 5 of the Banking Act 2009 gives the Treasury the power to make a recognition order in respect of an inter-bank payment system where it is satisfied that any deficiencies in the design of such system, or any disruption of its operation, would be likely to threaten the stability of, or confidence in, the UK financial system, or have serious consequences for business or other interests throughout the UK.

The BoE assumed responsibility for oversight of payment systems under Part 5 on 31 December 2009 and has adopted 14 principles which system operators must comply with, and which may be found here. The Bank may require such operators to establish rules for the operation of their systems. The Bank's September 2009 paper explaining how it intends to fulfil its responsibilities of overseeing inter-bank payment systems may be found here. The competent authority for firms providing payment services under the Regulations is the FSA. The interaction between the FSA and the BoE has been clarified in a recent Memorandum of Understanding.

The Treasury must revoke a recognition order where an inter-bank payment system no longer meets the requirements set out. Any person wishing to make a request to the Treasury to make a recognition order in respect of an inter-bank payment system or to make representations for the de-recognition of a recognised system should contact the Payment Systems Unit. Treasury guidance on the recognition process for inter-bank payment systems can be found here.

The Treasury has launched a consultation on extending the BoE's powers under Part 5 by allowing it to disclose specified information for the purpose of, or in connection with, criminal investigations and proceedings, or for those investigations and proceedings that could result in the imposition of civil penalties. The consultation also sets out the circumstances under which the BoE may publish specified information.

The Banking Act 2009 (Inter-Bank Payment Systems) (Disclosure and Publication of Specified Information) Regulations 2010 (SI 2010/828) came into force on 9 April 2010 which:

- Enable the BoE to disclose specified information with a broader range of persons and in a greater range of scenarios than is currently permitted under the Banking Act.
- Set out the circumstances in which the BoE can exercise its right to publish specified information, including when it is obliged to consult with the FSA prior to publication.

CODE OF TAX CONDUCT

HM Revenue and Customs ("**HMRC**") introduced a voluntary code of tax conduct for all banks operating in the UK in 2009. The code states that;

- banks should have strong governance around tax, which is integrated into their business decision making
- they should follow the spirit of the law in addition to the letter – meaning that banks can undertake tax planning to support their business operations, but this should not be used to achieve tax results that are contrary to the intentions of Parliament
- HMRC and the banks should work together to encourage mutually open and transparent relationships

Although signing up to the code is voluntary, failure to sign is taken into account by HMRC in assessing the bank's risk status and is likely to result in greater scrutiny. There is no sanction for non-compliance following signature though pressure will be put on the board to comply, and reports might be made to professional bodies when appropriate. HM Treasury announced on 30 November 2010 that the top fifteen banks operating in the UK have now adopted the Code of Practice on Taxation, following pressure in late 2010 from new Chancellor George Osbourne. As at the 17 October 2010, only four out of the top fifteen banks had adopted the code.

UK REGULATORY REFORM

Finance (No.3) Bill 2010-2011

This received Royal Assent on 19 July 2011 and so while it is still referred to as a bill it is in fact an Act and shall be referred to here as the Finance No.3 Act. The Finance No.3 Act puts in place many of the measures announced in the 2011 Budget given on 23 March 2011. For the purpose of this update, the Finance No. 3 Act introduces the bank levy which is intended to make banks contribute to a degree that reflects the risk that bank failure poses to the UK financial system and global economy.

Financial Services Act 2010

The Financial Services Act 2010 (the "**FS Act**") received Royal Assent in April 2010, and has resulted in the following changes to the regulatory regime;

- *Living wills* - the FSA may require authorised firms to prepare and keep up to date recovery and resolution plans (i.e. so called 'living wills'). A recovery plan would set out the proposed actions of a firm experiencing stressed conditions, such as restructuring or the scaling back of operations. Resolution plans would set out actions to be taken upon the failure of a business, or when failure is likely. Such plans may identify any obstacles to the authorities in applying resolution tools or to the insolvency official carrying out his duties and put forward actions that may facilitate the effectiveness of such tools and ease in carrying out such duties. Britain's largest banks were required to present their "living wills" to the Financial Services Authority in October 2010, ahead of the G20 summit in Seoul in November. On 9 August 2011 the FSA published its proposals for recovery and resolution plans in consultation paper CP11/16. The FSA proposes that regular submissions of firms' recovery and resolution plans begin from 2013. Responses to the consultation paper are invited by 9 November 2011.

- *Disclosure of Short selling* – the FSA has set out its short selling rules in its new Handbook module Financial Stability and Market Confidence Sourcebook which came into force in June 2010. Holders of “significant net short positions” in UK institutions such as banks and insurers must disclose these positions. However, the FSA acknowledges that these rules will be superseded once a European short selling disclosure regime has been finalised.

- *Increased powers of suspension of firms and approved persons* – under the FS Act, the FSA has been given the power to suspend or impose restrictions on approved persons, and impose penalties on persons who perform controlled functions without approval. In addition the limitation period within which the FSA must take action against an approved person has been extended from two to four years.

- *Information gathering* – the FSA has been given new information gathering powers under the FS Act, and is proposing to request information as required so that it can identify threats to financial stability, which includes developing threats and threats which arise through the activities of unauthorised entities.

- The Consumer Financial Education Body (CFEB) was established in April 2010 to increase public awareness of the FSA.

New financial services regulatory structure

A major element of the FSA’s reform programme is the creation of the new supervisory architecture which is to come into operation by the end of 2010. HM Treasury published a consultation paper on 17 February 2011 which builds on George Osborne’s Mansion House Speech in June 2010 and reflects responses to previous consultations and reports. The consultation paper provided detail on the Government’s proposals to:

- abolish the existing tripartite system of the BoE, the FSA and the HM treasury;

- make the BoE solely responsible for macro-prudential supervision;

- provide the BoE with adequate powers to address aggregate risks and vulnerabilities identified across the financial system which have the potential to threaten overall stability;

- enhance macro-economic stability by addressing cyclical imbalances through the financial system; and

- bring the monitoring of firms on a collective and individual level closer together, by bringing macro-prudential oversight and macro-prudential regulation under the ultimate control of the BoE.

The main idea in the break up of the FSA is to split the responsibility for macroeconomic and microeconomic regulation, with the aim of preventing another economic crisis (or failing that, providing better leadership should another economic crisis occur).

The FSA will be broken up into two organisations, Prudential Regulation Authority (“**PRA**”) and the Financial Conduct Authority (“**FCA**”). One notable change in the consultation paper is that the name of the latter which is to be responsible for conduct of business regulation, as well as most of the FSA's existing market regulation functions, has been changed from the Consumer Protection and Markets Authority (“**CPMA**”) to the catchier, FCA. The Financial Policy Committee will sit as a committee within the BoE and will be responsible for macroeconomic policy. The consultation paper provides information on the macro-prudential tools potentially available to the FPC to address systemic risk, including capital requirements, liquidity tools and collateral requirements.

The consultation paper also includes further detail and proposals on the following:

- The primary legislation introducing the reforms will amend the Financial Services and Markets Act 2000.
- The statutory objectives of the new FCP, PRA and FCA, including the fact that the FCA's objectives will include a greater emphasis on competition issues.
- The nature of the firms to be dual-regulated by the PRA and the FCA, which will include investment firms classified as BIPRU 730K firms and Lloyd's of London, as well as other insurers and deposit-takers.
- Accountability mechanisms for the new regulators.
- Co-ordination between the new regulators, including in crisis management situations.
- The approaches of both the PRA and the FCA to regulation. The former will be "judgement-led" while the latter will take a more interventionist stance.
- The PRA and FCA's enforcement powers. In particular, the Treasury power is proposing giving the FCA greater power regarding product intervention (including the power to ban products for up to 12 months), financial promotions (including publishing when the FCA has forced a firm to amend or withdraw a financial promotion) and the early publication of enforcement actions (controversially including publishing when a warning notice has been sent to a firm, even if this is subsequently withdrawn).

This was followed by the publication on 16 June 2011 by HM Treasury, of a consultation document and white paper, including the draft Financial Services Bill, which builds on the Government's previous consultations in July 2010 and February 2011. The June 2011 consultation document provides details of the Government's proposals and how these proposals may be given legislative effect. The consultation period closed on 8 September 2011.

The draft Financial Services Bill is not an official parliamentary documents and will need to undergo pre-legislative parliamentary scrutiny. It makes a number of amendments to legislation already in force, notably FSMA. In light of this, the Treasury has produced a consolidated version of FSMA to reflect proposed amendments made by the Draft Financial Services Bill.

The move to "twin peaks" regulation has been seen as controversial as a result of concerns of overlapping obligations and duplication for larger firms who will be subject to the oversight of both bodies. However, certain firms have welcomed the guidance in the consultation paper, and it is hoped that communication between the peaks will take into account the position of such firms.

On the same day, HM Treasury and the BoE announced the delayed establishment of the interim Financial Policy Committee ("**FPC**") and the appointment of four external members to it - Alastair Clark, Michael Cohrs, David Kohn and Richard Lambert. The external members will join Mervyn King, as Chair, the BoE's Deputy Governor for Financial Stability, Paul Tucker, the BoE's Deputy Governor for Monetary Policy, Charlie Bean, the Chief Executive of the FSA, Hector Sants (in his capacity as future Deputy Governor for Prudential Regulation of the BoE and Chief Executive of the new Prudential Regulation Authority ("**PRA**")), the Chairman of the FSA, Adair Turner, the BoE's Executive Director for Financial Stability, Andy Haldane, and the BoE's Executive Director for Markets, Paul Fisher. There will also be two non-voting members of the interim FPC. The FPC will be responsible for '*macro-prudential surveillance'* in the UK, operating in line with the global work of the IMF, the Financial Stability Board and the European regulatory bodies in this area.

Independent Commission on Banking

In addition to the reform highlighted above, in June 2010 George Osborne also announced the establishment of the Independent Commission on Banking (the "**ICB**"), to be chaired by Sir John Vickers. The ICB's job has been to formulate policy recommendations, with the following scope and objectives:

- reducing systematic risk in the banking sector, exploring the risk posed by banks of different size, scale and function;
- mitigating moral hazard in the banking system;
- reducing both the likelihood and impact of firm failure; and
- promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail.

The government also published Terms of Reference for the ICB, which detailed the ICB's remit to make recommendations. Their remit was focused on structural measures to reform the banking system, along with related non-structural measures which promote stability and competition in banking for the benefit of consumers and businesses.

On 12 September 2011, the ICB published its Final Report in which it sets out its recommendations for banking reform in the UK. In accordance with the Terms of Reference, the Final Report identifies two broad areas of reform: (i) financial stability, and (ii) competition.

To improve financial stability in the banking sector, the ICB recommends the ring-fencing of retail banking services and that banks should be required to hold more capital relative to their assets, in order to increase their loss-absorbency. More specifically it suggests that large ring-fenced banks should be made to hold at least 10% equity against their risk-weighted assets - a stricter capital maintenance requirement than any imposed under Basel III.

The ICB also emphasises the need to promote competition in UK banking in the Final Report. It recommends various ways in which to enhance customer choice, for example through the introduction of an effective account switching service.

The ICB recommends that the reforms be adopted as soon as possible, but proposes a full implementation by 2019, in line with Basel III.

Future of Banking Commission report

The Future of Banking Commission was established in December 2009 by Which? as an independent commission with the aim of putting the wider interests of society at the heart of any reforms to the banking system. It invited comments from the general public on their opinion of banks and banking reform, and in June 2010 published its report on recommendations for banking reform.

The report notes that most of the planned banking reform has focused on increasing bank capital, however the Future of Banking Commission do not view this as being sufficient. They believe that "significant reform to the structure, regulation, governance and culture of the industry" is required. The key recommendations for reform are as follows:

- the introduction of living wills;
- increased depositor protection, including clearer promotion of products which are not covered by the FSCS compensation scheme;
- extending the Volcker rule (splitting proprietary trading from other activities of banking conglomerates) to prohibit banks that advise clients from trading any form of security, and separating corporate advice from investor advice;
- all securities above a certain size (including derivatives) should only be tradable if they are registered on a system such as the Stock Exchange Daily Official List;
- splitting regulation of banks into three functions (consumer protection regulation, prudential regulation and systemic risk regulation), in a similar way to the reform that has now been announced by the government (noted above); and
- changing the culture of banking, including remuneration not purely based on sales and the development of a "Good Financial Practice Code".

The report has been submitted to the Chancellor, George Osborne and many of the recommendations are reflected in the current reforms. The Future of Banking Commission is headed by Conservative MP David Davis, and has Vince Cable as a member.

EUROPEAN REFORM

A similar structural shake up is occurring from the European perspective with the creation of the following new bodies:

- the European Systemic Risk Board ("**ESRB**"); and
- the European System of Financial Services which will be composed of three new European Supervisory Agencies ("**ESAs**") – (i) the European Banking Authority; (ii) the European Insurance and Occupational Pensions Authority; and (iii) the European Securities and Markets Authority ("**ESMA**").

The three new ESAs, together with the ESRB, have extensive new powers including the ability to impose directly binding technical standards. The ESAs will coordinate the work of national regulators, and they will also be able to mediate and arbitrate in any disagreements between national regulators. Of the three, the powers of ESMA which has direct and exclusive supervisory powers over credit rating agencies as well as supervisory powers over trade repositories under the proposed regulation on OTC derivatives markets, appear the most wide ranging and direct.

In terms of these institutions' significance, Hector Sants, in his speech on the future of insurance regulation has gone so far as to say: "Going forward, the FSA and its successor authorities will thus essentially be a supervisory arm of an EU policy setting body." It is important that the UK authorities lobby in respect of European reforms to ensure the best results for UK firms. It will be too late once European proposals have been adopted. In addition, a knowledge of the EU regulatory structure and reforms is important to the compliance arms of UK firms.

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Author

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