THE BANKING REGULATION REVIEW

Tenth Edition

Editor
Jan Putnis

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PREFACE

Banking regulation continues to confound the idea that views about how banks should be regulated will eventually settle down to an orthodoxy broadly accepted throughout the world.

Few global banking groups ever considered that a time would come when they would face consistent systems of regulation across the world, and still less that regulators would coordinate their activities in a way that would make life easy for those groups. Legal and compliance professionals who have worked in or with the industry since long before the financial crisis of 2007 to 2009 are generally not surprised by the examples of banking regulation diverging in many jurisdictions: in some ways it marks a return to a time when there can be no certainty that governments and regulators are all facing the same way and pulling in the same direction.

Running a global banking group continues to be a tough exercise, and the possibility of further fragmentation of approaches to regulation around the world risks adding further to the cost bases of these groups. As predicted since the UK electorate voted to leave the European Union in 2016, Europe in particular looks set to become a less cost-efficient and more complex place in which to run a cross-border banking franchise. Indeed this is already the case for the banking groups that have largely completed their Brexit reorganisations, establishing or expanding EU subsidiaries. While this has stimulated banking groups to consider cost cutting and other efficiency measures in connection with their Brexit planning, in many cases these measures scarcely compensate for the inherent inefficiency of requiring additional licensed legal entities through which to conduct business in Europe.

Aside from the largely regional challenge of Brexit, this tenth edition of *The Banking Regulation Review* is published in the midst of a number of industry developments that are challenging regulators and banks alike in all major banking centres.

The challenges are far-reaching and have no central theme, ranging from the continuing revolution in finance stimulated by emerging technologies and the related exploitation of the value of data on the one hand, to the continual revelations of the widespread use of banks for money laundering on the other.

While it is too early to say that the remarkable global consensus that emerged about prudential regulation following the financial crisis is fracturing, it is certainly eroding around the edges, with liberalising tendencies in the United States and even in the European Union.

All of these factors make work as a legal, compliance or risk professional in the sector both more interesting and more perilous than ever before: more interesting because there is so much going on, and more perilous because there seems to be more that can go wrong within banks nowadays, from misallocation of capital to business units that struggle, to whistleblowing and money laundering problems, to catastrophic IT outages.

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Money laundering issues have been particularly prominent in banking in the past year, suggesting that the industry still has a long way to go to tackle this problem. Many of the issues uncovered are legacy in nature, but the industry has much to do to convince regulators and governments that those issues will not recur.

IT problems have led to an increasingly intense debate about what can be done to improve the operational resilience of banks. This is not simply a continuation of the somewhat sterile debate about the incompatibility of many legacy banking IT systems with attempts to modernise risk management and the customer experience. Regulators have realised that operational resilience is a subject that can only be tackled effectively by making two significant changes to the way that this subject has traditionally been viewed. First, operational resilience should be considered in a holistic way, looking not only at banks' own systems but also across the whole of the financial sector at the resilience of the inter-connections between banks, financial market infrastructure and other market participants. Secondly, work on operational resilience achieves little unless it is considered with customers and other end users of services in mind. The resilience of a bank's systems is not a meaningful concept unless it delivers an acceptable level of service to customers and incorporates tolerances for the levels of inconvenience that customers may suffer in the event of extreme disruption, recognising that disruption could originate outside the bank itself.

More immediately, IT challenges in banks expose the need for effective crisis management capabilities. Recovery and resolution planning has helped some banks to develop this expertise, but has been less helpful in this respect than might have been hoped. There is no substitute for more detailed planning for crises than many banks have so far included in their recovery planning. Those who disagree with this view should consider how many banks have performed poorly when crises have hit them, and how many of those banks would have argued beforehand that their systems were adequate to cope with a range of foreseeable adverse scenarios.

Conduct risk remains high up the agenda of most banks. The final report of the Royal Commission into misconduct in the banking, superannuation and financial services industry in Australia was notable outside that country for the familiarity of almost all of its findings. Whatever the ultimate legislative and regulatory response to that report, it is a reminder that banking remains vulnerable to poor conduct unless senior management make good conduct a cornerstone of their strategy and ensure that it is embedded in the incentive arrangements for all staff who have a material influence on customer outcomes.

This edition covers 37 countries and territories in addition to our usual chapters on international initiatives and the European Union. Thanks are due to all of the authors who continue to devote time to this project despite busy schedules. There must be a feeling among many of the authors that banking regulation is a subject that will never settle down; that it will never return to being the rather duller subject that it was before it became a political issue more than 10 years ago.

Thank you also to the partners and staff of Slaughter and May in London and Hong Kong for supporting this book, and in particular to Nick Bonsall, Ben Kingsley, Peter Lake, Emily Bradley, Tolek Petch, Jocelyn Poon, Tamara Raoufi and David Shone.

Finally, the team at Law Business Research deserve as much credit for their patience this year as for their usual work as the publishers of this book. Thank you in particular to Gavin Jordan and Katie Hodgetts. The uncertainties that Brexit has thrown up have left a number of authors wondering what the best time to publish would be, before the realisation dawned that Brexit is likely to be a more protracted process than many envisaged and that therefore

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no one publication date would be better than any other. The other issues noted above look set to run in some form indefinitely.

Perhaps by the time the next edition of this book is published, all will be much clearer, but those of us who are endlessly fascinated by the subject of banking regulation know all too well just how unlikely that is.

Jan Putnis
Slaughter and May
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Chapter 1

INTERNATIONAL INITIATIVES

Jan Putnis and Tolek Petch[1]

I INTRODUCTION

Banking regulation has never had a higher profile than it has today, and has arguably never been so important. The subject has risen up the agenda as politicians have realised the damage that the failure of banks can do to national and regional economies.

If anyone assumed that an internationally agreed set of common principles as to how banks should be regulated would emerge quickly from the financial crisis of 2007 to 2009, they have been disappointed. However, much of the replacement regulatory framework is now in place, and new standards have been or are in the course of being adopted on almost all the important issues with an implementation date of 2022 or earlier. In particular, the Basel Committee on Banking Supervision (Basel Committee) has published and further developed the Basel III Capital Accord in response to the financial crisis and is carrying out work on updating other aspects of its prudential framework, including a fundamental review of the trading book and the treatment of securitisations.

Since the global crisis first manifested itself in 2007, it has at times been difficult to keep track of the numerous international initiatives that have been launched. These initiatives may broadly be classified as those developed to try to understand what went wrong before and during the crisis, and those developed to propose and monitor the implementation of reforms to prevent the recurrence of problems that have been identified. The proliferation of international initiatives has reflected the number of stakeholders involved, and the potentially conflicting approaches to identifying and addressing the causes of the crisis as well as differing political agendas, with the crisis being seen by some as an opportunity for advancing proposals that previously had attracted limited support. It has also reflected a period of intense reflection among financial regulators and governments on the causes and consequences of the financial crisis. However, cynics may argue that the world could have done with fewer initiatives and greater clarity about the direction of reform in the past few years.

As far as banking regulation is concerned, we focus on the two main bodies that have emerged from the crisis to lead the debate: the Basel Committee and the Financial Stability Board (FSB), which emerged in 2009 as a new global leader in the debate on measures to improve international financial stability.

1 Jan Putnis is a partner and Tolek Petch is a senior associate at Slaughter and May.

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II BASEL COMMITTEE

i Introduction

The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for international cooperation on banking supervisory matters. It is principally concerned with the prudential regulation of banks rather than the regulation of their business activities as such. It must, however, be recognised that there are many overlaps between these two areas of regulation, with capital requirements creating incentives for banks to engage in certain activities but not in others.

The Basel Committee comprises senior officials with bank regulatory and financial supervisory responsibilities from central banks and banking regulators in 28 jurisdictions.[2] The current Chair is Pablo Hernádez de Cos, who is also Chair of the Bank of Spain. The Committee now reports to an oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), which comprises central bank governors and (non-central bank) heads of supervision from member countries. The current Chair of the GHOS is Mario Draghi, President of the European Central Bank (ECB). The Basel Committee reports to the GHOS and seeks its endorsement for major decisions. In addition, the Committee looks to the GHOS to approve the Basel Committee on Banking Supervision Charter (BCBS Charter) and any amendments, to provide general direction for the Basel Committee work programme, and to appoint the Committee Chair from among its members.

The stated mandate of the Basel Committee is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.[3] Its main focus has traditionally been on internationally active banks, although the Committee's standards have been applied more widely, particularly in the European Union.

The Basel Committee formulates standards and guidelines and recommends statements of best practice. The rules and guidance adopted by the Basel Committee have no legal force[4] and their authority derives from the commitment of banking supervisors in member countries (and, increasingly, non-member countries) to implement the requirements agreed by the Committee. The Basel Committee has adopted standards on a wide range of issues relevant to banking supervision, including banks' foreign branches, core principles for banking supervision (revised in September 2012), core principles for effective deposit insurance, internal controls, supervision of cross-border electronic banking and risk management guidelines for derivatives.

However, in recent years, the Basel Committee has devoted most of its attention to regulatory capital, principles for effective banking supervision and cross-border banking

2 Argentina, Australia, Belgium, Brazil, Canada, China, the European Union, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. (In addition to member organisations, a number of institutions currently hold observer status. These include country observers: the Central Bank of Chile/Banking and Financial Institutions Supervisory Agency, the Central Bank of Malaysia and the Central Bank of the United Arab Emirates; and the following supervisory groups and international agencies or bodies: Bank of International Settlements, Basel Consultative Group, European Banking Authority, European Commission and International Monetary Fund.)

3 Basel Committee on Banking Supervision Charter, Paragraph 1.

4 Ibid., Paragraph 3.

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supervision. It has also been active in the important areas of liquidity risk and developing frameworks for the recovery or orderly wind-down of internationally active banks that get into financial difficulties.

The Basel Committee's work is largely organised around groups, working groups and taskforces. Groups report directly to the Committee and form part of its permanent internal structure. Working groups consist of experts who support the technical work of Committee groups. Taskforces comprise technical experts from Committee members and are created to undertake specific tasks for a limited time; high-level taskforces serve a similar purpose.

The Basel Committee's work is organised under five main groups:

a the Supervision and Implementation Group, which concentrates on the implementation of the Committee's guidance and standards and the advancement of improvements in banking supervision. The Supervision and Implementation Group is also responsible for the implementation of Basel III;

b the Policy Development Group, which is charged with identifying issues of importance to banking supervision as they emerge, and with developing policies for the Basel Committee that promote a sound banking system and high supervisory standards;

c the Macroprudential Supervision Group, which monitors and reports to the Committee on systemic risk and global developments that relate to macroprudential and systemically important banks' supervision policy;

d the Accounting Experts Group, which is concerned with international accounting and auditing standards and, in particular, with ensuring that those standards promote sound risk management at financial institutions, support market discipline through transparency, and reinforce the safety and soundness of the banking system; and

e the Basel Consultative Group, which provides an interface between the Basel Committee and non-member banking regulators.

ii The Basel framework

The Basel Committee on Banking Supervision has its origins in the financial market turmoil that followed the breakdown of the Bretton Woods system of managed exchange rates in 1973, which led to a number of banks across the globe incurring large foreign currency losses, with some forced to close as a result. In response to these and other disruptions in the international financial markets, the central bank governors of the G10 countries established a Committee on Banking Regulations and Supervisory Practices, later renamed the Basel Committee. At the outset, one important aim of the Committee's work was to close gaps in international supervisory coverage so that no foreign banking establishment would escape supervision, and supervision would be adequate and consistent across member jurisdictions. A number of principles and standards on sharing supervisory responsibility and exchanging information between the regulatory authorities followed, laying down the foundation for supervision of internationally active banks.

Once this initial framework was in place, capital adequacy became the main focus of the Committee's activities. In 1988, a capital measurement system (commonly referred to as the Basel Capital Accord (Basel I)) was approved by the G10 governors and released to banks. Basel I comprised a set of international banking regulations setting out the minimum capital requirements aimed at minimising credit risk and creating a bank asset classification system. Over the next few years the framework evolved with several amendments and additions introduced to it, including the Market Risk Amendment, which took effect at the end of

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1997. One important aspect of the Market Risk Amendment was that banks were, for the first time, allowed to use internal models (value-at-risk models) as a basis for measuring their market risk capital requirements, subject to strict quantitative and qualitative standards.

In June 1999, the Basel Committee issued a proposal for a new capital adequacy framework to replace Basel I. This led to the release of the Revised Capital Framework in June 2004 (generally known as Basel II), which remained the prudential regulatory framework promulgated by the Basel Committee until the financial crisis of 2007 to 2009.

Basel II was based on three pillars that were intended to be interdependent and mutually reinforcing:

a Pillar 1 (minimum capital standards) set out the minimum capital requirements for banks;

b Pillar 2 (the supervisory review process) set out standards for banking supervisors in applying Basel II. In particular, it required that supervisors should have the power to compel banks to hold capital in excess of the 8 per cent minimum ratio under Basel II, where this was justified. Standards were also established for the control of interest rate risk in a bank's loan portfolio, and to capture other risks not specifically covered under Pillar 1 (e.g., certain risks arising out of securitisations); and

c Pillar 3 (market discipline) provided for extensive disclosure of information to the market. The intention was that pressure from a bank's counterparties, analysts and rating agencies would serve to reinforce the minimum capital standards and ensure that banks carried on their business prudently. As was seen in the 2007–2009 financial crisis, it is highly debatable whether this aim was achieved. A revised Pillar 3 standard was published in December 2018.

iii The structure of Basel II

Basel II provided a choice of approaches for determining capital requirements. For example, it set out three ways of calculating credit risk and up to four ways of determining the capital charge for operational risk. Generally, banks were free to choose between more complex methodologies with the potential for capital savings, and simpler approaches that generally led to a higher capital charge, but with lower operational and systems costs.

The focus of Basel II was on internationally active banks. However, the Basel Committee considered that the principles developed in Basel II, when taken with the reforms described later in this chapter, were suitable as an international benchmark.

Overall, Basel II was considerably more risk-sensitive than its predecessor, Basel I. It also marked a shift away from the approach in Basel I of allocating specific capital charges for particular exposures in favour of greater reliance on banks' internal models and methodologies and external credit ratings. It was the intention of the Basel Committee that most sophisticated banks would adopt internal models to determine their capital requirements once they had the operational capacity to do so. Given the perceived failures by credit rating agencies in the run-up to the financial crisis, more recently the focus on external ratings under the standardised approach has been challenged.

Basel II underwent a number of developments prior to the financial crisis. In July 2005, the Basel Committee published a document addressing the treatment of banks' trading books under Basel II, which it had prepared in conjunction with the International Organization of Securities Commissions (IOSCO). The Basel Committee integrated this document into Basel II, and published a revised consolidated text of Basel II in June 2006.

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III FROM BASEL II TO BASEL III

i The limitations of Basel II

It is fair to say that critics of Basel II, who blamed aspects of the financial crisis on features of that regime, have not properly taken into account the fact that when the crisis arose, Basel II had not been implemented at all in a number of key jurisdictions, and had not long been implemented in others. The main requirements of Basel II came into force on 1 January 2007, with the most advanced methodologies only being implemented in January 2008. On the other hand, it is reasonable to conclude that, had Basel II been implemented in more countries for a longer period of time before the financial crisis, it is unlikely that the regime would have prevented many aspects of the crisis as they emerged. Hindsight is easy to employ, however, and there are many who argue that the crisis might not have been so severe had Basel II been implemented earlier.

In response to the crisis, the Basel Committee chose to build on Basel II rather than fundamentally change it. A consensus emerged that there were a number of deficiencies in the Basel II framework that needed to be addressed, including:

a insufficient capital in the banking system, often of inadequate quality;
b an excessive focus on capital at the expense of liquidity and leverage;
c a failure by firms and supervisors to see the overall picture;
d inadequate capital requirements in respect of banks' trading books (as well as capital arbitrage); and
e deficiencies in respect of the treatment of securitisations.

ii The Basel Committee's July 2009 reform package (Basel 2.5)

The first package of changes to Basel II following the financial crisis was adopted by the Basel Committee in July 2009, and included the following:

a increasing the capital charges for securitisation exposures, including introducing a new higher capital charge for resecuritisations (e.g., collateralised debt obligations and certain conduits) as well as increasing the capital charge for certain liquidity facilities. Banks that invest in securitisations are required to carry out due diligence on the underlying asset pool, and if they fail, or are unable to do so, they are required to deduct such positions from their capital;
b eliminating the regulatory arbitrage under which banks that choose to hold securitisation exposures in their trading book could avoid higher capital charges: instead, capital requirements for such exposures have been broadly aligned across the banking and trading books, based on the former's requirements;
c improvements to banks' models used to calculate capital charges for non-securitisation positions held in the trading book through a stressed value at risk calculation, which takes into account a defined observation period relating to significant losses. The intention is to capture the risks of low-frequency, high-impact tail events, as well as significant market movements over a sustained period; and
d the introduction of an incremental risk capital charge to address the effect of credit risk migration (i.e., ratings downgrades) on a bank's holdings of debt instruments in the trading book. This reflects the fact that trading book losses during the financial crisis did not principally result from defaults, but from credit migrations combined

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with the widening of credit spreads as a result of the loss of liquidity. Subsequently, the Basel Committee published enhancements to this treatment that will apply from 1 January 2022.

The Basel Committee's July 2009 reform package initially addressed the treatment of securitisation and trading book exposures. However, the Committee recognised the need for a comprehensive set of measures to strengthen the regulation, supervision and risk management of the banking sector. The result was a consultation paper entitled Strengthening the Resilience of the Banking Sector, published on 17 December 2009. This led to the adoption of a new, comprehensive reform package on design of the capital and liquidity requirements (Basel III) in 2010 (see below). Since then, the main focus of the Committee has been on finalising Basel III.

iii Other work

The Basel Committee is also currently engaged in work in the following areas.

Systemically important financial institutions

The Basel Committee is continuing to work with the FSB to implement an integrated approach to systemically important banks. On 28 September 2011, the Basel Committee finalised details of the additional capital buffer that will apply to global systemically important banks (G-SIBs). G-SIBs will be required to hold an additional buffer (above the Basel III requirements) of between 1 and 2.5 per cent of common equity, depending on the bank's systemic importance (the percentages being of risk-weighted assets (RWAs)). An initially empty 3.5 per cent bucket will be imposed on G-SIBs that become even more systemically important as a disincentive to such behaviour. Final rules for G-SIBs were published on 2 November 2011. In October 2012, the Basel Committee adopted a framework for domestic systemically important banks (D-SIBs), which builds on the rules adopted for G-SIBs. The framework is composed of 12 principles and gives states considerable national discretion to reflect the characteristics of their domestic financial system. D-SIBs will be required to meet higher capital requirements to reflect their degree of systemic importance. An updated assessment methodology for G-SIBs was published by the Basel Committee in July 2013. The latest FSB list of banks identified as G-SIBs using the Basel Committee's methodology was issued in November 2018 (the list will next be updated in November 2019). In March 2017, the Basel Committee consulted on a revised framework for G-SIBs. The proposed changes include removal of the cap on the substitutability category, expansion of consolidation to include insurance subsidiaries, introduction of a trading volume indicator, revisions to the disclosure requirements and transitional provisions.

Bail-in

Work continues internationally and in the EU on the feasibility of developing debt write-down and conversion of debt to equity to enable a failing bank to continue (whether temporarily or permanently) as a going concern. The Basel Committee published its requirements for enhanced loss absorbency for additional Tier 1 and Tier 2 capital instruments on 13 January 2011. These requirements are summarised in Section IV.

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IV BASEL III: CAPITAL REQUIREMENTS

On 12 September 2010, the Basel Committee announced its agreement on the new Basel III minimum capital requirements for banks, which significantly increased the amount of common equity that banks must hold. The detailed requirements were published on 16 December 2010 and revised on 1 June 2011. Further guidance on the new capital definitions and the requirements for counterparty credit risk was published in the form of frequently asked questions in September 2017.

Basel III reforms aim to strengthen the regulation, supervision and risk management of the banking sector, and are designed to target both microprudential regulation and macroprudential risks. More specifically, Basel III extends the framework in a number of ways, including introducing the following additional measures:

a a capital conservation buffer, an additional layer of common equity that, when breached, restricts distribution of capital to help protect the minimum common equity requirement (see subsection iv for further details);

b a countercyclical capital buffer, which places restrictions on participation by banks in country-wide credit booms with the aim of reducing their losses in credit busts (see subsection v for further details);

c a leverage ratio (a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting) (see subsection vi for further details);

d two liquidity requirements: a liquidity coverage ratio (LCR), a minimum liquidity ratio intended to provide enough cash to cover funding needs over a 30-day period of stress; and a net stable funding ratio (NSFR), a longer-term ratio intended to address maturity mismatches over the entire balance sheet (see Section V for further details); and

e additional proposals for systemically important banks, including requirements for supplementary capital, augmented contingent capital and strengthened arrangements for cross-border supervision and resolution.

i New definitions of capital

Much greater equity

Under Basel II, banks were required to hold common equity equal to 2 per cent of RWAs (although, in practice, most banks held more). Regulatory deductions were applied to total Tier 1, or total capital, so certain hybrid instruments and preference shares, as well as some subordinated debt, could be used to cover such deductions.

Under Basel III, the common equity component of capital (including reserves) increased to 4.5 per cent and the total Tier 1 ratio to 6 per cent. For banks structured as joint-stock companies, the equity requirement must be met solely with ordinary shares.

Non-core Tier 1 capital

Detailed requirements were adopted in respect of additional (i.e., non-core) Tier 1 capital, which has been effectively limited to 1.5 per cent of RWAs. These instruments must be perpetual, and may only be called after five years and with prior supervisory consent. Interest payments must be made out of distributable profits and, if the instrument is classified as a liability for accounting purposes, it must have principal loss absorption through either conversion to common equity or write-down of principal. The trigger level for write-down

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or conversion must be at least 5.125 per cent, although banks can choose (or be required) to apply a higher trigger. The European Union also applies this requirement to equity-accounted instruments (e.g., most preference shares).

Other tiers of capital

Basel III abolished innovative Tier 1 and Tier 3 capital, and harmonised Tier 2 capital, based on lower Tier 2 capital under Basel II. Recognition of Tier 2 capital is effectively limited to 2 per cent of RWAs. Under Basel II, the limit was 4 per cent.

Under Basel III, all Tier 1 and Tier 2 capital instruments (other than common equity) must include a clause in their terms and conditions requiring the instrument to be written off on the occurrence of a trigger event (i.e., the bank ceases to be a going concern or receives an injection of public sector capital) if there is no statutory scheme under which such instruments can be required to absorb losses. The only compensation for such write-off that may be provided to investors is the issue of new ordinary shares (or the equivalent for mutuals).

The new requirements for common equity, as well as the other minimum ratios, have been phased in.

	Common equity (%)	**Total Tier 1 (%)**	**Total Tier 1 and Tier 2 (%)**	**Total capital, including the capital conservation buffer (explained below) (%)**
Basel II requirement	2	4	8	8
From 1 January 2019	4.5	6	8	10.5

Minority interests

Detailed rules set out the contribution that third-party minority interests in group companies can make towards consolidated capital.

ii Grandfathering of existing capital instruments

The Basel III agreement includes a detailed approach to the grandfathering of existing instruments. It should be noted that the approach to grandfathering in the European Union under the Capital Requirements Regulation[5] is different. Under Basel III:

a non-compliant capital instruments issued on or after 12 September 2010 are not grandfathered. It follows that any such instruments needed to satisfy the Basel III requirements for Tier 1 and Tier 2 capital if they were to be eligible from 1 January 2013. An exception to this rule is available for non-core Tier 1 and Tier 2 capital instruments that did not meet the requirement for write-down or conversion to common equity at the point of non-viability if issued before 1 January 2013. Non-compliant capital instruments were eligible for grandfathering;

b capital instruments that no longer qualify as non-common equity Tier 1 or Tier 2 capital under Basel III are being phased out over a 10-year period that started on 1 January 2013. The base is fixed at the nominal amount outstanding on 1 January 2013. The level of

5 Regulation 575/2013/EU.

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recognition was capped at 90 per cent on 1 January 2013, and is being reduced by 10 percentage points in each subsequent year. Recognition of capital instruments will be fully phased out by 1 January 2022; and

c recognition of instruments with an incentive to redeem (e.g., a step-up in their coupon if redemption does not take place on a certain date) will be phased out at their effective maturity date. This will catch most existing innovative Tier 1 issues as well as Tier 2 issues with a step-up.

iii Deductions from capital

Basel III provides for a harmonised set of deductions from capital, most of which are made from common equity. The list of deductions includes:

a goodwill and other intangibles;
b deferred tax assets that rely on future profitability to be realised;
c cash-flow hedge reserve relating to hedging of items not fair valued on the balance sheet;
d shortfall of provisions to expected losses;
e cumulative gains and losses owing to changes in a bank's own credit risk on fair-valued liabilities (including derivatives);
f defined benefit pension fund assets and liabilities;
g investments in own shares;
h reciprocal cross-holdings; and
i significant investments in the capital of banking, financial and insurance entities outside of the consolidated group.

These deductions are made under a corresponding deduction approach, so the deduction is from the element of capital that it would have constituted had it been issued by the bank.

The new approach to deductions started on 1 January 2014 (i.e., one year after the implementation of the new requirements for common equity) and was phased in progressively, coming fully into effect on 1 January 2018.

iv Capital conservation buffer

A key element of Basel III is the requirement that banks hold a capital buffer on top of the minimum capital requirements. This buffer is not intended to form part of the minimum capital requirement. It follows that a bank that fails to hold sufficient common equity to satisfy the buffer (but meets the other minimum capital requirements) will not be subject to restrictions on its operations, and will not be at risk of resolution or the withdrawal of its banking licence. However, banks that operate within the buffer are subject to restrictions on the distribution of capital, including the payment of dividends and staff bonus payments, with the result that the buffer is likely to be treated by banks as an effective floor. According to the Basel Committee:

a the purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distribution; and

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b banks will, of course, be able to rebuild capital buffers through raising new capital. However, in the Committee's view, it is not acceptable for banks that have depleted their capital buffers to use future predictions of recovery as justification for maintaining generous distributions to shareholders, other capital providers and employees.

The restrictions on distributions, share buy-backs and staff bonus payments are as follows:

Common Equity Tier 1 (%)	Minimum capital conservation ratio (expressed as a percentage of earnings)
Between 4.5 and 5.125	100
Between 5.125 and 5.75	80
Between 5.75 and 6.375	60
Between 6.375 and 7	40
More than 7	Zero

The requirements apply on a consolidated basis, although supervisors are able to apply the regime at a solo level to conserve capital in specific parts of the group. The new capital buffer requirements came into force on 1 January 2016 (i.e., after the new common equity and Tier 1 capital requirements were required to have been fully implemented), but once again a transitional period applied, with the amount of the buffer increasing in stages to 2.5 per cent on 1 January 2019.

The Basel Committee has stated that national authorities should have the discretion to impose a shorter transition period, and should do so where appropriate. Banks that meet the minimum capital ratio during the transition period but whose common equity is less than 7 per cent 'should maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible'.

v Countercyclical capital buffer

The countercyclical capital buffer is intended to ensure that capital requirements take account of the macroprudential environment in which banks operate. It will be applied when excess credit growth is associated with a build-up of system-wide risk. It is based on the following elements:

a each regulator will decide, based on credit conditions in its country, when to activate the buffer. Once activated, the buffer will take the form of an add-on to minimum capital requirements. At all other times the buffer will be zero;

b a decision to impose a buffer will be announced up to 12 months before it takes effect to give banks time to adjust (if necessary, by increasing capital or reducing lending). Reductions to the buffer will take effect immediately when announced;

c banks with purely domestic exposure will be subject to the full amount of the buffer; and

d banks that are internationally active will apply an add-on depending on the geographical location of their credit exposures.

The Basel Committee has stated that setting this buffer is likely to be appropriate where the ratio of credit to gross domestic product (GDP) exceeds its long-term trend. However, as this measure is not always a clear indicator of excessive credit growth, judgement will need to be applied.

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The range of the buffer will generally be between zero and 2.5 per cent, and will be added to the capital conservation buffer. Unlike the capital conservation buffer, this additional buffer may be satisfied by common equity or other fully loss-absorbing capital, although until the Basel Committee has issued further guidance on the requirements for such loss-absorbing capital, the buffer will need to be met with common equity. According to the Committee, countries that experience excessive credit growth should consider accelerating the build-up of the capital conservation buffer and the countercyclical capital buffer.

In December 2010, the Basel Committee published guidance for national authorities operating the countercyclical capital buffer, and in October 2015, the Committee published further guidance on the countercyclical capital buffer in the form of frequently asked questions.

vi Leverage ratio

The years leading up to the 2007–2009 financial crisis were characterised by a significant increase in the leverage of financial institutions, enhancing the (apparent) profitability of the financial sector, but also resulting in a greater probability of individual firms failing as well as increased systemic risk generally. Basel III's leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), and is expressed as a percentage. The capital measure is currently defined as Tier 1 capital, and the minimum leverage ratio is 3 per cent. Accounting values will generally be applied. More detailed requirements for the leverage ratio, including its disclosure from 1 January 2015, were published by the Committee in January 2014. In July 2015, the Committee published guidance on the leverage ratio in the form of frequently asked questions.

Supervisors measured the leverage ratio between 1 January 2013 and 1 January 2017. Banks were required to disclose their leverage ratio from 1 January 2015. In December 2017, the Committee published various refinements to the definition of the leverage ratio exposure method. These include modifying the way in which derivatives are reflected in the exposure measure and updating the treatment of off-balance sheet exposures. The new definitions come into force on 1 January 2022.

In December 2017, the Basel Committee also published a revised leverage ratio framework for global systemically important banks, which will come into force in January 2022.

In October 2018 this was supplemented by a consultation document on the leverage ratio treatment of client cleared derivatives.

vii Counterparty credit risk

Basel III brought about a number of improvements to the treatment of counterparty credit risk with effect from 1 January 2013. The changes included the following:

a banks that use an internal model to calculate their counterparty credit risk on over-the-counter (OTC) derivatives, repurchase agreements and securities financing transactions are required to use stressed inputs to address the risk of the model underestimating low-frequency, high-impact events;

b a new capital charge was introduced to cover mark-to-market losses associated with a deterioration in the creditworthiness of counterparties;

c requirements have been imposed to address wrong-way risk (i.e., where an exposure to a counterparty is adversely correlated to the credit quality of that counterparty);

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d risk weights on exposures to large financial institutions are subject to a multiplier to reflect the fact that during the financial crisis, the credit quality of financial institutions deteriorated in a more highly correlated manner than that of non-financial counterparties;

e standards for collateral management and margining have been strengthened. Banks with large and illiquid derivatives exposures have to apply a longer margining period when determining their capital requirements;

f greater haircuts apply to securitisation collateral, with a prohibition on recognition of resecuritisation exposures as collateral to reduce counterparty exposures; and

g harmonised capital charges for exposures to central counterparties (CCPs) have been introduced.

viii Revised standardised approach (January 2022)

In December 2014, the Basel Committee published a consultation document on revisions to the standardised approach to credit risk. In December 2015, the Committee published a second consultation document, with the aim of addressing the issues raised by respondents with respect to the initial proposal. The new standardised approach was published in December 2017 and is due to be implemented by 1 January 2022. Securitisation exposures are addressed in the Basel securitisation standard. The key aspects of the proposals are:

a Exposures to sovereigns and public sector entities are unchanged from Basel II.

b Exposures to banks will be risk-weighted based on the following hierarchy: external credit risk assessments, and the standardised credit risk assessment approach for unrated banks as well as jurisdictions that do not allow the use of external credit ratings. Under the latter approach, banks are allocated to three risk-weight buckets or grades ranging from 40 to 150 per cent for the base risk weight. Compared with Basel II, some of the risk weights have been recalibrated. A stand-alone treatment for covered bonds has also been introduced.

c Exposures to corporates (including insurers) differentiate between general corporate exposures and specialised lending exposures. The former will be risk-weighted between 20 per cent and 150 per cent; unrated corporates will be risk-weighted at 100 per cent. Jurisdictions that do not allow the use of external ratings may allow a 65 per cent risk weight for exposures to investment grade borrowers (as defined in the standard). Unrated SME exposures will generally receive a risk weight of 85 per cent. Specialised lending is now divided into three categories: project finance, object finance and commodities finance. Issue-specific (not issuer-specific) ratings may be used where available and permitted. Otherwise, object and commodities finance will be risk-weighted at 100 per cent and project finance at 130 per cent during the pre-operational phase, and at 80 per cent or 100 per cent during the operational phase.

d A new risk class is introduced for subordinated debt, equity and other capital instruments not deducted from regulatory capital or risk weighted at 250 per cent under Basel III (i.e., threshold deductions). Speculative unlisted equity exposures will be risk weighted at 400 per cent and all other equity holdings at 250 per cent.

e A more granular treatment will apply to residential real estate, distinguishing between different types of portfolio.

f A new treatment for commercial real estate will be introduced based on the loan-to-value ratio and whether repayment is materially dependent on cash flows generated by the property.

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ix Internal ratings-based approach (January 2022)

Basel II introduced two model-based approaches for the calculation of credit risk in the banking book: the foundation internal ratings-based (IRB) approach and the advanced IRB approach. New requirements for the IRB approach were published in December 2017 and will come into effect on 1 January 2022 (at the same time as the revisions to the standardised approach). According to the Basel Committee, the 2007–2009 financial crisis highlighted a number of shortcomings in the use of internal models, including the excessive complexity of IRB approaches, the lack of comparability in banks' internally modelled capital requirements and the lack of robustness in modelling certain asset classes. The intention is to remove own-estimates of loss given default (LGD) and exposure at default (EAD) for those portfolios which the Committee considered were important sources of RWA variability.

As a result, the availability of the IRB approach will be significantly curtailed. In summary, the position under Basel III will be as follows:

a large and mid-sized corporates (consolidated revenues of greater than €500 million): only the foundation IRB approach will be available;

b banks and other financial institutions: only the foundation IRB approach will be available;

c equities: no IRB approach will be available; and

d specialised lending: the same approaches will be available as under Basel II.

The advanced IRB approach remains available for sovereign, small corporate, specialised lending and retail lending. Where available, Basel III will introduce revised floors, depending on the type of transaction (except for sovereigns). However, the Committee published a discussion paper in December 2017 on the regulatory treatment of sovereign exposures. This includes a proposal (among others) that the IRB approach for sovereign exposures be withdrawn.

x CVA Risk Framework (January 2022)

As noted above, the Basel Committee published in December 2017 revisions to the framework addressing mark-to-market losses as a result of the deterioration of the creditworthiness of counterparties (CVA risk). The main changes are as follows: enhancement of the risk sensitivity of the framework; removal of the internal models approach to CVA risk. Instead there will be a standardised approach and a basic approach; and improvement of consistency with new market risk charges (see below).

xi Revised market risk framework (January 2022)

In 2009, the Basel Committee introduced amendments to the Basel II market risk framework to address the weaknesses in the capital framework for trading activities that became apparent during the crisis: it was updated in December 2010. In addition, the Committee initiated a review of the trading book with the aim of tackling a number of structural flaws in the market risk framework that were not addressed by the amendments introduced in 2009. This work has led to the revised market risk framework. Following a number of consultation papers and several quantitative studies, the Basel Committee issued standards on minimum capital requirements for market risk on 14 January 2016. The new framework takes effect in 2022. In January 2017, the Basel Committee published its first set of frequently asked questions on market risk capital requirements. In January 2019 the Basel Committee revised its proposals for market risk in certain respects.

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In summary, the revisions focus on three key areas:

a A revised boundary between the banking book and trading book to reduce incentives for a bank to arbitrage its regulatory capital requirements between the two regulatory books, while continuing to respect banks' risk management practices. In particular, stricter limits and capital disincentives are applied to the transfer of instruments between the banking book and trading book, which will now be applied at a trading desk level and not across the bank.

b A revised internal models approach for market risk with more coherent and comprehensive risk capture. In addition, the new approach introduces a more rigorous model approval process.

c A revised standardised approach for market risk that facilitates more consistent and comparable reporting on market risks across banks and jurisdictions, and is suitable for banks with limited trading activity while also sufficiently risk sensitive to serve as a credible fall-back for, as well as a floor to, the internal models approach.

The reasons for the changes were essentially fourfold:

a incentives for banks to take on tail risk: this is inherent in value-at-risk (VaR) models;

b inability to capture the risk of market illiquidity: in times of market stress, the market is likely to become illiquid when the banking system holds similar positions;

c inability to capture adequately the credit risk inherent in trading positions; and

d excessive recognition of the risk-reducing effect of hedging and diversification.

The basis of the Market Risk Amendment is the new internal models approach, which replaces VaR models. The new models-based metric is founded on three components: expected shortfall, which determines capital requirements for those factors for which a sufficient amount of data is available; a non-modellable risk factor for factors for which there is insufficient data, and a default risk requirement to determine the capital requirement associated with default risk for credit and equity positions.

The new standardised approach is based on a sensitivities-based method, similar to a stress test. The framework specifies a set of risk factors considered to be the main market variables that affect the value of banks' trading portfolios; risk weights applicable to those risk factors calibrated to stressed market conditions; and a methodology for aggregating the losses calculated for each risk factor to determine the loss for the scenario at the portfolio level.

The sensitivities-based method comprised delta risk (the potential loss due to a small change in the price of an equity or a commodity), vega risk (the potential loss due to a change in the implied volatility of an option) and curvature risk (the potential incremental loss beyond delta risk when large movements occur). To this is added a standardised default capital requirement and a residual risk add-on for other risks not adequately addressed (e.g. exotic derivatives).

In January 2019, the Basel Committee adopted a number of changes to the market risk framework based on feedback from banks. The main changes are as follows:

a clarifications to the allocation of positions between the trading book and banking book;

b revisions to the internal models approach: these include, in particular, a traffic light system for distinguishing between well and poorly performing models, and a more risk-sensitive approach to non-modellable risk factors;

c reductions to the operational burdens of the new standardisable approach; and

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d retention of the current standardised approach as a simplified alternative to the revised standardised approach subject to the application of specific scalars.

xii Operational risk (January 2022)

According to the Basel Committee, the 2007–2009 financial crisis demonstrated flaws with the Basel II operational risk framework: basically, capital requirements for operational risk proved insufficient to cover losses suffered by some banks while the nature of those losses, such as those caused by misconduct, highlighted the difficulties associated with using internal models to estimate capital requirements. All existing operational risk approaches in Basel II are being withdrawn. Instead, a new standardised approach based on two components is being introduced: a measure of a bank's income and a measure of a bank's historical losses. Operational loss will be calculated from 2022 as the multiplier of the business indicator component and an internal loss multiplier. The business indicator component is the sum of three components: the interest, leases and dividends component, the services component and the financial component. The internal loss multiplier (ILM) is a function of the business indicator component and the loss component, where the latter is equal to 15 times a bank's average historical losses over the preceding 10 years. It increases as the latter increases, although at a decreasing rate. At national discretion, the ILM may be set at 1, with the result that solely the business indicator component would drive the operational risk capital calculation.

xiii Interest rate risk in the banking book

Interest rate risk in the banking book is part of the Pillar 2 framework of Basel II and subject to 2004 guidance. In April 2016, the Committee decided to update the principles to reflect changes in market and supervisory practices that will remain within Pillar 2. The key updates to the principles are:

a greater guidance on expectations for a bank's management process, in particular the development of shock and stress scenarios, the key behavioural and modelling assumptions, and the internal validation process;
b updating disclosure requirements to promote greater consistency, transparency and comparability;
c updating the supervisory process; and
d Section IV of the standard sets out a standardised framework that supervisors could require banks to follow, or a bank could choose to adopt.

Banks were expected to implement the standard by 2018.

xiv Securitisation

The Basel Committee has undertaken a fundamental review of the securitisation framework, including an alternative treatment for simple, transparent and comparable (STC) securitisations. The new framework came come into force in 2018. The changes reflect the following deficiencies in the Basel II securitisation framework:

a mechanistic reliance on external ratings;
b excessively low risk weights for high-rated securitisations;
c excessively high risk weightings for low-rated senior securitisation exposures;
d cliff effects; and
e generally insufficient risk sensitivity.

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The new framework is based on a hierarchy that places the internal ratings-based approach at the top followed by the external ratings-based approach (where permitted in the jurisdiction) and then the securitisation standardised approach. A slightly modified (and more conservative) version of the standardised approach will be the only approach available for resecuritisation exposures. The STC framework increases the risk sensitivity of the securitisation framework but, owing to its potential to introduce significant operational burdens, jurisdictions retain the option not to implement it. The Basel STC criteria build on the July 2015 Basel and IOSCO criteria with certain enhancements. The EU has implemented its own standards.

In July 2017, the Committee published a consultation document on the capital treatment for STC securitisations. This sets out additional guidance and requirements for the purpose of applying a preferential regulatory capital treatment for banks acting as investors in, or as sponsors of, STC short-term securitisations, typically in asset-backed commercial paper (ABCP) structures. The additional guidance and requirements include that investors have access to key monthly information on the performance and key characteristics of the ABCP structure; the redemption risk of the underlying assets is addressed from the sponsor's perspective; and the transactions funded by the conduit have an enforceable legal structure and that the relevant information is disclosed by the sponsor to investors.

xv Basel I floor (output floor)

Basel II introduced a capital floor based on Basel I capital requirements of 80 per cent. Basel III will replace the Basel II floor with a new floor based on the use of standardised approaches to limit the benefit obtained by banks from the use of internal models. This will be introduced in stages from 1 January 2022 to 1 January 2027, rising from 50 per cent to 72.5 per cent.

V BASEL III: LIQUIDITY

The 2007–2009 financial crisis demonstrated the critical importance of liquidity. Before then, funding was easily available at relatively low cost. However, the rapid reversal of market sentiment demonstrated how quickly liquidity can evaporate, necessitating unprecedented central bank intervention to support the money markets and individual financial institutions. As a result, the Basel Committee has adopted two liquidity standards: the LCR and the NSFR. These liquidity requirements apply on a consolidated basis. Revisions to the LCR, incorporating amendments to the definition of high-quality liquid assets and net cash outflows, were adopted in January 2013. Details of the NSFR were published in 2014.

i LCR

The LCR is an essential component of the Basel III reforms. It seeks to ensure that banks have an adequate stock of unencumbered high-quality liquid assets that can be converted into cash to meet their liquidity needs over a 30-day period under a significant liquidity stress scenario. The 30-day period is based on the assumption that this will be sufficient for corrective action to be taken by the bank, or for the bank to be resolved in an orderly manner without exposing the taxpayer to losses.

The LCR standard is as follows:

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over a 30-day period}} \geq 100 \text{ per cent}$$

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The LCR is based on two elements: a definition of high-quality liquid assets and a metric for calculating net cash outflows in a liquidity stress scenario.

ii High-quality liquid assets

The Basel Committee has identified two types of eligible assets: Level 1 and Level 2. Level 1 assets can be used to satisfy the LCR without limit, whereas Level 2 assets are capped at 40 per cent of the overall stock of assets held to satisfy the LCR. The calculation of the limit is adjusted to reflect the impact of secured funding transactions or collateral swaps.

Level 1 assets include cash, central bank reserves, claims on sovereigns and public sector entities assigned a zero per cent risk weight under the Basel II standardised approach, and claims on non-zero per cent risk-weighted sovereigns and public sector entities that are issued in the domestic currency of the relevant sovereign.

Following the January 2013 revision to the LCR, Level 2 assets are divided into Level 2A and Level 2B assets. Level 2A assets include claims on sovereigns and public sector entities risk-weighted at 20 per cent or below under Basel II, with corporate bonds and covered bonds that are rated AA- or better and have a proven record as a reliable source of liquidity during stressed market conditions. Level 2 assets are subject to a minimum 15 per cent haircut on their current market value. Level 2B assets comprise lower-quality assets and are capped at 15 per cent of overall liquid assets. This subclass includes corporate bonds rated A+ to BBB-, certain equities and residential mortgage-backed securities rated AA or higher. Haircuts of 15 per cent or 50 per cent apply to Level 2B assets. In addition, supervisors may choose to include within Level 2B assets the value of any committed liquidity facility provided by a central bank where this has not already been included in high-quality liquid assets.

iii Net cash outflows and inflows

Basel III sets out a metric with assumed outflows and inflows depending on the type of deposit or transaction, which was revised in January 2013. Some examples of outflows are set out in the following table:

Transaction type	Assumed cash outflow (%)
Trade finance	Zero or 5
Fully insured retail deposits	3 or 5
Less stable retail deposits	10
Unsecured wholesale funding (small business)	5 or 10
Unsecured wholesale funding within operational relationships	25
Unsecured wholesale funding from non-financial corporates, sovereigns and public sector entities	20 or 40
Unsecured wholesale funding from others	100
Secured funding	Zero to 100 depending on collateral
Derivatives	Zero to 100 depending on collateral
Covered bonds and structured financing instruments	100
Asset-backed commercial paper, conduits, structured investment vehicles (SIVs) and other financing facilities	100
Committed credit and liquidity facilities	5 to 100 depending on borrower. The assumed outflow on committed liquidity facilities extended to corporates has been reduced from 100% to 30%

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The Basel Committee has also specified parameters for expected cash inflows. Some examples are given in the following table:

Transaction type	Assumed cash inflow (%)
Maturing reverse repos and similar transactions	Zero to 100 depending on collateral
Lines of credit, liquidity facilities and similar arrangements	Zero
Retail and small business receivables	50
Receivables from non-financial wholesale counterparties	50
Receivables from financial institutions	100
Derivatives	100

Of particular relevance to banks is the assumption that credit lines and other contingent funding arrangements provided by other financial institutions are assumed to be incapable of being drawn. The intention is to reduce the contagion risk of liquidity shortages at one bank causing shortages at other banks. Inflows are capped at 75 per cent, requiring banks to hold liquid assets of at least 25 per cent of outflows.

The LCR was introduced in stages from 1 January 2015, reaching 100 per cent in 2019.

In January 2014, the Basel Committee published the final version of the disclosure requirements for the LCR. The Committee expected national authorities to give effect to the liquidity disclosure requirements relating to the LCR by no later than 1 January 2015. Banks were expected to comply with these requirements from the date of the first reporting period after 1 January 2015. In June 2017, the Committee published a second set of frequently asked questions on the LCR.

iv NSFR

The Basel Committee was unable to finalise the detailed requirements for the NSFR in the initial text of Basel III. The objective of the NSFR is to establish a minimum amount of stable funding based on the liquidity characteristics of a bank's assets and activities over a one-year horizon. The aim is to ensure that longer-term assets are funded with at least a minimum amount of stable liabilities.

The requirement is as follows:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100 \text{ per cent}$$

Stable funding is defined as the portion of those types and amounts of eligible equity and liability financing expected to be reliable sources of funds over a one-year period in conditions of extended stress. The required amount of this funding depends on a bank's assets, off-balance sheet liabilities and activities. The detailed definitions of stable funding were published in October 2014.

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The amount of available stable funding is summarised in the table below.

Category of stable funding	Percentage recognised (%)
Regulatory capital before the application of deductions	100
Any capital instrument that has an effective residual maturity of one year or more	100
Secured and unsecured borrowings and liabilities with effective residual maturities of one year or more	100
Stable deposits provided by retail and small business customers	95
Less stable deposits provided by retail and small business customers	90
Funding with a residual maturity of less than one year provided by non-financial corporate customers	50
Operational deposits	50
Funding with a maturity of less than one year from sovereigns, public sector entities and multilateral and national development banks	50
Other funding (secured and unsecured) not included in the above with residual maturity of not less than six months and less than one year	50
All other categories including liabilities without a stated maturity	Zero

The amount of stable funding required depends on the broad characteristics of the risk profile of a bank's assets and off-balance sheet liabilities. Some examples are as follows:

Asset	Required stable funding (%)
Coins and banknotes	Zero
Central bank reserves	Zero
Unencumbered Level 1 assets	5
Unencumbered loans to financial Institutions with residual maturities of less than six months where the loan is secured against Level 1 assets	10
Unencumbered Level 2A assets	15
All other unencumbered loans to financial institutions with a maturity of less than six months	15
Unencumbered Level 2B assets	50
High-quality liquid assets encumbered for a period of between six months and one year	50
Loans to financial institutions and central banks with a residual maturity of between six months and less than one year	50
Other assets not included in the above with a residual maturity of less than one year including loans to non-financial corporate clients, loans to retail customers, loans to sovereigns, central banks and public sector entities	50
Unencumbered residential mortgages with a residual maturity of one year or more attracting a risk weight of 35% or less under Basel II	65
Other unencumbered loans – excluding loans to financial institutions – with a residual maturity of one year or more and a risk weight of 35% or less	65
Unencumbered performing loans – excluding loans to financial institutions – with risk weights greater than 35% and a residual maturity of one year or more	85
Unencumbered securities that are not in default and do not qualify as Level 1 or Level 2 assets and exchange-traded equities	85
Physical commodities and gold	85
All other assets including assets encumbered for one year or more, net derivatives assets, non-performing loans and loans to financial institutions with a residual maturity of over one year	100

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Off-balance sheet liabilities are subject to the NSFR, based broadly on whether the commitment is a credit or a liquidity facility, or some other contingent funding obligation, without assigning actual percentages other than for irrevocable and conditionally revocable credit and liquidity facilities. National supervisors will be able to specify the required stable funding based on national circumstances.

In June 2015, the Basel Committee published the final version of the disclosure requirements for the NSFR. The Committee expected national authorities to give effect to the liquidity disclosure requirements relating to the NSFR no later than 1 January 2018. Banks are required to comply with these requirements from the date of the first reporting period after 1 January 2018. In February 2017, the Basel Committee published Basel III – The Net Stable Funding Ratio: frequently asked questions.

VI FINANCIAL STABILITY BOARD

i Introduction

The FSB is an international body that monitors and makes recommendations about the global financial system. It has its origins in the Financial Stability Forum (FSF), which was founded in 1999 by the finance ministers of the G7 countries.[6] The foundation of the FSF arose from work carried out by the then Deutsche Bundesbank president, Hans Tietmeyer, on structures to enhance regulatory cooperation and cooperation between regulators and international financial institutions to promote international financial stability.

The FSF was re-established as the FSB at the G20 Summit held in London in April 2009, following calls in November 2008 by leaders of the G20 countries to enlarge the FSF's membership, and subsequent calls for the FSF to assume a more central role in developing structures and mechanisms to address international financial stability issues.[7] The FSB emerged from the 2009 G20 Summit with a broader mandate to promote financial stability. On 28 January 2013, the FSB established itself as a not-for-profit association under Swiss law, with its seat in Basel, Switzerland.

The Charter and organisation of the FSB

The Charter of the FSB came into effect on 25 September 2009, but is not intended to create legal rights and obligations. It does, however, set out the FSB's objective, which is:

> *to coordinate at the international level the work of national financial authorities and international standard-setting bodies (SSBs) in order to develop and promote the implementation of effective*

6 Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

7 The member jurisdictions of the FSB now comprise Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the United Kingdom, the United States and the European Union. Other members include international financial institutions (comprising the Bank for International Settlements, the International Monetary Fund, the Organisation for Economic Co-operation and Development (OECD) and the World Bank) and international standard-setting, regulatory, supervisory and central bank bodies (comprising the Basel Committee, the Committee on Payments and Market Infrastructures, the Committee on the Global Financial System, the International Accounting Standards Board, the International Association of Insurance Supervisors and the International Organization of Securities Commissions).

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regulatory, supervisory and other financial sector policies. In collaboration with the international financial institutions, the FSB will address vulnerabilities affecting financial systems in the interest of global financial stability.[8]

The mandate and tasks of the FSB are stated in the Charter to be to:

a assess vulnerabilities affecting the global financial system, and identify and review on a timely and continuing basis, within a macroprudential perspective, the regulatory, supervisory and related actions needed to address them, and their outcomes;

b promote coordination and information exchange among authorities responsible for financial stability;

c monitor and advise on market developments and their implications for regulatory policy;

d advise on and monitor best practice in meeting regulatory standards;

e undertake joint strategic reviews of, and coordinate the policy development work of, the standard-setting bodies (SSBs) to ensure their work is timely, coordinated, focused on priorities and addressing gaps;

f set guidelines for and support the establishment of supervisory colleges;

g support contingency planning for cross-border crisis management, particularly with respect to systemically important firms;

h collaborate with the International Monetary Fund to conduct early warning exercises;

i promote member jurisdictions' implementation of agreed commitments, standards and policy recommendations through monitoring of implementation, peer review and disclosure; and

j undertake any other tasks agreed by its members in the course of its activities and within the framework of its Charter.[9]

The FSB has also taken on the task of coordinating the alignment of the activities of SSBs.[10]

The FSB comprises a Plenary Group, Steering Committee, standing committees, working groups, regional consultative groups, a chairperson and a Secretariat.[11] The Plenary is the sole decision-making body of the FSB for all matters governed by its Charter, and comprises representatives of the members of the FSB,[12] chairs of the main SSBs and committees of central bank experts, and senior representatives of the International Monetary Fund (IMF), the World Bank, the Bank for International Settlements and the OECD. Decisions are taken by consensus.[13] The Plenary may establish standing committees and working groups as necessary.[14]

8 FSB Charter, Article 1. The Charter was amended and restated in June 2012.

9 FSB Charter, Article 2(1).

10 FSB Charter, Article 2(2).

11 FSB Charter, Article 7.

12 The representatives are to be at the level of central bank governor or immediate deputy, head or immediate deputy head of the main supervisory or regulatory agency, and the deputy finance minister: FSB Charter, Article 10(1).

13 FSB Charter, Article 9(2).

14 FSB Charter, Article 9(3)(g).

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The Steering Committee of the FSB is mandated with providing operational guidance for the FSB between meetings of the Plenary. The duties of the Steering Committee include monitoring the progress of the FSB's work, distributing information to members of the FSB, and reviewing the policy development work of the SSBs for the Plenary to consider.[15]

The Chair of the FSB is Randal Quarles, currently Vice-Chairman for Supervision at the US Federal Reserve.

Peer reviews

Peer reviews take place under a new FSB Framework for Strengthening Adherence to International Standards. Under this Framework, member countries of the FSB disclose their level of adherence to international financial standards; they undergo periodic, thematic and single-country peer reviews to evaluate their adherence to these standards; and the FSB identifies non-cooperative jurisdictions (especially those of systemic importance with weak adherence) and assists them with adherence.

OTC derivatives and rating agencies

In October 2010, the FSB published a report on implementing OTC derivatives market reforms. The report includes 21 recommendations addressing practical issues in implementing the G20 leaders' commitments concerning standardisation, central counterparty (CCP) clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions. In particular:

a the report concluded that the proportion of the OTC derivatives market that is standardised should be substantially increased to promote CCP clearing and trading on organised platforms, to reduce systemic risk and improve market transparency;

b the report specifies factors that should be taken into account when determining whether a derivative product is standardised and suitable for CCP clearing;

c authorities may consider measures to limit or restrict trading in OTC derivatives that are suitable for clearing but not centrally cleared. Authorities should also ensure that access to CCPs is based on objective criteria, and that a safe and sound environment exists for indirect access. Supervisors should apply prudential requirements that appropriately reflect the risks of non-centrally cleared OTC derivatives;

d work should be undertaken to identify those actions needed to ensure that all standardised OTC derivative products are traded on exchanges or electronic trading platforms, where appropriate; and

e national authorities need to have a global view of the OTC derivatives markets through full and timely access to relevant data.

In Europe, these recommendations have been addressed through the regulatory regime for OTC derivatives and CCPs contained in Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (Chapter 20, Section VIII).

15 FSB Charter, Article 12(3).

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On 27 October 2010, the FSB published principles for reducing reliance on credit rating agency ratings. Excessive reliance on ratings as a substitute for independent credit analysis was a feature of the run-up to the financial crisis. The recommendations included the following:

a standard setters and authorities should assess references to credit rating agency ratings in standards, laws and regulations and, wherever possible, remove them or replace them with suitable alternative standards of creditworthiness;

b banks, market participants and institutional investors should make their own credit assessments, and not rely solely or mechanistically on ratings;

c central banks should reach their own credit judgements on the financial instruments that they will accept in open market operations, both as collateral and as outright purchases; and

d banks must not rely mechanistically on ratings for assessing the creditworthiness of assets. Larger, more sophisticated banks should be expected to assess the credit risk of all assets that they hold (either outright or as collateral).

These principles are echoed in the Basel Committee's consultation papers on the revisions to the standardised approach (see above).

Dealing with systemically important financial institutions

On 2 November 2010, the FSB published a report containing recommendations for enhanced of systemically important financial institutions (SIFIs). The FSB considered that the level of supervision applied by national authorities to SIFIs must be commensurate with the potential destabilisation risk that such firms pose to their domestic financial system, as well as the broader international financial system. The report made a series of recommendations covering the mandates of supervisors, independence, adequate resources, supervisory powers, techniques of supervision, group-wide and consolidated supervision, macroprudential surveillance and the use of third parties.

On 12 November 2010, the FSB followed up with a report on reducing the moral hazard posed by SIFIs. Its recommendations included the following:

a All FSB member jurisdictions should put in place a policy framework to reduce the risks and externalities associated with domestic and global SIFIs (G-SIFIs) in their jurisdiction.

b G-SIFIs should have a loss-absorption capacity beyond the Basel III standards. They should have a higher share of their balance sheets funded by capital or by other instruments that increase the resilience of the institution as a going concern. Depending on national circumstances, this could be drawn from a menu of alternatives, and achieved by a combination of a capital surcharge, a quantitative requirement for contingent capital instruments, and a share of debt instruments or other liabilities represented by bail-inable claims. In some circumstances, further measures, including liquidity surcharges, tighter large exposure restrictions, levies and structural measures could reduce the risks that a G-SIFI presents. The Basel Committee's proposals for additional capital to be held by G-SIBs have already been mentioned. In November 2011, the FSB published an initial list of G-SIFIs that are subject to requirements for additional loss absorbency. The list is reviewed and updated annually; the most recent update was issued in November 2018.

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c All jurisdictions should undertake legal reforms necessary to ensure that they have in place a resolution regime that makes feasible the resolution of any financial institution without taxpayer exposure to losses. National authorities should consider restructuring mechanisms to allow recapitalisation as a going concern by way of contractual or statutory debt-equity conversion and write-down tools.

d Recovery and resolution plans that assess G-SIFIs' resolvability should be mandatory. Authorities must have powers to require a financial institution to make changes to its legal and operational structure to facilitate resolution. If a SIFI has multiple significant legal entities, it should:

- maintain information on a legal-entity basis;
- minimise any undue intragroup guarantees;
- ensure that service agreements are appropriately documented and cannot be abrogated in resolution; and
- ensure that significant global payment and settlement services are legally separable.

Resolution regimes

On 4 November 2011, the FSB published its Key Attributes of Effective Resolution Regimes for Financial Institutions, setting out the core elements necessary for an effective resolution regime. The Key Attributes include essential features that should be part of the resolution regimes of all jurisdictions, including scope, the resolution authority, set-off, segregation of client assets, safeguards, crisis management and institution-specific cross-border cooperation arrangements. The Key Attributes continue to provide the fundamental practical and intellectual basis for resolution regimes in all major banking jurisdictions, including the EU and, to a significant extent, the United States. The FSB concluded that an effective resolution regime (interacting with applicable arrangements for the protection of depositors, insurance policyholders and retail investors) should:

a ensure continuity of systemically important financial services, and payment, clearing and settlement functions;

b protect, where applicable, depositors, insurance policyholders and investors that are covered by insurance arrangements, and ensure the rapid return of segregated client assets;

c allocate losses to firms' owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;

d not rely on public support and not create an expectation that such support will be available;

e avoid unnecessary destruction of value, and therefore seek to minimise the overall costs of resolution and, where consistent with the other objectives, losses for creditors;

f provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;

g provide a legal mandate for cooperation, information exchange and coordination domestically and with foreign resolution authorities;

h ensure that non-viable firms can exit the market in an orderly manner; and

i be credible, and thereby enhance market discipline.

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It was also determined that resolution powers should include stabilisation options (through the sale or transfer of shares to a purchaser or to a bridge bank, recapitalisation, or both) as well as liquidation options.

In July 2013, the FSB published three reports on aspects of recovery and resolution planning for SIFIs to assist authorities and firms in meeting the requirements of the FSB's Key Attributes of Effective Resolution Regimes.

The first of these set out guidance on developing effective resolution strategies; that resolution plans should help achieve an orderly resolution and facilitate the effective use of resolution powers. Common considerations included:

a the sufficiency of loss-absorbing capital;
b the position of that capital in the creditor hierarchy and the operational structure, legal structure, enforceability and implementation of bail-in;
c the treatment of financial contracts in resolution;
d funding arrangements; and
e cross-border cooperation and coordination in the proximity of failure.

The report considered as alternatives a single point of entry and multiple points of entry in a banking group in a resolution scenario. In the former case, resolution powers would be applied at the top parent or holding company level, and would involve the write-down or mandatory conversion of unsecured debt into equity. Multiple point of entry resolution involves the application of resolution powers by two or more resolution authorities to different parts of the group, and is likely to result in the break-up of the group into two or more separate units. The choice of resolution strategy should take into account the structure and business model of the group concerned and the group's particular characteristics. According to the report, a single point of entry may represent the most effective option for a banking group that operates in a highly integrated manner, whereas a multiple point of entry strategy may well be suitable for a group with a decentralised structure, with subgroups of relatively independently capitalised and separately funded subsidiaries. Neither strategy is, in reality, without significant legal and practical challenges, and it may be that, over time, the norm for global banking groups (if there could be such a thing) will be a resolution strategy that is a hybrid of the single point of entry and multiple point of entry strategies.

The second FSB report set out guidance on recovery triggers and stress scenarios. The report referred to both quantitative and qualitative triggers. Quantitative triggers include ratings downgrades, credit risk limits, withdrawal of deposits or other funding, and the three-month interbank rate. This will presumably be replaced by risk-free rates. Qualitative triggers could include requests from counterparties for early redemption of liabilities, difficulties in issuing debt at current rates, an unexpected loss of senior management or adverse court rulings. The report noted that G-SIFIs typically use two to four stress scenarios for recovery planning purposes. These may include both systemic and idiosyncratic stress scenarios. Examples of stress scenarios include losses through a rogue trader, a euro or dollar crisis, decreasing GDP rates, loss of goodwill, a significant withdrawal of deposits, an exodus of talent, a collapse of global financial markets and fraud. The report notes that some G-SIFIs also perform reverse stress testing (which involves identifying scenarios in which the group would fail).

The third FSB report provided guidance on the identification of critical functions and critical shared services that resolution regimes and strategies should seek to preserve. A critical

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function is one provided by a G-SIFI to third parties where the sudden failure to provide the function would be likely to have a material impact on third parties because of the systemic relevance of the function or of the G-SIFI in providing the function.

In October 2016, the FSB published the Key Attributes Assessment Methodology for the Banking Sector. The Methodology is intended primarily for use in assessments performed by authorities of existing resolution regimes and of any reforms, peer reviews of resolution regimes, and IMF and World Bank assessments of resolution regimes. The document sets out five preconditions for effective resolution regimes and 12 key attributes. The preconditions include:

a a well-established framework for financial stability, surveillance and policy formulation;
b an effective system of supervision, regulation and oversight of banks;
c effective protection schemes for depositors and clear rules on the treatment of client assets;
d a robust accounting, auditing and disclosure regime; and
e a well-developed legal framework and judicial system.

The key attributes set out essential criteria as well as explanatory notes.

In November 2017, the FSB consulted on proposed guidance to support resolution planning and promote resolvability. The first consultative document proposes a set of principles to assist authorities as they make G-SIB bail-in resolution strategies operational. The second sets out proposed guidance on the development of a plan for funding in resolution that builds on the FSB's August 2016 Guiding Principles on the temporary funding needed to support the orderly resolution of a G-SIB and existing supervisory and resolution guidance on liquidity risk management and resolution planning.

Shadow banking

The FSB published a report entitled Shadow Banking: Strengthening Oversight and Regulation on 27 October 2011, addressing the risks posed to financial stability in the pre-crisis period by non-banks that engaged in maturity transformation. The FSB defined shadow banking as credit intermediation involving entities and activities outside the regular banking system. National authorities should have appropriate system-wide oversight of the shadow banking system, backed up by adequate data-gathering powers and exchange of data within and between jurisdictions. The FSB proposed a three-step approach involving an assessment of the overall shadow banking system, the identification of systemic risk or cases of regulatory arbitrage followed by a detailed assessment of concerns identified. Particular attention should be paid to maturity transformation, liquidity transformation, credit risk transfer and leverage. The report also set out specific regulatory responses:

a consolidation rules should ensure that shadow banking entities that a bank sponsors are included within its regulatory balance sheet for the purposes of capital, liquidity and leverage;
b limits on the size and nature of a bank's exposures to shadow banking entities should be enhanced;
c risk-based requirements for banks' exposures to shadow banking entities should be reviewed to ensure all such risks are captured;
d banks' ability to stand behind non-consolidated entities should be restricted through stricter regulation of implicit support;
e the regulation of money market funds needed to be enhanced;

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f further regulation should be considered in respect of other shadow banking entities where they pose systemic risk or provide opportunities for regulatory arbitrage (e.g., conduits, SIVs), finance companies, mortgage insurance companies and credit hedge funds); and

g regulation of repo agreements and securities lending should be considered.

In August 2013, the FSB set out an overview of policy recommendations for strengthening oversight and regulation of shadow banking.[16] The FSB identified five areas in which oversight and regulation needed to be strengthened:

a mitigating risks in banks' interactions with shadow banking entities;

b reducing the susceptibility of money market funds to runs;

c improving transparency and aligning incentives in securitisation;

d dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending; and

e assessing and mitigating financial stability risks posed by other shadow banking entities and activities.

The Overview was accompanied by two reports. IOSCO had previously published policy recommendations for money market funds and global developments in securitisation markets. The first report provided a policy framework for addressing shadow banking risks in securities lending and borrowing. The report made a number of recommendations, including the following:

a authorities should collect more granular data on securities lending and repo exposures among large international financial institutions;

b trade data and regular snapshots of outstanding balances for repo markets should be collected;

c the total national and regional data for both repos and securities monthly lending should be aggregated;

d authorities should review reporting requirements for fund managers to end investors;

e authorities for non-bank entities that engage in securities lending should implement regulatory regimes meeting the minimum standards for cash collateral reinvestment in their jurisdiction;

f authorities should ensure that regulations governing re-hypothecation of assets meet minimum standards;

g authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants; and

h authorities should evaluate the costs and benefits of introducing CCPs in the inter-dealer repo market.

The report also set out a proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions. This regulatory framework was revised in November 2015.

16 Available at www.fsb.org/wp-content/uploads/r_130829a.pdf.

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The second report set out a policy framework for strengthening oversight and regulation of shadow banking entities. The report included a set of toolkits available to address risks presented by specific shadow banking entities. These are based on four overarching principles:

a authorities should define and keep up to date the regulatory perimeter (i.e., the activities that are regulated);

b authorities should collect information needed to address the extent of risks caused by shadow banking;

c authorities should enhance disclosure by other shadow banking entities; and

d authorities should assess non-bank financial entities based on their economic functions.

ii Total loss-absorbing capacity principles for G-SIBs

G-SIBs

In November 2014, the FSB published a consultation paper on the adequacy of loss-absorbing capacity of G-SIBs, expounding the concept of total loss-absorbency capacity (TLAC). The consultation paper consisted of two parts. The first proposed principles on loss absorption and recapitalisation capacity of G-SIBs in resolution. The second part contained a proposal for a term sheet for instruments that contribute to TLAC as an implementing measure of these principles in the form of an internationally agreed standard for G-SIBs.

On 9 November 2015, the FSB published the final TLAC principles and term sheet, which reflects changes made following the public consultation and the comprehensive impact assessment studies.

G-SIBs will be required to meet the TLAC requirement alongside the minimum regulatory requirements set out in the Basel III framework. Specifically, they will be required to meet a minimum TLAC requirement of at least 16 per cent of the resolution group's RWAs (TLAC RWA minimum) from 1 January 2019 and at least 18 per cent from 1 January 2022. Minimum TLAC must also be at least 6 per cent of the Basel III leverage ratio denominator (TLAC leverage ratio exposure (LRE) minimum) from 1 January 2019, and at least 6.75 per cent from 1 January 2022.

G-SIBs headquartered in emerging market economies will be required to meet the 16 per cent RWA and 6 per cent LRE minimum TLAC requirement not later than 1 January 2025, and the 18 per cent RWA and 6.75 per cent LRE minimum TLAC requirement not later than 1 January 2028. This period will be accelerated if, within five years of 2015, corporate debt markets in these economies reach 55 per cent of the emerging market economy's GDP.

The FSB will monitor implementation of the TLAC standard and will undertake a review of the technical implementation by the end of 2019.

In December 2016, the FSB consulted on the Guiding Principles on the Internal TLAC Capacity of G-SIBs (internal TLAC). Internal TLAC is the loss-absorbing capacity that resolution entities have committed to material subgroups. It provides a mechanism by which losses and recapitalisation needs of material subgroups may be passed with legal certainty to the resolution entity of a G-SIB resolution group without the entry into resolution of the subsidiaries within the material subgroup. A material subgroup is either an individual subsidiary or group of subsidiaries that are not resolution entities, and that meet certain quantitative criteria or are identified by a firm's crisis management group as material to the exercise of the firm's critical functions. Each material subgroup must maintain internal TLAC

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of between 75 and 90 per cent of the external minimum TLAC requirement that would apply if the subgroup were a resolution group. The guiding principles cover:

a the process of identifying material subgroups and their composition;
b the role of home and host authorities, and the factors to be considered when determining the size of the internal TLAC requirement;
c practical considerations relating to the issuance and composition of internal TLAC;
d features of the trigger mechanism for internal TLAC; and
e cooperation and coordination between home and host authorities in triggering internal TLAC.

The Basel Committee published a standard for the prudential treatment of banks' investments in TLAC in October 2016. Basically, G-SIBs and non-G-SIBs will be required to deduct non-regulatory capital TLAC holdings from Tier 2 capital. However, a materiality threshold will apply of 10 per cent of the common shares and TLAC holdings of the issuer. Amounts above 10 per cent will be deducted and lower amounts risk-weighted. For G-SIBs, there is a 5 per cent threshold for the investing bank's common equity for TLAC holdings held in the trading book and sold within 30 business days.

In December 2016, the FSB published a consultation document on guidance on continuity of access to financial market infrastructure for a firm in resolution.

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Chapter 2

ARGENTINA

Pablo José Torretta and Ivana Inés Grossi[1]

I INTRODUCTION

The Argentine financial system is currently composed of 63 banks and 14 financial entities (other than banks). In accordance with the last survey published by the Argentine Central Bank (BCRA),[2] the top five financial institutions, in terms of consideration of their total assets, are:

a Banco de la Nación Argentina, whose assets in 2018 rose to a sum of 1,252,519.8 million Argentine pesos;

b Banco Santander Rio SA, whose assets in 2018 were worth 502,037.2 million Argentine pesos;

c Banco de Galicia y Buenos Aires SAU, whose assets in 2018 were worth 494,311.4 million Argentine pesos;

d Banco de la Provincia de Buenos Aires, with assets of 444,632.3 million Argentine pesos in 2018; and

e BBVA Banco Frances SA, whose assets in 2018 rose to a sum of 335,368 million Argentine pesos.

In spite of major efforts over the past few years that have strengthened the existing controls over the banking industry, enabling it to become a relatively conservative system and reducing risk exposures, there is still much work to be done as there continues to be a real lack of confidence in the system. Proof of this can be seen in the fact that our country still has below-average levels of banking inclusion (only 49 per cent, according to a report issued by the Argentine Fintech Chamber in 2018[3]) in comparison with other countries of the region.

In this sense, over the past year, financial regulations have especially focused on financial inclusion, taking advantage for this purpose of the worldwide appearance of new players in the financial system: fintechs. Through the strategic alliance of and cooperation between banks and fintechs, it is expected that banks will improve their functionality and expand their reach to the significant majority of people currently excluded from the financial system. The financial regulators have been encouraging this symbiosis to encourage the system's growth, leading to an interesting new range of possibilities, such as the use of technology in the provision and development of financial services, allowing, for instance, the creation of digital

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2 http://www.bcra.gov.ar/Pdfs/PublicacionesEstadisticas/Entidades/201811e.pdf.

3 Argentine Fintech Chamber Report: Informe Ecosistema Fintech Argentino (2018); page 43.

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wallets for the performance of instant payments or money transfers ordered through mobile devices or computers, or even the withdrawal of cash from retail stores having regulated non-financial correspondents.

Major improvements have also occurred in the foreign exchange field, where restrictions on the outflow from and the entrance of foreign currency into the country have been eliminated, dramatically reducing the control performed over these operations by financial institutions, and consequently increasing the performance of foreign investments in the country.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The Argentine banking industry is subject to strict regulations and controls, mainly provided by the Financial Institutions Law (FIL),[4] which has been regulating banking activities in Argentina since 1977. At the same time, the FIL places the supervision and control of the Argentine banking system on the BCRA.

The BCRA is an autonomous organism in charge of enforcing all financial regulations. It is ruled internally by its Organic Chart,[5] which determines its powers and functions as the lead regulator of the banking system.

The functions carried out by the BCRA can be grouped into two: all the concrete measures and actions taken to promote monetary and financial stability, which are the typical functions performed by central banks; and the regulatory faculties, which include the elaboration and enforcement of the regulations necessary to achieve its aims. Regarding its regulatory faculties, the BCRA has vested, through its Organic Chart, its supervisory powers and the enforcement of regulations enacted by it to the Superintendency of Financial and Foreign Exchange Institutions (Superintendency).

The FIL has explicitly conferred to the BCRA the following powers:

a granting and revoking bank licences;
b authorising the establishment of bank branches abroad;
c approving bank mergers, capital increases and certain transfers of stock;
d setting minimum capital, liquidity and solvency requirements and lending limits;
e granting credit facilities to financial institutions in cases of liquidity problems; and
f promulgating all the regulations that are deemed necessary for such purposes.

Regulations enacted by the BCRA are known as communications, and play an essential role in the banking regulatory system. The BCRA is also the enforcement authority of the foreign exchange market, regulating all relevant aspects of it. Furthermore, the BCRA regulates certain effects produced in the banking system by some other specific regimes, such as those introduced by the following regulations:

a the Capital Markets Act;[6]
b the Anti-Money Laundering Act;[7]
c the Credit Cards Act;[8]

4 Law No. 21,527.
5 Law No. 24,144.
6 No. 26,831.
7 No. 25,246.
8 No. 25,065.

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d the Data Protection Act;[9]
e the Antitrust Act;[10] and
f the Consumer's Defence Act.[11]

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

As the regulator of the Argentine financial system, the BCRA requires financial institutions to submit information on a daily, monthly, quarterly, semi-annual and annual basis. These reports, which include balance sheets and income statements, and information relating to reserve funds, deposits, portfolio quality and other matters, allow the BCRA to monitor institutions' financial conditions and business practices.

Accordingly, since 1994, the BCRA began to rate financial institutions based on the CAMEL quality rating system. Each letter of the CAMEL system corresponds to an area of the operations of each bank being rated, with 'C' standing for capital, 'A' for assets, 'M' for management, 'E' for earnings and 'L' for liquidity. Each factor is evaluated and rated on a scale from one to five, being one the highest rating an entity can receive.

This system was replaced in 2000 by CAMELBIG. Even though the objective and basic methodology of this new system do not differ substantially from the previous CAMEL system, the components were redefined to evaluate business risks separately from management risks. Therefore, the components used to rate business risks are capital, assets, market, earnings, liquidity and business. The components to rate management risks are internal control and the quality of management. By combining the individual factors under evaluation, an index can be obtained that is representative of the final ratings for the financial institutions analysed.

ii Management of banks

Regarding financial entities' management structures, directors and top-level managers of banks in Argentina must be appointed, and must exercise their functions in accordance with specific dispositions given by the BCRA. The latter evaluates their capacity, experience, reputation and ability in the financial field, and is also in charge of approving their appointment for such appointment to be effective. The management personnel designated for the management of foreign financial entities branches set up in Argentina must be approved by the BCRA.

The current regulations also establish that banks must have an audit committee composed of at least two members of the board of directors and by the internal audit. Whenever the internal audit function is conducted by independent professionals, the tasks of the internal audit designated responsible may be conducted by any of the designated directors (members of the committee).

In addition, BCRA policies have established that financial institutions must implement adequate internal control procedures for monitoring compliance with corporate governance requirements, and the applicable laws and regulations, and for reporting any deviation to the managers or the board of directors. Therefore, the BCRA has established guidelines and methodologies that firms' internal controls should follow. Under these, the internal controls

9 No. 25,326
10 No. 25,156.
11 No. 24,240.

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should focus on three different categories: measuring the effectiveness and efficiency of transactions, testing the reliability of accounting information, and monitoring compliance with the applicable laws and regulations.

The responsibility for compliance with the internal controls lies, according to the BCRA criteria, on all members of financial entities. However, such responsibility is especially assigned by the regulations to the board of directors, the managers, the audit committee and the internal auditor. The BCRA has also elaborated a set of guidelines for financial entities' good corporate governance (good practices).

With respect to financial entities' management and employees' bonus payments, a specific procedure and requirements must be met for their granting, mostly related to financial entities' compliance with minimum cash and capital requirements, among other conditions. These requirements are revised periodically, mainly in consideration of the volume of financial entities' operations.

In this sense, the regulations establish that bonus payments may be carried out provided that financial entities are not found to be undergoing a regularisation or restructuration process; they do not register for financial assistance from the BCRA; and they do not present delays or non-compliance with the BCRA informative regimes, or deficiencies of integration of capital or minimum cash requirements.

iii Regulatory capital and liquidity

Minimum capital requirements

The BCRA has also worked during the past few years on the implementation of policies aiming to comply with the Basel III guidelines, designing a roadmap for this purpose. On the same note, it has established regulations regarding the liquidity coverage ratio (LCR), LCR monitoring tools, and introducing Basel principles for liquidity risk management and supervision.

In that sense, the BCRA has stated that the minimum legal capital requirement should be equal to the greater value resulting from a comparison between the applicable basic requirement (corresponding to the type of entity) and the sum of those requirements determined by credit and market risk, as well as the operational risk.

The minimum legal capital requirement may be increased by 1 per cent in relation to certain assets if the financial institution is considered systemically important. Furthermore, when banks act as a custody or registry agent, exigencies are higher.

To verify compliance with the minimum capital requirements, the paid-in capital to be considered shall be the computable regulatory capital (RPC).

Any financial institution operating with an RPC under the minimum legal capital requirement shall pay in the correspondent amount within a certain period as of when it was determined to have failed to comply with the requirement, or submit to the Superintendency a regularisation and reorganisation plan. The Superintendency may appoint a supervisor and impose restrictions on distribution of dividends, among other actions.

Moreover, any financial institution operating under the minimum daily capital requirement related to market risk, when such failure is caused by the requirements established to prevent interest rate risk, foreign exchange risk or equity prices risk, shall pay in the corresponding amount or reduce its asset position, or both, until the applicable requirement is complied with. In cases where the non-compliance situation remains after the given term has elapsed, the entity must submit a regularisation and reorganisation plan to the Superintendency within the following five days.

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Legal reserves

The BCRA requires that every year banks allocate to a legal reserve that is not higher than 20 per cent or lower than 10 per cent of their yearly net profits. Such reserve may only be used during periods of bank losses and after using up every allowance and other reserves. Distribution of dividends will not be allowed if the legal reserve has been impaired.

Minimum cash requirements

Financial institutions are also required to observe minimum cash requirements. These are established as a percentage of the balances of the different types of bank deposits. For term deposits, the percentage varies depending on the time remaining until maturity. The deposit amount minus the minimum cash requirement is such deposit's lending capacity.

Compliance with the minimum cash requirements is determined in averages, for monthly periods. The BCRA modifies from time to time the percentages of the minimum cash requirements depending on monetary policy considerations. Compliance must be accomplished with certain assets, and completed in the same currency as the deposit that triggers such requirement.

Supervision of banking groups

Financial entities must require each shareholder in Argentina or abroad to prepare consolidated financial statements of the group to be presented semi-annually to the Superintendency. Consolidated financial statements of foreign groups will also be required to be audited by a firm of recognised prestige.

Entities that own or acquire shares in foreign subsidiaries must give their consent to provide the information required by the Superintendency for the purpose of exercising supervision based on the consolidated financial situation. For the determination of the information requirements, the Superintendency shall take into account the legislation of the country where the subsidiary is located and the agreements that are made with the local supervisory body.

In cases in which the Superintendency does not have the information that it deems necessary to evaluate the situation of a consolidated financial institution, local financial entities will not be allowed to hold shares in banks or foreign companies subject to consolidation as significant subsidiaries. Given this, the Superintendency will suggest to the BCRA the appropriate time frame for the sale of such shares.

iv Recovery and resolution

Financial entities' regularisation

The FIL establishes that financial institutions that evidence a deficiency in their cash reserves or have not complied with certain technical standards that are required, including minimum capital requirements, or whose solvency or liquidity is deemed to be impaired by the BCRA, must submit a restructuring plan to the BCRA.

In relation to the restructuring plans, the BCRA may require a financial institution involved to provide guarantees or to limit the distribution of profits, and appoint a supervisor to oversee such financial institution's management with the power to veto decisions taken by the financial institution's corporate authorities.

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Revocation of authorisation to function

If a restructuring plan is not filed, approved or fulfilled by the financial entity, the BCRA may revoke its authorisation to function. The BCRA board may also resolve the revocation of an authorisation to operate a financial institution in the following situations: at the request of the authorities of the entity; in cases of dissolution established in the codes and laws that regulate its existence as a legal entity; and in other cases established in the FIL (e.g., sanctions or a fundamental change to the basic conditions taken into account at the time of authorisation).

Restructuring and dissolution of financial entities

Argentina's legal system has a specific procedure to deal with banking insolvency – which differs from the ordinary procedure established by the Bankruptcy Law – that involves the intervention of the BCRA to protect customers and creditors. Such procedure is regulated in Section 35-bis of the FIL and establishes that if, in the judgment of the BCRA, a financial institution is in a situation that the FIL would authorise the BCRA to revoke the financial institution's licence to operate as such, the latter may, prior to considering such revocation, order a variety of measures, including:

a taking steps to reduce, increase or sell the financial institution's capital;
b revoking the approval granted to the shareholders of the financial institution to own an interest therein, giving a term for the transfer of such shares;
c excluding and transferring assets and liabilities;
d constituting trusts with part or all of the financial institution's assets;
e granting temporary exemptions to comply with technical regulations, or paying charges and fines arising from such defective compliance, or both; and
f appointing a bankruptcy trustee and removing statutory authorities.

It is important to note that any actions authorised, commissioned or decided by the BCRA under the FIL involving the transfer of assets and liabilities, or such deemed necessary to execute the restructuring of a financial institution, as well as those related to the reduction, increase or sale of their equity, are not subject to any court's authorisation, and cannot be deemed inefficient in respect of the financial institution's creditors.

Regarding the dissolution of financial entities, the BCRA must be notified of any decision to dissolve a financial institution pursuant to the FIL. The BCRA must then notify a court of competent jurisdiction, which will determine who will liquidate the entity (either the corporate authorities or an appointed independent liquidator). This determination is based on the ability of the corporate authorities and the existent assurances to carry out the liquidation properly.

Moreover, the bankruptcy of a financial institution cannot be adjudicated until the licence is revoked. No creditor, with the exception of the BCRA, may request the bankruptcy of a former financial institution before 60 days have elapsed since the revocation of its licence.

Finally, it is worth noting that financial entities' branches are responsible for their own assets: parent companies do not respond for them.

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Suspension of functions

The BCRA Organic Chart authorises the Superintendency, subject to the prior approval of the President of the BCRA, to suspend for up to 30 days, in whole or in part, the operations of a financial institution if its liquidity or solvency has been adversely affected. Notice of this decision must be given to the BCRA's board of directors.

If at the end of such suspension period the Superintendency considers it is necessary to renew it, it can only be authorised by the board of directors for an additional period of up to 90 days. During the suspension period, there is an automatic stay of claims, enforcement actions and precautionary measures; any commitment increasing the financial institution's liabilities is void; and the acceleration of indebtedness and interest accrual is suspended.

Deposit insurance system

Argentina also has an insurance deposit system called SEDESA that protects the rights of depositors under crisis scenarios. This system is funded with periodic mandatory contributions from banks and guarantees, which has currently risen up to 450,000 Argentine pesos per person, account and deposit.

IV CONDUCT OF BUSINESS

The Superintendency, in its capacity as the banking system enforcement authority, performs formal inspections of all banking institutions to monitor their compliance with the legal and regulatory requirements established by the FIL and BCRA regulations. These include control of the fulfilment of the different informative regimes established by this entity.

If regulations are breached, the Superintendency may impose various sanctions, depending on the seriousness of the infringement. Sanctions range from warning calls to fine impositions, or even the revocation of a licence. In certain cases, non-compliance may result in the mandatory filing of a specific adequacy plan, which must be approved by the BCRA to remain operational (e.g., in the case of non-compliance with minimum capital requirements). In addition, financial entities may be sanctioned through the application of other regimes' general rules, such as the consumer's defence regime,[12] or for a breach of any obligation protected by the Argentine Civil and Commercial Code, in which case they will be treated and judged as ordinary legal entities.

At the same time, financial institutions may be judged by criminal courts when they have performed a criminal offence as provided by the Argentine Criminal Code (such as the performance of non-authorised financial or securities intermediation).

Financial institutions are also subject to the foreign exchange criminal regime, which was created to reinforce the fulfilment of BCRA regulations on foreign exchange transactions through the imposition of criminal sanctions. Sanctions range from the issuance of a fine, the suspension from or impairment to operating as a financial institution, up to the imprisonment of directors, managers or other legal representatives.

12 The Consumer's Defence Act establishes the mandatory disclosure of the annual effective interest rate for financial operations for consumption and consumers' credit. Its omission will determine that the obligation of the borrower to pay interest will be adjusted to the annual average passive rate, published by the BCRA on the date of conclusion of the contract. By this Act, the BCRA is entitled to take the necessary measures to reinforce such obligations.

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Furthermore, the FIL and BCRA communications regulate banking secrecy. Such regulations ban the disclosure of passive operations (e.g., savings accounts, checking accounts, time deposits and other liability products) to ensure the confidentiality of information and documents related to a financial entity's client and to a certain transaction, but only regarding information referred to passive operations and to an identified or identifiable customer. Notwithstanding, there are some exceptions to this rule (e.g., judicial disposition). The sanctions applicable for violations of banking secrecy rules are those established by the FIL, and may also constitute a criminal offence.

V FUNDING

In addition to their own equity, financial entities may also obtain funds from deposits (in Argentine pesos or US dollars) or investments from outside the financial sector, and from other alternative sources such as the issuance of bonds and by the performance of a public offering of their shares in the market.

The FIL includes, among financial entities' permitted activities, the capacity to:

a receive loans;

b receive deposits from the general public in local and foreign currencies;

c securitise their customers' debts; and

d acquire, place and trade with shares and debt securities in the Argentine over-the-counter market, subject to a report to the Securities National Commission (CNV).

They may also sell its assets through private transactions, provided that certain regulatory requirements are fulfilled.

Likewise, subject to the prior authorisation of the Superintendency, the following instruments are allowed as capital contributions: securities issued by the government, debt instruments issued by the BCRA, and a financial institution's deposits and other liabilities resulting from financial intermediation, including subordinated obligations.

Furthermore, under certain circumstances, the BCRA authorises financial entities to carry out repurchase transactions provided that determined requisites are observed. Certain financial entities may also obtain loans from the BCRA, whose repayment shall pre-emptively occur when an entity's liquidity ratio exceeds 40 per cent. According to the BCRA's Organic Chart, this may provide advances or further discounts for financial entities with transitory liquidity issues. Moreover, in such transitory situations, the BCRA may assign, transfer or sell credits acquired from the affected financial institutions.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The FIL and BCRA communications regulate the reporting duties and approval conditions required for a change in financial entities' equity's composition, and for the acquisition of financial entities.

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Substantial modifications of equity composition

A negotiation of shares or other circumstances capable of producing a change in the qualification of, or that may alter the structure of the respective groups of shareholders of, financial entities, must be reported. This obligation shall apply to sellers and purchasers of shares, and to boards of directors of cooperative societies and their members.

Within 15 days of the performance of such reporting, detailed information of the operation must be provided to the Superintendency. The transaction (payment of the price, transfer of stocks, etc.) cannot be performed until a resolution is passed.

Authorisation is a condition precedent for a transaction to be enforceable and, once presented to the competent authorities, there is no legal time frame for the BCRA to decide on it.

The BCRA will analyse the information provided, and will pass a resolution based on the convenience and opportunity of the operation, and on the grounds of the precedents credited by the parties (regarding their previous conduct and sanction impositions). At the same time, the BCRA may also revoke authorisations granted if there have been fundamental changes in the basic conditions taken into account for the granting of such.

If granted, an authorisation to operate will depend on the suitability of the initiative, the characteristics of the project, the general and particular conditions of the market, and the background and responsibility of the applicants and their experience in financial activities. There are no specific instructions regarding how a detailed business report is to be presented to the Superintendency for its approval.

Changes in financial entities' equity composition

Legal entities that intend to acquire shares of financial institutions must be regularly constituted, and, in the case of foreign companies, must be registered with the correspondent corporate authority in their home jurisdiction. When an acquirer is a foreign financial institution, a certificate from the supervision authority of the country of origin must be presented granting its legal establishment in such country and crediting proper supervision to the enacting authority.

Acquisitions by financial entities

Financial entities shall report to the Superintendency prior to making commitments or undertaking negotiations aimed at acquiring shares of another financial institution in such a proportion as to enable it to exercise control when total deposits of the entity whose shares would be transferred exceed 2 per cent of the deposits of the financial system; total deposits of the entity whose shares would be transferred exceed 50 per cent of the total deposits of the acquiring entity; or when the entity that would acquire those shares have a rating of three to five with the Superintendency.

Acquisition by controlling entities of other financial entities

Companies that directly or indirectly control financial entities must report directly to the Superintendency prior to entering into commitments or negotiations aimed at acquiring, directly or through branches or subsidiaries, shares of another financial entity in such a proportion that allows them to exercise control for the welfare of society when any of the following situations occurs: the total deposits of the entity whose shares would be transferred exceed 2 per cent of the total deposits of the financial system; the total deposits of the entity

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whose shares would be transferred exceed 50 per cent of the total deposits of the entity already controlled; or when some of the financial entities controlled by the acquiring company of the shares of another financial institution have a rating of three to five with the Superintendency.

Other approvals for acquisitions of financial entities

There are some other notification duties and approvals necessary for the purchase of shares of a financial institution when such purchase implies a change of control, such as notification to the CNV and to the National Commission of Competition (CNDC).

Pursuant to the applicable regulations, in the event of a change of control, the local licensed company will retain its licence. However, such company must promptly notify the CNV and any other relevant administrative authority. The notification shall be performed immediately after the first binding document or memorandum of understanding has been executed. Otherwise, an administrative investigation might be started, and the CNV might apply warnings, fines and even the suspension of a licence.

In addition, unless a 'first landing exception' becomes applicable – that is to say, the purchasing group does not own shares of Argentine companies or Argentine assets – the transaction must also be submitted to the CNDC for approval. Even though it is a not a condition precedent for closing pursuant to the applicable law, an operation shall not have effect until the approval is received. Filing must be performed by any of the parties involved, within seven days from the relevant documents' execution date. The CNDC could reject a transaction or raise objections. In any case, a buyer will be requested to take measures in order for the transaction to be approved (e.g., sale of assets, partial divestiture).

There are no specific rules regarding banking acquisition structuring processes other than those explained above. Notwithstanding, is important to highlight the fact that financial entities cannot constitute liens on their assets without the prior approval of the BCRA; nor can they receive their own shares as guarantees.

ii Transfers of banking business

Bank business transfers do not have a specifically regulated process, and banks are allowed to sell or transfer portions of their business by single transactions as long as they do not constitute transfers of goodwill. Transfers of goodwill must be approved by the Superintendency.

VII THE YEAR IN REVIEW

Following the goals and efforts completed throughout the past couple of years, regulations still aim to boost the financial industry to achieve financial stability and modernise the banking system. This has been approached mainly through the loosening of restrictions on the foreign exchange market, the introduction and development of certain technological tools and resources for banking operations, the BCRA's active intervention in the regulation of the economy, and by several efforts undertaken to achieve financial inclusion, leading to the following changes:

a the Argentine foreign exchange market has been released from the strict controls and regulations to which it was previously subject (as already mentioned);

b in the wake of the softening of the foreign exchange rules, since March 2018, retail stores and other individuals may register within the BCRA to be authorised to perform foreign exchange transactions with the public; and

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c to contribute to financial inclusion, in November 2018 the BCRA began to regulate non-financial correspondents, thereby enabling financial entities to assign certain services to be rendered by other persons (individuals or entities) in their favour, especially in places where financial entities do not have a physical presence.

Meanwhile, the BCRA is also continuing to adjust, by every feasible means, local regulations to align with international recommendations, such as Basel III (e.g., it has stated that the observance of the International Financial Reporting Standards by financial institutions is mandatory), to keep pace with worldwide tendencies and regulations.

In addition, the Argentine financial system has made significant progress in recent years in increasing minimum capital and cash requirements, and strengthening compliance regulations, mainly in the anti-money laundering field, to comply with international standards.

VIII OUTLOOK AND CONCLUSIONS

On the past few years, and especially since the political transformation the country has witnessed since 2015, the financial industry in Argentina has continued to evolve considerably. There is still much work to be done, not only towards improving financial inclusion, the incorporation of technology into banks' operations and expanding the size of the financial market, but also towards fighting inflationary pressure and achieving financial stability.

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Chapter 3

AUSTRALIA

Andrea Beatty, Gabor Papdi and Chelsea Payne[1]

I INTRODUCTION

The Australian banking industry is dominated by the big four banks – Commonwealth Bank of Australia Limited, Westpac Banking Corporation, National Australia Bank Limited and Australia and New Zealand Banking Group Limited – which are by far the largest banks in Australia by total assets, accounting for almost 80 per cent of total bank assets.[2] The big four banks also make up four of the 10 largest entities by market capitalisation listed on the Australian Securities Exchange. Other institutions, including mutual financial institutions, local operations of foreign banks (whether operating through a local subsidiary or not) and specialist financial services providers, also carry on banking business in Australia. The Australian banking industry is globally connected, with the big four banks (and Macquarie Group Limited) having operations overseas and most global banking groups having operations in Australia. Recently, the conduct of banks towards their customers has been the subject of intense public scrutiny through the Royal Commission into Misconduct in the Banking, Financial Services and Superannuation (Banking Royal Commission), which exposed considerable misconduct in the financial sector and recommended law reforms in relation to consumer lending and non-banking financial services commonly provided by banks in Australia.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The Australian Constitution grants the national (federal) legislature legislative power with respect to banking, other than state banking within the boundaries of the state concerned. Banking business has long been held to be the taking of deposits from customers on loan, to be repaid on demand or as otherwise agreed between the lender and the customer, and the utilisation of that money in the interim by the lending of it.[3] Deposit-taking is the essential element of banking. This definition is substantially replicated in legislation.[4] This limited concept of banking business is relevant when considering the Australian regulatory environment.

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2 APRA Monthly Banking Statistics, October 2018. The most recent APRA Monthly Banking Statistics are available at <https://www.apra.gov.au/publications/monthly-banking-statistics>.

3 *Commissioners of the State Savings Bank of Victoria v. Permewan Wright & Co Ltd* (1914) 19 CLR 457 at 471.

4 Banking Act 1959 (Cth) Section 5(1).

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Australia has a twin peaks approach to financial sector regulation: the Australian Prudential Regulation Authority (APRA) is responsible for financial system stability and depositor protection; and the Australian Securities and Investments Commission (ASIC) is responsible for market conduct and consumer protection.

The Reserve Bank is also involved as the central bank, lender of last resort and facilitator of interbank settlements, and in regulating payment systems.

A person may only carry on banking business in Australia if authorised by APRA to do so.[5] Unless it otherwise determines, APRA may only authorise bodies corporate (and not other kinds of corporate structures) to engage in banking business.[6] Bodies corporate authorised by APRA are called authorised deposit-taking institutions (ADIs).

Banking business is regulated separately from the provision of financial services. This includes insurance, securities dealing, fund management, underwriting, stockbroking, custodial and depositary services, and advisory services. Financial services are regulated separately by ASIC, and in most cases require an Australian financial services licence (AFSL). ADIs must obtain an AFSL to provide financial services, although the power to impose or revoke conditions on the AFSL that would affect the ADI's ability to carry on its banking business are removed from ASIC and vested in the Minister for Financial Services personally.[7]

For most purposes, the provision of credit is not a financial service and does not require an AFSL. Consumer credit activities are regulated separately by ASIC. Persons who wish to provide credit to consumers require a credit licence issued by ASIC. ADIs must hold a credit licence in order to lend to consumers, although they are entitled to this licence as of right.[8]

In considering whether to grant ADI authorisation to an applicant, APRA will consider the following factors:[9]

a capital: applicants must be able to comply with the capital adequacy requirements imposed by APRA;

b ownership: applicants (or their holding companies) must comply with the ownership restrictions in the Financial Sector (Shareholdings) Act 1999[10] (discussed later on), and all substantial shareholders must be fit and proper in the sense of being well-established and financially sound entities of standing and substance;

c governance: applicants must satisfy APRA prudential standards concerning corporate governance, and have policies in place to ensure that key officeholders are fit and proper persons;

d risk management and internal controls: applicants must satisfy APRA that these are adequate and appropriate for limiting risk exposures from their operations;

e compliance: applicants must have compliance processes and systems in place that are adequate and appropriate for ensuring compliance with APRA prudential standards and other regulatory requirements;

5 Banking Act 1959 (Cth) Section 8.

6 Banking Act 1959 (Cth) Section 7.

7 Corporations Act 2001 (Cth) Section 913B(5).

8 National Consumer Credit Protection Act 2009 (Cth) Section 38.

9 APRA, ADI Authorisation Guidelines (April 2008), [15]–[33].

10 Financial Sector (Shareholdings) Act 1999 (Cth).

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f information and accounting systems: these must be adequate to maintain up-to-date records of all transactions, to keep management continuously and accurately informed of the ADI's condition and to comply with reporting obligations;

g audit: internal and external audit arrangements must satisfy APRA prudential standards; and

h for foreign bank applicants, the standard of supervision in their home jurisdiction and the consent of their home supervisor.

In an effort to increase competition in the banking industry, APRA allows applicants to apply to be authorised as a restricted ADI (RADI). RADIs are required to hold significantly less capital than full ADIs (the higher of 20 per cent of adjusted assets or A$3 million plus a winding up reserve) and are subject to less stringent prudential standards. However, RADIs may only accept protected deposits (discussed later) up to A$250,000 per customer and up to A$2 million in aggregate. RADI authorisation is only valid for up to two years, after which the RADI must either obtain full ADI authorisation or exit the industry. The RADI licensing scheme was introduced to make it easier for new ventures to enter the Australian banking industry without prejudicing the depositor protection and financial stability achieved by current prudential standards. Unless otherwise stated, references in this chapter to ADIs are references to full ADIs.

The provision of a purchased payment facility (PPF) – a facility purchased from another person that is able to be used for making payments up to the amount standing to its credit from time to time, and under which payments are made by the provider of the facility rather than the purchaser[11] – or being the holder of stored value for a PPF is deemed by legislation to be carrying on banking business.[12] Consequently, providers of PPFs (e.g., digital wallet services) are required to obtain ADI authorisation from APRA. However, the authorisation granted to PPF providers is typically subject to a condition limiting them only to providing PPFs and preventing them from lending money (other than incidental advances to customers in the course of providing a PPF).

ADIs in Australia are structured as bodies corporate. Mutual (customer-owned) financial institutions existing under state laws were, from 1 July 1999 onwards, converted to companies limited by shares under the national corporations legislation.[13] Notwithstanding their conversion to companies with share capital, mutual financial institutions are subject to additional disclosure requirements if their constitutions are to be amended to vary or cancel the rights of members or a class of members.[14] At the time of writing, the federal Treasury had published for consultation draft legislation that, if enacted, will narrow the scope of the definition of mutual entities and make it easier for them to raise capital from external sources.

Financial institutions may be corporate groups. It is only the entity carrying on banking business – that is, accepting deposits from customers – that must be an ADI. Other entities in the corporate group can provide other non-banking services that are typically provided by banks in Australia, such as securities dealing, wealth management, wholesale debt issuance and insurance. The ADI may be either the holding company or a subsidiary within the corporate group. If a holding company is not an ADI, APRA may authorise it to be a

11 A more precise definition is provided in Section 9 of the Payment Systems (Regulation) Act 1998 (Cth).

12 Banking Regulation 2016 (Cth) Regulation 6.

13 Financial Sector Reform (Amendments and Transitional Provisions) Act (No. 1) 1999 (Cth).

14 Corporations Act 2001 (Cth) Schedule 4 Clause 29.

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non-operating holding company (NOHC) of an ADI. If a prospective ADI is a subsidiary of another body corporate, APRA may refuse to grant it authority to carry on banking business unless the body corporate of which it is a subsidiary is authorised as an NOHC.[15] NOHC authorisation subjects the holding company to the ownership restrictions in the Financial Sector (Shareholdings) Act 1998.

Foreign banks may enter the Australian banking industry either by obtaining ADI authorisation for a local subsidiary or by obtaining authorisation to carry on banking business through a branch in Australia (the latter is called a foreign ADI in the Banking Act; the former is in reality a local ADI but with a foreign owner). A local subsidiary ADI of a foreign bank is subject to the same capital requirements and other prudential standards as a locally owned ADIs. Local branches of foreign banks are not subject to any capital requirements, but APRA imposes a condition on their ADI authorisation prohibiting them from accepting initial deposits of less than A$250,000 from individuals (other than their employees) and unincorporated entities. If a foreign bank wishes to accept retail deposits, it must establish a local subsidiary.

APRA is a statutory body corporate[16] established for the purposes of regulating bodies in the financial sector in accordance with laws providing for prudential standards or for retirement income standards, and administering the financial claims scheme (FCS) provided for in the Banking Act 1959 and Insurance Act 1973 (the FCS is discussed later). In performing its functions, APRA is obliged to balance the objectives of financial safety, efficiency, competition, contestability and competitive neutrality; and promote financial system stability in Australia.[17]

In performing its functions and exercising its powers, APRA is also required to support New Zealand authorities in meeting their statutory responsibilities for prudential regulation and financial system stability and, to the extent reasonably practicable, to avoid any action that is likely to have a detrimental effect on financial system stability in New Zealand.[18]

APRA seeks to maintain a low incidence of failure among its regulated institutions, while not hindering competition and efficiency gains. Its stated strategic priorities for 2018 to 2022 are:[19]

a broadening risk-based supervision;
b improving data-enabled decision-making;
c building resolution capability;
d strengthening external engagement and collaboration;
e enhancing leadership, people and culture; and
f lifting organisational capability.

APRA, together with the Reserve Bank of Australia (RBA), ASIC and the federal Treasury, is a member of the Council of Financial Regulators. The Council of Financial Regulators is a coordinating body for Australia's main financial regulators, facilitating the sharing of information between regulators and their cooperation on matters of common concern. The

15 Banking Act 1959 (Cth) Section 9(3A).

16 Australian Prudential Regulation Authority Act 1998 (Cth) Section 13.

17 Australian Prudential Regulation Authority Act 1998 (Cth) Section 8.

18 Australian Prudential Regulation Authority Act 1998 (Cth) Section 8A.

19 APRA, 2018–22 Corporate Plan, p. 7: <https://www.apra.gov.au/sites/default/files/Documents/corporate-plan-2018-22_1.pdf>.

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four members of the Council of Financial Regulators are also members of the Trans-Tasman Council on Banking Supervision, along with the New Zealand Treasury, the Reserve Bank of New Zealand and the New Zealand Financial Markets Authority. The Trans-Tasman Council on Banking Supervision aims to support the development of a single economic market in banking services between Australia and New Zealand, and to promote a joint approach to trans-Tasman banking supervision and crisis resolution.[20]

Internationally, APRA and the RBA represent Australia on the Basel Committee on Banking Supervision and the RBA and federal Treasury represent Australia on the Financial Stability Board.

ADIs with total liabilities of A$100 billion (in July 2017-equivalent values; the threshold is indexed quarterly) in any quarter are subject to a quarterly tax – the Major Bank Levy – of 0.015 per cent of their total liabilities, adjusted to exclude Additional Tier 1 (AT1) capital, FCS-protected deposits, net derivatives liabilities and their exchange settlement account balance with the RBA. The high level of concentration in the Australian banking industry means that the Major Bank Levy is only payable by the big four banks plus Macquarie Group Limited (an NOHC, the ADI being Macquarie Bank Limited), with other ADIs at little risk of exceeding the A$100 billion liabilities threshold. The Major Bank Levy was imposed to reduce the competitive advantage that the major banks derive from their size and greater access to international capital markets, as well as to extract a contribution from them for the implicit subsidy they receive from perceptions of being too big to fail.[21,22]

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

APRA describes its supervisory approach as forward-looking, primarily risk-based and consultative. It also appears to view its role as being protective, with a number of APRA publications referring to depositors, insurance policyholders and superannuation fund members as its beneficiaries.[23] Notwithstanding, APRA is obliged under its founding statute to balance the often competing objectives of financial stability and safety on the one hand, and competition, contestability and competitive neutrality on the other. APRA therefore aims to maintain a low incidence of failure among regulated institutions rather than to guarantee that a regulated institution will never fail. It recognises that primary responsibility for the financial soundness of regulated institutions lies with the management and directors of those institutions.[24]

20 Terms of Reference for the Trans-Tasman Council on Banking Supervision, <https://www.cfr.gov.au/about/trans-tasman-council-on-banking-supervision/terms-of-reference.html>.

21 While Australia does not have any formal bank bailout scheme, other than the FCS in respect of deposits up to a certain amount, the size and market share of each major bank and their importance to the Australian economy means that they are likely to be bailed out by the government if they ever encountered financial distress.

22 Parliament of Australia, The Major Bank Levy explained (23 June 2016), <https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/FlagPost/2017/June/The_Major_Bank_Levy_explained>.

23 See, for example, APRA, 17/18 Annual Report, p. 50; APRA, 2018-22 Corporate Plan, p. 2.

24 APRA, 2018-22 Corporate Plan, p. 3.

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APRA's supervision of ADIs consists of both data analysis and on-site interaction with the ADIs being supervised. The fact that ADIs are required to obtain APRA approval for certain transactions and arrangements also facilitates close cooperation between ADIs and APRA.

In addition to general financial reporting obligations, ADIs are subject to reporting requirements under the Financial Sector (Collection of Data) Act 2001[25] (FSCODA), which facilitates the collection of statistical data by APRA. FSCODA applies not only to ADIs, but also to non-bank lenders who carry on a business of providing finance (although most reporting standards applying to non-bank lenders state that they apply only to named non-ADI entities or non-ADI entities if they have total assets of A$50 million or more). APRA has issued reporting standards under FSCODA that prescribe the data that ADIs must supply to APRA and the form in which it must be supplied.

The data required to be supplied to APRA under FSCODA includes both general financial information, such as a statement of financial position,[26] and specific information about particular kinds of assets and liabilities associated with banking business.[27] The reporting standards require monthly or quarterly reporting, ensuring that APRA has access to current data to assist its decision-making. APRA collects data under FSCODA both to assist it in performing its supervisory functions and for statistical purposes. Data collected by APRA is also shared with other regulators and the Australian Bureau of Statistics, and summary statistical data is made available to the public.

APRA regulates ADIs primarily through the imposition of prudential standards with which ADIs must comply. The prudential standards are, on the whole, concerned with risk management for an ADI. Prudential standards set by APRA address key areas of risk for ADIs, including capital adequacy, liquidity and governance, and aim to ensure that such risks are properly identified and managed. Capital adequacy (which is discussed in more detail later) is the cornerstone of risk management, ensuring that the ADI can absorb losses that arise when adverse risks materialise.

APRA's approach to dealing with regulated entities is consultative and collaborative, both in relation to the setting of standards and enforcement. Its preference has been to work with ADIs to address concerns that it has, as opposed to litigation. The Banking Royal Commission criticised APRA (and ASIC) for their approach to enforcement, suggesting that more litigation to obtain penalties is called for.[28] Much of the misconduct considered by the Banking Royal Commission was within ASIC's field of operation rather than APRA's: it concerned unlawful and undesirable conduct towards consumers in the provision of services other than deposit accounts.

ii Management of banks

Corporate governance requirements

Prudential Standard CPS 510: Governance (CPS 510) sets out governance requirements that ADIs must comply with in addition to general corporations law obligations.

25 Financial Sector (Collection of Data) Act 2001 (Cth).

26 See reporting standards ARS 320.0, ARS 322.0 and ARS 323.0.

27 See, for example, reporting standards ARS 320.1 (debt securities held), ARS 320.4 (bill acceptances and endorsements) and ARS 320.8 (housing loans).

28 See, for example, Interim Report: Royal Commissions into Misconduct in the Banking, Superannuation and Financial Services Industry (28 September 2018), executive summary p. 1.

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Locally incorporated ADIs must have a board of directors consisting of at least five directors, which is ultimately responsible for oversight of the management of the ADI. CPS 510 sets out the following requirements for a board of a locally incorporated ADI:

a it must be:
- composed of a majority of independent directors (unless the ADI is a subsidiary of another APRA-regulated entity or an equivalent overseas regulated entity): a director is independent if he or she does not have any business or other associations with the ADI that could materially interfere with the exercise of his or her independent judgement, such as a substantial shareholding, recent employment as an executive or a professional consulting engagement; and
- composed of a majority of non-executive directors; and

b it must have:
- procedures for performance assessment and renewal;
- a remuneration committee to oversee the ADI's remuneration policy composed of at least three directors, a majority of whom are non-executive directors;
- an audit committee to oversee the internal audit function, accounting, statutory reporting and external audit composed of at least three directors, a majority of whom are independent; and
- a risk committee to oversee and implement the ADI's risk management framework composed of at least three directors, a majority of whom are independent.

The board must comprise a majority of independent directors, and a majority of those eligible to vote at any meeting must be non-executive directors, unless the ADI is a subsidiary of another APRA-regulated entity (e.g., an NOHC) or an overseas-equivalent entity. The board must also have procedures for assessing its performance on an annual basis. The ADI must also have a policy, overseen by the board remuneration committee, setting out the structure and objectives of its remuneration arrangements, but CPS 510 does not mandate any particular division between fixed and variable remuneration. The board must also have an audit committee to oversee reporting and audit obligations, in addition to the ADI maintaining an appropriately resourced internal audit function. The board must also have a risk committee.

Foreign ADIs need only to have a senior officer outside Australia with delegated authority from the board to oversee the Australian branch operation, and a senior manager ordinarily resident in Australia to be responsible for the local operation and available to meet with APRA on request.

Prudential Standard CPS 520: Fit and Proper (CPS 520) requires responsible persons – directors, senior managers and auditors – to be fit and proper. A person is fit and proper if he or she:

a possesses the competence, character, diligence, honesty, integrity and judgement to perform his or her duties;

b is not disqualified from holding his or her position; and

c does not have a material conflict of interest that would affect the performance of his or her duties.

An ADI is required to maintain a fit and proper policy setting out the processes for assessing whether a responsible person is fit and proper, and the consequences that will occur if a person is not fit and proper or ceases to be fit and proper. Information about each responsible

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person, and a statement of whether he or she has been assessed under the ADI's fit and proper policy, must be given to APRA each time that a person is appointed to a responsible person position or if any of the particulars in the statement changes.

An applicant for ADI authorisation must, at the time of application, satisfy APRA that it fulfils the governance requirements in CPS 510 and CPS 520.

Banking executive accountability regime

In 2018, the federal government introduced a new banking executive accountability regime (BEAR) into the Banking Act. The BEAR amendments hold ADIs and their senior executives and directors accountable for heightened standards of behaviour. The regime came into force for large ADIs on 1 July 2018, and will apply to small and medium ADIs from 1 July 2019.

In assessing the size of an ADI for the purposes of the regime, calculations are based on a three-year average of total resident assets, as follows: a small ADI has less than or equal to A$10 billion in total resident assets, a medium ADI has between A$10 billion and A$100 billion in total resident assets, and a large ADI is any ADI with greater than or equal to A$100 billion in total resident assets.

The BEAR consists of four sets of obligations: accountability obligations, key personnel obligations, deferred remuneration obligations and notification obligations.

The accountability obligations under the BEAR apply to ADIs and their accountable persons: senior managers who must be registered with APRA. They require ADIs and their accountable persons to conduct their business and responsibilities with honesty, integrity, due care, skill and diligence; deal with APRA in an open, constructive and cooperative way; and prevent matters from arising that would adversely affect the ADI's prudential standing or prudential reputation. ADIs also have an obligation to ensure that their accountable persons and their non-ADI subsidiaries comply with the accountability obligations.

The key personnel obligations require an ADI to:

a ensure that the responsibilities of its and its subsidiaries' accountable persons cover all aspects of the corporate group's operations and all prescribed functions;
b ensure that all accountable persons are registered with APRA;
c ensure that none of their accountable persons are disqualified by APRA;
d comply with directions given by APRA in relation to the ADI's key persons; and
e ensure that its non-ADI subsidiaries comply with the key personnel obligations.

The deferred remuneration obligations require ADIs to set remuneration policies that defer a specified proportion of the variable remuneration of accountable persons for at least four years (or a shorter period approved by APRA). The proportion of variable remuneration there must be depends on the particular accountable person's role and the size of the ADI.[29] This is intended to incentivise senior managers to make decisions for the long-term benefit of the ADI. This obligation also cannot be avoided simply by not paying variable remuneration or paying only token variable remuneration, as the thresholds are expressed in terms of both variable remuneration and total remuneration (e.g., for the CEO of a large ADI, the lesser of 60 per cent of variable remuneration or 40 per cent of total remuneration must be deferred).

29 Banking Act 1959 (Cth) Section 37EB.

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Deferred variable remuneration must also be withheld if the ADI considers it likely that an accountable person has failed to comply with his or her accountability obligations, pending determination of whether they have in fact failed to meet their accountability obligations.

The notification obligations require an ADI to:

a give to APRA an accountability statement in respect of each accountable person, setting out that person's responsibilities and the parts of the ADI's operations that they manage or control;

b give to APRA an accountability map identifying accountable persons, areas of responsibility and reporting lines for the ADI;

c notify APRA when a person ceases to be an accountable person;

d notify APRA when an accountable person is suspended, dismissed or has their variable remuneration reduced due to failure to comply with the accountability obligations; and

e notify APRA when the ADI itself or one of its subsidiaries has failed to comply with its accountability obligations.

iii Regulatory capital and liquidity

Capital

Regulatory capital requirements for ADIs (other than foreign ADIs and PPF providers, who are not subject to prudential capital requirements) in Australia are imposed by Prudential Standard APS 110: Capital Adequacy (APS 110), with the different classifications of capital instruments being set out in Prudential Standard APS 111: Capital Adequacy: Measurement of Capital (APS 111). The capital requirements largely mirror Basel III requirements, with amendments where appropriate for the Australian environment and a more conservative approach to the classification of capital instruments. Basel III requirements are fully implemented in Australia, and were in fact implemented ahead of the time frame required by the Basel Committee on Banking Supervision.

According to the RBA, the effect of APRA's adjustments to Basel III standards has the effect of increasing the Common Equity Tier 1 (CET1) capital positions of banks by between 1 and 1.5 per cent of risk-weighted assets.[30] Concern has been raised about the impact of this on Australian banks' ability to obtain international funding – because they disclose lower capital ratios than equivalent banks overseas, and it may not be known by potential funders that this is due to more conservative capital standards – and in August 2018 APRA published a discussion paper[31] setting out the following options to improve the international comparability of Australian ADIs' capital disclosures:

a ADIs continue to use existing capital measurement standards, but APRA would specify a methodology to quantify certain aspects of relative conservatism in Australian capital standards to be used to estimate internationally comparable capital ratios for disclosure purposes only; or

b some conservatism in Australian capital measurement standards is relaxed to make them correspond more closely to international capital standards, with minimum capital ratios and capital buffers being increased to maintain ADIs' current capital positions.

30 RBA, Financial Stability Review 2013 – September 2013: Box B: The Basel III Capital Reforms in Australia, <https://www.rba.gov.au/publications/fsr/2013/sep/box-b.html>.

31 APRA, 'Discussion paper: Improving the transparency, comparability and flexibility of the ADI capital framework' (14 August 2018).

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APS 110 requires ADIs to meet at least the following minimum prudential capital requirements (although APRA may determine a higher minimum prescribed capital ratio for a particular ADI at any time): CET1 ratio of 4.5 per cent of risk-weighted assets (RWA), Tier 1 capital ratio of 6 per cent of RWA and total capital ratio of 8 per cent of RWA.

RADIs, however, must hold their entire capital requirement as CET1 capital, unless they are a mutually owned RADI, in which case they may hold their capital as Tier 2 capital and agree with APRA on a time frame for building up Tier 1 capital.

APS 110 also requires ADIs to hold a capital conservation buffer of CET1 capital of 2.5 per cent of RWA. This means that an ADI's CET1 capital ratio must not fall below 7 per cent of RWA at any time. ADIs must also maintain a countercyclical capital buffer of between zero and 2.5 per cent of RWA, with the precise amount determined by APRA for each ADI. ADIs are required to report their countercyclical capital buffer position quarterly under Reporting Standard ARS 110.0. If an ADI's CET1 capital is not sufficient to satisfy the capital conservation buffer and countercyclical buffer requirements, it is constrained in its ability to make distributions (including discretionary bonus payments to staff).

ADIs and authorised NOHCs must obtain APRA's written approval prior to making any planned reduction in capital (including the repayment of any Tier 1 or Tier 2 capital instrument or trading in their own shares), and in seeking that approval give to APRA projections that show that they will meet capital adequacy requirements for at least the next two years.

APS 111 classifies capital instruments as follows.

a CET1: a permanent and unrestricted commitment of funds, freely available to absorb losses, not imposing any unavoidable servicing charge against earnings and ranking behind the claims of depositors and other creditors in the winding up of the ADI; it includes paid up ordinary shares, retained earnings, undistributed current year earnings, accumulated other comprehensive income, land and building revaluation reserves, minority interests that are ordinary shares and regulatory adjustments.

b AT1: a permanent and unrestricted commitment of funds, freely available to absorb losses, providing for fully discretionary distributions and ranking behind the claims of depositors and other creditors in the winding up of the ADI; they are instruments that do not meet the requirements for CET1 capital but that rank behind everything except CET1 capital in the winding up of the ADI, are redeemable only by the ADI with the consent of APRA, and convert automatically into ordinary shares or mutual equity interests (MEIs), or are written off on the occurrence of a non-viability trigger event.

c Tier 2: irrevocably paid up instruments with a minimum maturity of five years, amortised on a straight-line basis, redeemable only at the option of the issuing ADI no sooner than five years after receipt of the paid up amount and only with APRA's approval, and ranking behind everything except CET1 and AT1 instruments in the winding up of the ADI; long-term preference shares or subordinated loans that convert automatically into ordinary shares, mutual equity interests or are written off on the occurrence of a non-viability trigger event.

Notably, APS 111 requires equity holdings and other capital support provided to overseas deposit-taking institutions, holdings of its own capital instruments, asset impairment not recognised in profit or loss, deferred tax assets and liabilities, equity holdings and other capital support provided to non-financial entities, guarantees and any surplus in a defined benefit superannuation scheme, to be deducted in full from CET1 capital. There is no threshold

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treatment for the deduction of such items. Equity holdings and other capital support provided to financial institutions and own instrument holdings must also be deducted in full from the same tier of capital that the instrument held would qualify for had it been issued by the ADI itself (so, for example, ordinary shares in another financial institution must be deducted from the ADI's CET1capital). MEIs are instruments representing a claim on the issuing ADI that rank equally with CET1 instruments (but behind the subscription price paid for member shares), and on which distributions can only be made from retained earnings and for an amount no greater than 50 per cent of the issuing ADI's net profit for the period to which the distribution relates. MEIs were defined and allowed to be included in CET1 capital to enable mutual ADIs to raise capital from external sources (that is, from persons other than their members) in order to meet increasing minimum capital ratios without compromising their mutual status or triggering the demutualisation provisions in the Corporations Act.

For capital adequacy measurement purposes, ADIs must use the standardised approach based on prescribed risk weights for different asset types, with credit risk being dependent on ratings assigned by external credit assessment agencies.[32] ADIs may obtain approval from APRA to use their internal risk rating models to rate the risk of their assets and then apply weights prescribed in Prudential Standard APS 113: Capital Adequacy: Internal Ratings-based Approach to Credit Risk.

Liquidity

Prudential Standard APS 210: Liquidity (APS 210) governs ADI liquidity requirements. In addition to requiring ADIs to identify their liquidity risk and develop strategies to manage liquidity and liquidity risk, APS 210 requires ADIs to either meet a liquidity coverage ratio (LCR) or minimum liquidity holdings (MLH), depending on which measure APRA determines applies to the ADI.

An ADI to which an LCR applies must maintain an adequate level of unencumbered high-quality liquid assets (HQLA) to meet its liquidity needs for 30 days under a severe stress scenario. The LCR is calculated as unencumbered HQLA held divided by total net cash outflows over the next 30 days (although APS 210 differentiates between grades of HQLA, mandates at least a 15 per cent haircut to relatively lower quality asses and limits the proportion of HQLA that can comprise relatively lower quality assets). A local ADI must maintain an LCR of at least 100 per cent on both an Australian dollar and all currencies basis. A foreign ADI must maintain an LCR of at least 40 per cent on an all currencies basis. APRA may require an ADI to maintain a higher minimum LCR if it has concerns about the ADI's liquidity risk profile or the quality of its liquidity risk management. An ADI to whom LCR applies must also maintain a net stable funding ratio (NSFR) of at least 100 per cent, unless APRA specifies a higher minimum NSFR for a particular ADI.

An ADI to which MLH applies must hold unencumbered prescribed liquid assets – physical currency, Australian government securities, foreign government securities eligible for repurchase agreements with the RBA, debt securities guaranteed by the Australian government or a foreign government and eligible for repurchase agreements with the RBA, bank bills certificates of deposit and debt securities issued by ADIs and net at-call deposits with other ADIs – equivalent to 9 per cent of its liabilities (both on-balance sheet and

32 Prudential Standard APS 112: Capital Adequacy: Standardised Approach to Credit Risk.

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irrevocable off-balance sheet commitments). APRA may require an ADI to maintain higher MLH if it has concerns about the ADI's liquidity risk profile or the quality of its liquidity risk management.

Unlike capital requirements, liquidity requirements apply to both locally incorporated ADIs and ADIs that are local branches of foreign banks.

Group supervision

Prudential standards generally apply both to an ADI individually and to the consolidated group of which the ADI or an authorised NOHC is the parent entity (referred to in APRA's prudential standards as Level 1 and Level 2 respectively). Individual prudential standards either specify whether the requirements apply without any difference to the corporate group or prescribe different requirements on a Level 1 and Level 2 basis. For corporate group (Level 2) purposes, APS 110 also gives APRA power to determine which entities are to be included in the group for capital measurement purposes. This enables APRA to exercise supervision over entire banking groups in addition to individual banks.

iv Recovery and resolution

Planning for failure

Although the concept has been suggested, ADIs are currently not required to prepare or maintain recovery and resolution plans (commonly called living wills) to deal with their failure. However, to obtain RADI authorisation, applicants must have a credible exit plan that demonstrates to APRA that they will be able to exit their banking business and protect depositors without relying on the FCS or requiring the use of APRA's crisis management powers. This is because RADIs have a two year time frame in which they must either transition to full ADI authorisation or cease carrying on banking business.

Regulator's power to take control of distressed ADIs

Broadly speaking, APRA can intervene in an ADI if there is a risk of depositors suffering loss or if there is a threat to the financial system's stability. The Banking Act provides for APRA to take control of a locally incorporated ADI's business, or to appoint an administrator to take control of a locally incorporated ADI's business, if:[33]

a the ADI informs APRA that it considers itself likely to be unable to meet it obligations or that it is about to suspend payment;

b APRA considers that, without external support, the ADI may become unable to meet its obligations, may suspend payment or is likely to be unable to carry on banking business in Australia consistently with the interests of its depositors or the stability of the financial system in Australia;

c the ADI becomes unable to meet its obligations or suspends payment;

d an external administrator has been appointed to a holding company of the ADI (whether in Australia or overseas) and APRA considers that it poses a significant threat to the soundness of the ADI, interests of depositors or financial stability in Australia; or

e for a foreign ADI, an external administrator or equivalent has been appointed to the ADI or an application has been made for such an appointment.

33 Banking Act 1959 (Cth) Section 13A(1).

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Where necessary to facilitate the resolution of an ADI or its corporate group, APRA may also take control of or appoint an administrator to the authorised NOHC of the ADI, another subsidiary of the authorised NOHC or a subsidiary of the ADI.

APRA or the administrator in control of an ADI's business (as appropriate) is referred to as a statutory manager in the legislation. The statutory manager may exercise all of the powers of the ADI during its in control of the ADI, and can compel officers of the ADI to give information to it for the purpose of investigating the affairs of the ADI and resolving the ADI. It may also sell or otherwise dispose of all or part of the ADI's business on terms that it considers appropriate. Where necessary or convenient for facilitating the performance of the statutory manager's functions and duties, the statutory manager may also unilaterally vary the ADI's corporate constitution.

If an ADI is insolvent and APRA considers that it cannot be restored to solvency within a reasonable period (whether or not a statutory manager has attempted to resolve the ADI), APRA may apply to the Federal Court of Australia for an order to wind up the ADI.

Recapitalisation

In the circumstances described above giving rise to APRA's power to take control of or appoint an administrator to an ADI, as an alternative to appointing a statutory manager, APRA may direct an ADI or an authorised NOHC to increase its capital to a specified level.[34] The direction may require the ADI to issue shares in itself, rights to acquire shares in itself or such other kinds of capital instruments as specified by APRA in the direction. However, as a safeguard for existing shareholders of the ADI, APRA must obtain an expert's report on the fair value of shares in the ADI prior to directing an ADI to issue such shares or rights to acquire shares. While APRA must consult with the competition regulator, the Australian Competition and Consumer Commission (ACCC), before giving a recapitalisation direction, the acquisition of shares, options or other capital instruments in an ADI that were issued in compliance with a recapitalisation direction is exempt from competition legislation prohibiting mergers and acquisitions that lessen competition.

Once an ADI is under the control of a statutory manager, the statutory manager may issue shares in the ADI or rights to acquire shares in the ADI, cancel shares or rights to acquire shares in the ADI, cancel paid-up share capital that is not represented by available assets or vary the rights attached to a class of shares in order to recapitalise the bank.[35] The statutory manager can do this of its own motion without express direction from APRA, but its recapitalisation actions are subject to the same requirement to obtain and consider an independent report on the fair value of the ADI's shares prior to taking any recapitalisation action.

Deposit guarantee: the FCS

The Banking Act was amended in 2008 to implement the FCS, a federal government deposit guarantee scheme applicable to deposit accounts[36] held with local ADIs (including Australian incorporated subsidiaries of foreign banks, but not mere branches of foreign banks). Under the FCS, the Treasurer may declare that the FCS applies to an ADI if a statutory manager

34 Banking Act 1959 (Cth) Section 13E.

35 Banking Act 1959 (Cth) Section 14AA.

36 Except credit balances on loan accounts or credit cards, purchased payment facilities, pre-paid card and wallet facilities, and nostro and vostro accounts of foreign corporations carrying on banking or financial services business in a foreign country: Banking Regulation 2016 (Cth) Regulation 8.

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is in control of an ADI or APRA has applied for an ADI to be wound up. Operation of the FCS is not automatic; it is activated at the discretion of the Treasurer (although, in relation to a large ADI, the political pressure to do so may well be hard to avoid). Once activated, the FCS is administered by APRA.

An account holder with an ADI subject to a declaration is entitled to payment of the balance of his or her account, plus uncredited interest up to the date of the declaration, up to a maximum amount of A$250,000. The A$250,000 limit applies across all protected accounts held with an ADI, including any seemingly separate brand under which the ADI may trade, but does not extend between ADIs, so a person with accounts with multiple declared ADIs may recover more than A$250,000 in aggregate. APRA may pay FCS amounts to account holders either directly or into an account established for them (with or without their consent) at another local ADI.

Upon payment of an FCS amount to an account holder, APRA is subrogated to the account holder's claim against the ADI. If the FCS does not cover any part of the account holder's deposits with the bank (e.g., if the account balance exceeded A$250,000), it remains a debt of the ADI owing to the account holder and may be admitted in the winding up of the ADI without proof by the account holder. APRA's costs of administering the FCS are also a debt payable to APRA, provable in the winding up of the ADI.

Bail-in powers

Australia does not have any mandatory bail-in provisions for creditors of ADIs or their holding companies. The terms of particular debt instruments may provide for automatic writing-off or conversion to equity on the occurrence of certain events, providing for the same outcome in substance as a bail-in, but any such write-off or conversion occurs pursuant to the contract between the entity and the holder of the instrument, rather than a special bail-in provision. Under APS 111, instruments must provide for writing-off or conversion into ordinary shares (or mutual equity interests) on the occurrence of certain non-viability events if they are to qualify as AT1 or Tier 2 capital. The big four banks regularly issue preference shares and convertible notes on terms that provide for mandatory conversion to ordinary shares on the occurrence of certain non-viability events, so that those instruments qualify as AT1 or Tier 2 capital.

Other debts not containing write-off or conversion provisions are not subject to mandatory bail-in. However, if the statutory manager of a distressed ADI sells all or part of the ADI's business to a third party on terms that do not involve the third party assuming the liabilities associated with that business (which the statutory manager is empowered to do, and which will likely be necessary in many cases to protect depositors and maintain financial system stability), non-depositor creditors of the distressed ADI will have little prospect of recovery and will likely be in substantially the same position as if they had been bailed-in.

IV CONDUCT OF BUSINESS

The conduct of banks' business in Australia is governed by general law and statute law. In addition to ADI-specific rules discussed elsewhere in this chapter, the following legislation governs banks in the activities that they typically undertake:

a National Consumer Credit Protection Act 2009 (Cth): regulates conduct in relation to credit provided to consumers, including pre-contractual disclosure, the terms on which credit is provided and enforcement against defaulting consumers;

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b Corporations Act 2001 (Cth): Chapter 7 regulates conduct in relation to financial products and services, including financial advice, deposit account provision, insurance, stockbroking, asset custody, wealth management and market-making;

c Australian Securities and Investments Act 2001 (Cth): Division 2 of Part 2 contains consumer protection obligations in relation to financial services (which for this purpose include credit), most notably obligations to not engage in misleading or deceptive conduct or unconscionable conduct, and protections against unfair contract terms in standard form consumer and small business contracts for financial products or services;

d Privacy Act 1988 (Cth): regulates entities' dealings with personal information about individuals, including credit reporting information;

e Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth): imposes obligations in relation to the prevention of money laundering and terrorism financing, including customer identification, transaction monitoring, and reporting and suspicious matter reporting. Most financial activities by banks, including the provision of deposit accounts and making of loans, are designated services that give rise to obligations under the Anti-Money Laundering and Counter-Terrorism Financing Act;

f Personal Property Securities Act 2009 (Cth): governs the creation, priority and enforcement of security interests in property other than land (subject to some exceptions); and

g state and territory real property legislation: in relation to dealings in land and the creation and enforcement of mortgages over land.

As a condition of their credit licences and AFSLs (if they provide financial services to retail clients), banks must be members of the Australian Financial Complaints Authority (AFCA) external dispute resolution scheme. AFCA is a free and independent non-judicial dispute resolution service for consumers and small businesses to bring complaints against financial service providers. AFCA is not constrained by law and procedure in the same manner as a court, and is able to have regard to community standards and good industry practice when determining a dispute. If AFCA identifies systemic issues in the course of determining a dispute, it may refer these to ASIC to further action.

ASIC has published the ePayments Code, a non-binding code that providers of electronic payment facilities may subscribe to. The ePayments Code sets out rules concerning the disclosure of terms and conditions and the allocation of liability in relation to fraudulent and mistaken electronic payments (including obligations to make efforts to recover mistaken payments).

The banking industry in Australia also self-regulates through voluntary codes of practice developed and regulated by industry associations. The major industry codes of practice are the Australian Banking Association's Banking Code of Practice and the Customer Owned Banking Association's Customer Owned Banking Code of Practice. Compliance with an industry association's code of practice is a condition of membership of industry associations, and the terms of the applicable code are incorporated into the banker–customer contract. Industry codes of practice include consumer protection obligations that go beyond what is required by law, and also operate for the benefit of small businesses. Membership of an industry association is not mandatory for an ADI.

Banks have a common law duty of confidentiality to their customers, arising from an implied term in their contracts with customers. This duty is separate to any obligation in the Privacy Act and is owed to both natural person and corporate customers. The duty extends

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beyond information obtained from the customers account to any information obtained from the banking relationship with the customer. Australian courts have recognised the English decision in *Tournier v. National Provincial & Union Bank of England*,[37] which identified four circumstances where a banker may disclose otherwise confidential information:

a where disclosure is under compulsion of law;
b where there is a duty to the public to disclose;
c where the interests of the bank require disclosure, and
d where the disclosure is made with the express or implied consent of the parties.

V FUNDING

The majority of bank funding is sourced through deposits, wholesale debt and equity. Following the global financial crisis, there has been a broad shift in funding sources towards more stable sources such as retail deposits and Tier 1 capital instruments. The big four banks and Macquarie Group all have on issue a range of debt-equity hybrid instruments (preference shares, convertible notes, etc.) that provide an alternative source of stable long-term funding.

The RBA provides a committed liquidity facility (CLF) as a part of Australia's implementation of the Basel III liquidity standards. The facility is required due to the limited amount of government debt on issue in Australia and ensures that participating ADIs have enough access to liquidity to respond to an acute stress scenario. The CLF allows participating ADIs to access pre-specified amounts of liquidity by entering into repurchase agreements of eligible securities outside the RBA's normal market operations.[38] ADIs are required to pay a fee of 15 basis points per annum, dependent on the size of the agreement, which is payable on both drawn and undrawn commitments. The cost of repurchase transactions to an ADI is either the target cash rate or the target cash rate plus a margin of 25 basis points (depending on the term of the repurchase transaction).

In addition to the FCS, during the global financial crisis the federal government implemented a temporary guarantee for ADIs' large deposit and wholesale funding liabilities. Initially, all wholesale funding instruments were guaranteed without charge, but from late November 2008 only pre-approved funding instruments would be guaranteed and a charge was imposed for the guarantee. The scheme closed to new liabilities on 31 March 2010, but existing liabilities from before that date remain covered to maturity.[39]

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

A 15 per cent ownership cap for financial sector companies exists in Australia to increase financial stability by limiting ties between an institution and the finances of any particular investors and their associates. Given the importance of ADIs to Australia's economic wellbeing, the ownership cap also prevents any person from accumulating large amounts of power in the financial system. The Financial Sector (Shareholdings) Act 1998 (Cth) prohibits a person, or two or more persons under an agreement, from acquiring greater than 15 per cent of a

37 *Tournier v. National Provincial & Union Bank of England* [1924] 1 KB 461.
38 https://www.rba.gov.au/media-releases/2011/mr-11-25.html.
39 See https://www.guaranteescheme.gov.au/qa/deposits.html.

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financial sector company's voting shares without the consent of the Treasurer. A shareholding greater than 15 per cent is considered an unacceptable shareholding situation, and will constitute an offence punishable by a fine no greater than 400 penalty units (A$84,000 at the time of writing) if a person was reckless as to whether the acquisition would result in this situation.[40] Financial sector companies include ADIs and holding companies of ADIs. From 1 April 2019, the ownership cap will increase from 15 to 20 per cent.[41]

If an unacceptable shareholding situation exists, the Federal Court may make orders to ensure the situation ceases. This may include requiring the disposal of shares, restraining the exercise of rights attached to shares, or prohibiting or deferring payment of sums related to the shares, such as dividends.[42]

A person may apply to the Treasurer for approval to hold more than a 15 per cent (20 per cent from 1 April 2019) share in a financial sector company. The application must specify the percentage stake the person currently holds in the company, the percentage he or she is seeking to hold, and set out the person's reasons for acquiring that interest, and the applicant must pay the prescribed fee.

In approving an application, the Treasurer may specify a period for which the approval remains in force, or may allow it to remain in force indefinitely. The Treasurer may revoke this approval by written notice if he or she is satisfied that it is in the national interest, that an unacceptable shareholding situation exists or that there has been a contravention of an approval condition.

From 1 April 2019, new or recently established ADIs may also apply to the Treasurer for a higher shareholding cap if their assets are less than A$200 million and the proposed shareholder is a fit and proper person to hold a stake greater than 20 per cent.

The Financial Sector (Shareholdings) Act also enables the Treasurer to declare that a person has practical control of a financial sector company if, either alone or together with associates, he or she does not hold a greater than 15 or 20 per cent stake in the company, but he or she is in a position to exercise control over the company, or the directors are obliged or accustomed to act in accordance with, the person's wishes or instructions.[43] The person is then required to take any steps necessary to relinquish his or her practical control of the company; this must be done within 90 days of being given a copy of the Treasurer's declaration, unless the Treasurer allows a longer period.

Since 1990, the federal government has maintained a four pillars policy under which it commits to preventing any acquisitions or mergers between the big four banks. This is a long-standing policy, being an indication of how discretionary powers under competition legislation will be exercised, rather than formal regulation itself. It has bipartisan support and has survived numerous changes in government. Recently, the policy was criticised by the Australian Productivity Commission for enabling complacency among the big four banks, removing the threat of takeover as a means of encouraging efficiency, but it is unlikely to be relaxed in light of the overwhelming market share that the big four banks currently collectively have.

The Competition and Consumer Act 2010 (Cth) prohibits acquisitions of shares in companies (or the assets of a company) that would, or would be likely to, have the effect of

40 Financial Sector (Shareholdings) Act 1998 Section 11.

41 With the commencement of the Treasury Laws Amendment (Financial Sector Regulation) Act 2018.

42 Financial Sector (Shareholdings) Act 1998 Section 12.

43 Financial Sector (Regulation) Act 1998 (Cth) Section 23.

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substantially lessening competition in any market, unless the acquisition is authorised by the ACCC.[44] While this would likely prevent the big four banks from acquiring other ADIs, it is unlikely to prevent consolidation among smaller ADIs to build a scale that enables them to better compete with the big four banks.

ADIs are subject to the provisions of the Corporations Act dealing with changes in corporate control generally. If an ADI or NOHC is publicly listed, or is unlisted but has more than 50 shareholders, a person cannot increase his or her voting power in the company to more than 20 per cent, or by more than 3 per cent every six months if he or she already holds more than 20 per cent, without making a takeover bid to shareholders generally.[45] A scheme of arrangement under Part 5.1 of the Corporations Act provides an alternative mechanism for obtaining control of an ADI.

Acquisitions of local ADIs by foreign persons are also subject to the Foreign Acquisitions and Takeovers Act 1975, which requires acquisitions of a substantial interest in an Australian corporation by foreign persons that meet a monetary threshold to be notified to the Treasurer, and empowers the Treasurer to prohibit the acquisition or to require the acquired assets to be disposed of if the acquisition is not in the national interest. At the time of writing, the monetary threshold is A$1,154 million (reduced to A$266 million for persons from countries with which Australia has a relevant agreement); this amount is indexed annually.

ii Transfers of banking business

Transfers of banking business in Australia are regulated by the Financial Sector (Transfer and Restructure) Act 1999 (Cth).

An ADI's banking business is a regulated business for the purposes of the Financial Sector (Transfer and Restructure) Act, and an ADI is a regulated body. Prior to a transfer of banking business taking effect, it must be approved by APRA. Two ADIs may apply to APRA for approval of a voluntary transfer of business from one of the ADIs to the other. APRA must approve the transfer if the application has been properly made, the transfer has been adequately adopted by the transferor and transferee (that is, proper governance procedures have been followed to approve the transfer); the transfer should be approved having regard to the interests of depositors of the transferor and transferee and the financial sector as a whole; and the Treasurer consents to the transfer (unless the Treasurer has determined in writing that his or her consent is not required). While the interests of customers are considered, customer consent is not required for APRA to approve a voluntary transfer of banking business.

If APRA approves a voluntary transfer of banking business, it must issue a certificate of transfer setting out material particulars of the transfer. The transfer takes effect when the certificate of transfer comes into force (this is specified in the certificate of transfer). When the certificate of transfer comes into force, all relevant assets and liabilities of the transferor become assets and liabilities of the transferee without further action by either party. The transferee becomes the successor in law to the transferor to the extent of the transfer.

The Financial Sector (Transfer and Restructure) Act also enables APRA to determine that all or part of an ADI's banking business is to be compulsorily transferred to another body corporate. APRA may make such a determination if the Treasurer has made a determination that there should be a compulsory transfer of banking business or APRA is satisfied that the transferring body has contravened the Banking Act, the ADI has informed APRA that

44 Competition and Consumer Act 2010 (Cth) Section 50.

45 See Chapter 6 of the Corporations Act 2001 (Cth).

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it is likely to become unable to meet its obligations or to suspend payment, or a statutory manager has been appointed to the ADI. APRA may also only make a determination for the compulsory transfer of banking business from an ADI if it is satisfied that the transferee consents to the transfer (it cannot compel another ADI to take on an ADI's banking business) and if the Treasurer has consented to the transfer (or has determined in writing that his or her consent is not required).

If APRA has determined that a compulsory transfer of banking business should occur, it must issue a certificate of transfer setting out particulars of the transfer. As discussed above in relation to voluntary transfers, a compulsory transfer takes effect when the certificate of transfer comes into force and thereafter the transferee becomes the successor in law to the transferor to the extent of the transfer. The Financial Sector (Transfer and Restructure) Act prevents contractual counterparties of the transferor and its related bodies corporate from denying contractual obligations, accelerating any debt, closing out any transaction under a contract or enforcing any security under a contract as a result of a compulsory transfer of banking business taking effect under the Act.

Under the Financial Sector (Transfer and Restructure) Act, APRA may also determine that all shares in an ADI are to be transferred to a particular transferee. When a certificate of transfer in relation to such a determination comes into force, all shares in the ADI become held by the transferee without any further action required by any person.

VII THE YEAR IN REVIEW

The Banking Royal Commission is widely perceived to have contributed to declining trust in the financial services industry. The 2018 Edelman Trust Barometer revealed that financial services is the second-least trusted sector in Australia, with only 49 per cent of Australians stating trust in the industry.[46]

i Banking Royal Commission

On 14 December 2017, the federal government established the Banking Royal Commission after public pressure to review recent media reports into the banking industry's 'profit at all costs' approach. Interestingly, after the government expended considerable political capital resisting calls for a royal commission into misconduct in the financial services industry, in late November 2017 the chief executive officers and chairpersons of the big four banks published an open letter to the Treasurer requesting a royal commission into their industry.[47] The Banking Royal Commission held hearings throughout 2018 on issues including consumer lending, financial advice, small business lending, issues affecting remote and regional communities, superannuation and insurance. Over 10,000 submissions were provided to the Banking Royal Commission. It published an interim report on 28 September 2018, which attributed much of the misconduct canvassed in the hearings to greed in the pursuit of short-term profit and appeared to advocate for more vigorous enforcement of the laws regulating financial services.

46 2018 Edelman Trust Barometer.

47 Stephen Long, 'This letter from the big banks helped shape the royal commission', Australian Broadcasting Corporation (online), 5 February 2019, <https://www.abc.net.au/news/2019-02-05/big-banks-ask-government-to-call-short-royal-commission-letter/10778928>.

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The Banking Royal Commission delivered its final report to the federal government on 1 February 2019, with the report being released to the public on 4 February 2019. It did not recommend any substantial law reforms to traditional banking business, but recommended substantial changes to other activities typically undertaken by banks, including strengthening consumer protection in lending, and removing conflicted practices in financial advice and superannuation.[48]

The report also recommended greater supervision by APRA of culture and remuneration within banks, and for conduct risks to feature more prominently in prudential standards. The report also calls for more litigious enforcement of the laws regulating banking and financial services, and recommended that criminal action be considered against certain institutions and individuals. Significantly, the Banking Royal Commission did not recommend undoing the vertical integration that is common among the major banks in Australia.

The recommendations of the Banking Royal Commission enjoy bipartisan support at the federal level, and the federal government at the time of writing indicated that it agrees with the recommendations and will act to implement them (except for a ban on commissions to mortgage brokers, which it promises only to review in three years' time).[49]

Notably, aside from lending activities, much of the misconduct uncovered was not in relation to banking business as such, but rather arose from other financial services businesses carried on by banks such as financial advice, superannuation, insurance and wealth management.

ii Easing of restrictions on property investor lending

Since December 2014, APRA had required ADIs to limit annual growth in their residential mortgage lending to investors to 10 per cent.[50] In March 2017, APRA imposed a benchmark requiring ADIs to limit new interest-only lending to no more than 30 per cent of new residential mortgage lending, and within that place strict internal limits on interest-only lending at loan-to-value ratios above 80 per cent, as well as ensure there is strong scrutiny and justification of any instances of interest-only lending at loan-to-value ratios above 90 per cent.[51] Both measures were introduced in an environment of rising capital city real estate values and concerns about Australian banks' exposure to residential real estate. Those concerns appear to have passed, and in April 2018 APRA removed the 10 per cent growth limit on investor lending from July 2018 onwards for ADIs that had complied with it for at

48 The Honourable Kenneth M Hayne, 'Final Report: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry' (Vol. 1), 1 February 2019, <https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf>.

49 Commonwealth of Australia, 'Restoring trust in Australia's financial system: The Government response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry', February 2019, <https://static.treasury.gov.au/uploads/sites/1/2019/02/FSRC-Government-Response-1.pdf>.

50 APRA, 'Letter: reinforcing sound residential mortgage lending practices', 9 December 2014, <https://www.apra.gov.au/sites/default/files/141209-Letter-to-ADIs-reinforcing-sound-residentialmortgage-lending-practices.pdf>.

51 APRA, 'Letter: further measures to reinforce sound residential mortgage lending practices', 31 March 2017, <https://www.apra.gov.au/sites/default/files/Further-measures-to-reinforce-sound-residential-mortgage-lending-practices.pdf>.

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least the past six months, and in December 2018 removed the 30 per cent benchmark for new interest-only loans.[52] APRA claims that both measures have been successful in improving lending standards across the banking industry.

iii New Payments Platform

The New Payments Platform (NPP) is a newly developed system for the clearing and settlement of electronic payments, developed as a superior alternative to (and likely eventual replacement for) the current Bulk Electronic Clearing System (also called the direct entry system). It was developed in response to the RBA Payments System Board's 2012 report, 'Conclusions on the Strategic Review of Innovation in the Payments System'. The NPP is owned and operated by a company that is owned by 13 ADIs, including each of the big four banks, and was rolled out to the public in February 2018.

The key value proposition of the NPP is real-time payments, with transferred funds being available to the recipient almost instantly (i.e., within seconds). Payment messages on the NPP are capable of carrying more information than those of the direct entry system, allowing payments to carry more detailed remittance information. The NPP also supports the development of overlay services: third-party services to enhance payments for users.

iv Neo-banks

The RADI path to ADI authorisation introduced by APRA in May 2018 has proved popular, with a number of neo-banks seeking RADI authorisation. At the time of writing, two banks had been granted RADI authorisation – the first new retail banks in Australia for 18 years – and one has transitioned from RADI to full ADI authorisation. These neo-banks seek to disrupt traditional banking models, seeking to compete on price and a more seamless customer experience through a digital-only model.

v Open banking

In November 2017, the federal government announced its intention to create a consumer data right: a right for consumers to direct a holder of certain data about them to supply that data to another person, or to provide a consumer with a copy of that data. It was also announced that banking would be the first sector in which a consumer data right will be implemented. At the time of writing, no legislation has been enacted to implement the consumer data right. The federal government initially intended to implement the consumer data right with respect to credit and debit card, deposit and transaction account products provided by the big four banks from 1 July 2019, and with respect to mortgages provided by the big four banks by 1 July 2020,[53] with other ADIs having an extra 12 months to implement the consumer data right for these products. However, in late 2018, it was announced that the implementation of the consumer data right would be delayed, with the big four banks being required only to share product data about credit and debit card, deposit and transaction account products from 1 July 2019, with customer data in relation to these products being required to be

52 APRA, 'Letter: embedding sound residential mortgage lending practices', 26 April 2018, www.apra.gov.au/sites/default/files/Letter-Embedding-Sound-Residential-Mortgage-Lending-Practices-26042018.pdf> and APRA, 'Letter: residential mortgage lending: interest-only benchmark', 19 December 2018, <https://www.apra.gov.au/sites/default/files/letter_residential_mortgage_lending_interest-only_benchmarks.pdf>.

53 ACCC, 'Consumer Data Right', 9 May 2018, <https://static.treasury.gov.au/uploads/sites/1/2018/05/t286983_consumer-data-right-booklet.pdf>.

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shared only from 1 February 2020. It was also announced that, from 1 July 2019, the big four banks, together with the ACCC and Data61 (the body that will be responsible for preparing the technical standards for data sharing), will participate in a pilot programme with customer data to test the performance, reliability and security of the consumer data right in relation to banking.[54]

The consumer data right will be governed by overarching legislation in the Competition and Consumer Act 2010 and Privacy Act 1988, with sector-specific rules and technical standards providing detailed requirements for implementing the right in particular sectors and with respect to particular data types (e.g., bank account transaction data).

When implemented, the consumer data right will increase competitive pressures for banks by removing the information advantage that they have with respect to their current customers. It will also reduce barriers to entry into businesses currently carried on largely by banks, including lending and insurance, by making it easier for new entrants to assess the risk profile of customers and set prices accordingly.

VIII OUTLOOK AND CONCLUSIONS

Overall, the Australian banking sector is a mature, stable and well-regulated industry. While the recent Banking Royal Commission exposed examples of wrongdoing among the major banks, this largely concerned their diversified financial services activities rather than core banking activities. However, banks are going to be subject to increased public scrutiny and political pressure in the short term, and can expect a more aggressive approach from regulators than they have been accustomed to in the past. Banks' organisational cultures and incentive structures will also be subject to greater scrutiny.

The reduction in trust in traditional banks will provide opportunities for new entrants into the banking industry, and the RADI licensing pathway will improve new players' ability to enter the banking industry. Open banking reforms (consumer data rights) will reduce established banks' information advantages over new entrants.

In relation to regulatory capital, banks can expect to be required to hold larger amounts of regulatory capital to maintain their prudential standing. This will reduce the quantity of credit that banks can provide, and affect their ability to engage in riskier but socially beneficial lending. An area of likely impact is lending to small businesses. Falling capital city housing markets may also increase mortgage portfolio loss rates and place pressure on banks' regulatory capital positions.

54 The Honourable Josh Frydenberg, 'Consumer Data Right Rules, Standards & Timeline', media release, 21 December 2018, <http://jaf.ministers.treasury.gov.au/media-release/077-2018/>.

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Chapter 4

BARBADOS

Sir Trevor Carmichael QC[1]

I INTRODUCTION

Barbados has a long tradition of commercial banking, both in a formal sense in terms of international banking institutions and, in a more informal sense, by way of credit unions and provident societies. Commercial bank development has reflected the growth and focus of the island's trade relations. In addition to commercial banks, there are regional and local development institutions that are primarily geared towards long-term lending in some cases, and in others to the financing of risks that are sometimes more development-oriented than commercially attractive.

The Caribbean Development Bank is a regional institution, headquartered in Barbados, and is in the business of financing development of its member countries. The Inter-American Development Bank, another regional institution, is also headquartered in Barbados and has a wider membership encompassing the hemisphere of the Americas. Its loan portfolio is larger and more diversified, and its terms of repayment extend longer than its Caribbean counterpart.

Barbados is also well served by a variety of well-organised and efficiently managed credit unions and provident societies whose activities are restricted to their members, and whose actions are governed by relevant applicable cooperatives legislation.

Offshore banking in Barbados was introduced in 1979 by virtue of the Offshore Banking Act, later repealed and replaced by the International Financial Services Act (IFSA), with the Central Bank of Barbados (CBB) in charge of the general administration of the Act and the Minister of Finance responsible for the issuing of licences. The Act stipulated that a licence may only be issued to an eligible company or a qualified foreign bank engaged in foreign-sourced banking or trust activities.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i Recent legislative changes

The IFSA has now been repealed by the Financial Institutions (Amendment) Act, 2018 (amended FIA). A new Guideline applies to licensees previously licensed under that Act and that are transitioning to the Financial Institutions Act (FIA). Such licensees are now deemed to be licensed under Part IIIB of the amended FIA as foreign currency earning banks (FCB) since 1 January 2019. The amended FIA provides in Part IIIA for the licensing of financial holding companies. Section 41G of the amended FIA contains the transitional provision

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for companies licensed under Part IIIB and carrying on the functions of a financial holding company. Licence fees continue to be applied at current levels until otherwise advised by the CBB.

Subsequent to the statutorily permitted transition, there will be a six-month grace period, which commenced from January 2019, during which a licensee's status continues uninterrupted and during which any legal or regulatory matters that emanate from the transition to the amended FIA (such as filing amended articles with the Corporate Affairs and Intellectual Property Office (CAIPO), or attending to outstanding filings with the Barbados Revenue Authority or the National Insurance Department) can be completed. The CBB has indicated that it will give consideration to extending the grace period in extenuating circumstances, but it reserves the right to recommend that a licence be suspended where a licensee fails to attend to any legal or regulatory matters within the grace period.

In cases where an amendment is needed to the articles of incorporation of an IFSA licensee transitioning to the amended FIA, authority for approval regarding the amendments to the articles of incorporation has been delegated to the CBB under the amended FIA. Section 114 of the amended FIA has been retained so as to provide for any consequential amendments to the Companies Act that may arise from the introduction of the FCB regime. CAIPO and the CBB are expected to collaborate as necessary to establish and communicate a common regulatory position.

As regards licensees that are transitioning to the amended FIA and whose ownership or subsidiary structures include entities licensed under statutes that have been repealed, such as the International Business Companies Act, they must notify the CBB of any proposed group reorganisations with 90 days of the issuance of the January 2019 guideline. This notification seeks to facilitate identification of changes in group organisations or holdings that would deviate from what was previously approved, allow for regulatory review if warranted and also ensure continued effective consolidated supervision.

Regulators are also expected to collaborate with the purpose of enhancing the regulatory regime for regular business companies (RBCs), which have now replaced international business companies (IBCs). These enhancements seek to facilitate the CBB's review of all banking groups that IBCs in the future will include RBCs, and allow for the determination of any conditions that may be deemed necessary.

ii Savings or grandfathering policy

Section 35 of the amended FIA contains a saving or grandfathering provision for the benefit of licensees. It allows old rules to apply to those entities that opt to be grandfathered. Hence, in spite of the repeal of the IFSA, the rights and benefits conferred upon licensees under the IFSA are saved as provided in the following manner: a licensee holding a valid licence issued prior to 17 October 2017 is entitled to receive the benefits until 30 June 2021; and a licensee holding a valid licence issued on or after 17 October 2017 ceases to be entitled to the benefits after 31 December 2018. The latter licensees will be subject to the arrangements for transitioning to the amended FIA. Furthermore, any obligation or penalties incurred by a licensee under the IFSA during the period of operation of that Act shall not be affected; and any related investigation, legal proceeding or remedy may be instituted, continued or enforced with penalties imposed as if the IFSA had not been repealed. If a licensee wishes to avail itself of the savings or grandfathering provisions, it must advise the CBB of its intent to be grandfathered as provided in Section 35 of the amended FIA. A grandfathered licensee must also amend its articles of incorporation, as applicable, within the six-month grace period.

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Provision is also made for exiting the grandfathered status. In cases where a grandfathered licensee chooses to exit its grandfathered status before 30 June 2021, it must notify the CBB. Upon notification and subsequent confirmation of non-objection by the CBB, the licensee is then deemed to be fully licensed under the amended FIA, and the transitioning arrangements shall apply.

There are additional benefits and exemptions. Holders of a foreign currency permit (FCP) are able to benefit from income tax concessions for specially qualified individuals for a period of three years, and are exempted from:

a exchange control;
b withholding tax on the payment of dividends to non-residents;
c withholding tax on all other payments to non-residents;
d payment of stamp duty and property transfer tax (save and except real estate) other than nominal duty of Bd$200 on all instruments and agreements; and
e payment of value added tax and duties on the importation of plant and machinery.

To apply for the FCP permit, a licensee must generate 100 per cent of its income in foreign currency. An application for an FCP together with the relevant fees should be made to the International Business Unit.

III REGULATORY HISTORY

The establishment of the CBB eliminated the need for external monetary regulation and management by the East Caribbean Currency Authority, thus promoting national autonomy. Unlike a commercial bank, the CBB does not offer public banking services. Rather, it works with the government to create sound monetary and fiscal policies that promote development and maintain public confidence in the economy. The CBB is committed to promoting monetary stability, creating a sound financial structure, strong monetary and capital markets, and the investment of commercial bank credit into productive activities.

As the nation's central bank, the CBB has the following main areas of responsibility:

a monetary regulation;
b acting as banker to government and commercial banks;
c advising the government on monetary and financial issues;
d foreign exchange reserves management;
e public debt management; and
f supervising financial institution operations.

In seeking to safeguard the integrity of the financial system, it has two key objectives: to regulate and monitor the financial environment, and to provide a stable monetary framework and sound financial structure. The Bank Supervision Department of the CBB is responsible for regulating and supervising international banks licensed in Barbados. The goals of the Department are:

a developing legislation and regulations for the financial system;
b inspecting licensed financial institutions to ensure that their operations are safe and in compliance with the legislation; and
c reporting on the performance and condition of each licensed financial institution.

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Barbados' regulatory framework has been developed to conform with international standards and best practices, as contained in the Basel Core Principles for Effective Banking Supervision. In the past decade, an increase in cross-border expansion of regional financial institutions has occurred. In response, the CBB has improved its ability to supervise banks with cross-border operations, and to monitor risks on a solo basis and on a consolidated basis. To facilitate cooperation and information sharing, Caribbean regulators have signed a memorandum of understanding (MOU) and meet twice yearly as supervisory colleges of pan-Caribbean banks. The CBB continues to be an active member of other regional and international regulatory groupings, such as the Association of Bank Supervisors of the Americas, the Group of International Finance Centre Supervisors, the Financial Action Task Force and the Caribbean Financial Action Task Force. Furthermore, the CBB continues to work closely with the other sectoral regulators of non-banking institutions that comprise the financial system in Barbados, and a domestic MOU has been implemented to allow for information sharing among domestic regulators. A large percentage of the banking institutions originate in Canada (more than 50 per cent of the six commercial banks and bank holding companies. As a result, Barbados has developed a strong relationship with the Canadian regulators. In 2010, the CBB and Canada's Office of the Supervisor of Financial Institutions (OSFI) signed an MOU to facilitate cooperation and information sharing, and the CBB visits and meets with the OSFI once a year.

IV PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The CBB was in the process of implementing the Basel II Capital Framework when the global financial crisis emerged in 2007, and several later enhancements to the Framework were made. The implementation road map has been reviewed, and focus was initially on the implementation of Pillar II, which emphasises the importance of strong regulatory oversight and strong industry risk-management practices. The CBB's implementation of the Framework has identified three phases, and it is continuing with the implementation of Basel II and Basel III.

The goals of the Bank Supervision Department are facilitated through both on-site and off-site inspections of all licensed financial institutions. During an on-site inspection, bank examiners review the major areas of risk for the institution. The process includes assessments of liquidity, and operational and other kinds of risks, fully recognising that the major risk on a bank's balance sheet in Barbados is often in the area of lending. It is also recognised that any serious causes of banking problems are directly related to poor credit standards for borrowers, poor credit administration, and a lack of attention by the bank to changes in the economy and other factors that may affect borrowers' ability to repay a debt.

Bank examiners also review the strength of corporate governance within banks. Under scrutiny are the structures and relationships through which the objectives of an entity are met, as well as a full assessment of the role of the board of directors, management of the entity, and the strategies, policies and practices that have been implemented. Inspections will also allow for an assessment of the internal control systems of the bank, a factor that is clearly critical for effective bank management and sound operations. Arising from the assessments undertaken, the examiner will determine areas of deficiencies. A report is prepared detailing the condition of the bank's operations and, where necessary, recommendations are made for improvement. The report is ultimately provided to the institution's board of directors.

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ii Management of banks

Management of Barbadian banks is governed by the general rules that apply to the prudence and skills criteria of the business director and, by extension, of the corporate enterprise. Typically, banks will also have an audit committee, a risk committee, an investment committee and a human resources committee, depending on the nature of the business areas, risk profile and size of the bank. They are required to have scheduled quarterly board meetings at which reports on the various committees will be considered in detail. The audit committee will often be expanded into or combined with a risk policy committee. At its quarterly meetings, the board will also typically receive a report on capital adequacy ratios, a financial report, a credit portfolio report, a new and large credit review, a watch list of non-performing loans, and a Treasury interbank and country limits review. Other matters will also be considered, such as a litigation review.

iii Regulatory capital and liquidity

By virtue of the FIA, a licence is not issued to a commercial bank unless (in the case of a Barbados bank) the stated capital or (in the case of a foreign bank) the assigned capital is at least Bd$4 million or such other amount as the CBB may in any particular case determine. Banks must not have a capital adequacy ratio of less than the percentage as may be prescribed by the CBB and must be calculated as prescribed. A bank is also required to have a reserve fund, and must transfer a sum of not less than 25 per cent of its net profits, prior to declaring dividends, each year whenever the amount in the reserve fund is less than its issued and paid-up capital. However, this stipulation will not apply to a bank that has satisfied the CBB that its aggregate reserves are adequate in relation to its business. The CBB may also require banks to maintain reserves for bad and doubtful debts of an amount that the CBB deems adequate. A bank may only pay an interim dividend out of the profits of previous years or out of the reserves of previous years.

Under the IFSA and the amended FIA, a licence for an international bank or FCB may be issued to a company that accepts third-party deposits if the stated or assigned capital of the company is at least Bd$4 million and, furthermore, does not accept third-party deposits if the stated or assigned capital of the company is at least Bd$1 million. The CBB also reserves the right determine a different amount of stated or assigned capital in any particular case.

Additionally, a bank must always maintain a capital adequacy ratio of less than the prescribed percentage, which is currently 8 per cent. Assigned capital in this context refers to the portion of the capital of a company represented by such unencumbered assets as are approved by the CBB and specifically assigned by the company to its local branch operations. A bank is mandated to maintain a reserve fund and, out of its net profits each year and before any dividend is paid, to transfer to the fund a sum equal to not less than 25 per cent of those profits wherever the amount of the reserve fund is less than the stated capital of the licence, or indeed such other sum as is prescribed. Yet again, this requirement will not apply to a licensee that has shown to the satisfaction of the CBB that its stated capital and aggregate reserves are adequate in relation to its business.

The CBB had previously indicated its intention to adopt the Basel II methodology for the calculation of capital adequacy in 2009 for licensees regulated under the FIA and the IFSA. As part of the process, the CBB issued the first round of guidance and reporting forms to the banking industry for comments and feedback in 2009. In view of lessons learned from the 2007–2009 financial crisis and the revisions to Basel II, and the emergence of Basel III, the CBB has deemed it prudent to adjust its approach to the implementation of Basel II.

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Papers issued by the Basel Committee on Banking Supervision (BCBS) and other entities that opined on the financial crisis have focused on the need to improve risk-management processes and techniques within the banking industry and to strengthen the regulatory framework. The importance of Pillar II of the Framework has therefore assumed special significance. In particular, 'Enhancements to the Basel II Framework', issued by the BCBS in July 2009, considered several of the risk-management weaknesses that were revealed during the financial crisis, and reinforced the ways in which banks should manage and mitigate risks identified through the Pillar II Internal Capital Adequacy Assessment Process (ICAAP). The CBB has issued a guidance note to banks indicating its expectation that they will improve and strengthen their risk-management processes. It indicated that the draft ICAAP guidance that was issued for comments should be used as a guide by banks.

The CBB is therefore using a phased approach to the implementation. It is focusing initially on the qualitative aspects of Pillar II and, in that regard, on gaining a better understanding of the risk profiles of licensees. It has proposed an implementation of Basel II in three phases. Within the first phase, the emphasis will be on strengthening the qualitative aspects of Pillar II, while the second phase will take into account the implementation of the Market Risk Amendment. It is proposed that Pillars I and III will be implemented in the third phase.

Phase I recognises the need to strengthen compliance with Pillar II by re-examining important risks and factors not covered under Pillar I, because Pillar II requires that banks assess the capital that is required to support all their material risks. Banks are therefore required to explore weaknesses and gaps in their risk-management framework, and to use better risk-management techniques in monitoring and managing risks. The procedures used to remedy these areas are generally subsumed under the nomenclature of an ICAAP, namely a process to more adequately link capital allocation to the risks inherent within a bank's operations. During Phase II, the CBB proposes implementing the Market Risk Amendment. In this regard, banks will be required to implement a standardised approach for the calculation of the market risk capital charge. The CBB will consider use of the more advanced internal models approach. The third phase will involve implementation of Pillars I and III.

The CBB's Pillar III reinforces Pillars I and II by way of increased disclosure requirements that impose market discipline on financial institutions. Banks will be required to make core and supplementary disclosures, which will allow market participants to assess important pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and therefore the capital adequacy, of the institution. Banks will also be required to publish information on their approach to risk management, thereby raising the overall standards of transparency within the jurisdiction.

The CBB is also making amendments to strengthen the framework for Basel III. Hence, it is conducting an assessment and impact study of the additional requirements introduced under Basel III, such as liquidity requirements and the redefinition of regulatory capital. It will therefore amend the plan as deemed necessary. It also recognises that further changes to the framework may be required, and has undertaken to consider the materiality of those updates on a case-by-case basis to determine their impact and applicability to the implementation process. It has assured the banking industry that it will be kept informed of any updates to the road map, and that the CBB will seek feedback and comments from the industry.

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iv Recovery and resolution

The procedures for the resolution of failed banks are well documented through the interplay of the banking legislation and the modern corporate legislation that Barbados borrows from the Ontario and Delaware statutes. The jurisdiction has also benefited from very effective regulation and, as a result, has had no bank failures. In the case of the global Bank of Credit and Commerce International collapse in the 1990s, Barbados as a jurisdiction put together a rescue plan, as a result of which no depositors suffered, and the book of business was taken over by another banking institution.

V CONDUCT OF BUSINESS

The conduct of banking business is governed by the applicable banking legislation and the many other statutes that govern areas related to fraud, criminal prosecution and the like. Similarly, precedent and case law in areas such as misrepresentation, negligence and confidentiality are fully entrenched jurisdictionally. The leading case of *Tournier v. National Provincial and Union Bank of England*[2] is still relevant to the subject of the implied contract between the banker and customer. Hence, as in most jurisdictions, the *Tournier* principle has been modified by the plethora of anti-money laundering legislation, which imposes a countervailing obligation on the part of banks and financial institutions generally. In this regard, Barbados has both an Anti-Money Laundering Act and a Proceeds of Crime Act.

VI FUNDING

To the degree that most of the Barbadian banks are subsidiaries or affiliates of foreign banks, the matter of funding will seldom raise a concern to be considered. Given the stringent requirements in the setting up of a bank, the matter of funding is a moot issue.

VII CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The issue of individual control in banking business is not a matter likely to raise problems, since all commercial banking institutions are generally owned and controlled by institutions, and are not closely held. As regards FCBs (previously international banks), the CBB has indicated very clear criteria that minimise the potential harm of any individual bank control.

The CBB has identified four categories of acceptable international banks.

First, it welcomes reputable, adequately capitalised and well-managed local companies with a proven track record.

Second, it encourages well-established financial institutions or international banks, including branches or subsidiaries and affiliates of international banks or financial institutions, which have a proven track record and are the object of effective consolidated supervision. In the case of such a bank, the prior written outward authorisation of the parent supervisory authority is a requirement.

Third, it has identified wholly owned subsidiaries of well-established international non-bank corporations with activities limited to intergroup treasury operations and with

2 [1924] 1 KB 461.

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operations that are consolidated in the published financial statements of the parent company. In such cases, the issued bank licence indicates that the bank will not accept deposits from third parties.

Finally, the CBB has allowed for banks where the beneficial ownership rests with individuals of high net worth. However, owners must submit an audited statement of net worth or other documented evidence that is acceptable to the CBB. In such circumstances, the banking licence is also granted on the condition that the bank will not accept deposits from third parties.

However, the FIA states that no person shall directly or indirectly hold any significant interest in a licensee without the approval of the CBB. A significant interest is considered 10 per cent of the value of the capital of the licensee or 10 per cent of any class of shares of the licensee. Furthermore, each licensee must submit to the CBB at the beginning of each year a list of shareholders on its register who hold shares of a value of 5 per cent or more of its stated capital. Under the IFSA, no person shall acquire or hold shares of more than 10 per cent of the stated capital of an international bank without the approval of the Minister of Finance.

ii Transfers of banking business

A bank may transfer its banking business to another existing and licensed banking institution, or it may engage in the sale of its banking business *simpliciter*.

Certain steps are necessary in this first category of amalgamation. The bank will be required to apply to the CBB for approval to merge with the amalgamated entity to carry on business under a specific legal entity name. Certain documents must be filed in support of the application:

a a draft amalgamation agreement;
b the proposed articles of amalgamation;
c a business plan for the merged entity;
d an operational migration plan;
e an undertaking to return the two licences on completion of the amalgamation; and
f the amalgamating companies' draft shareholders' resolutions or directors' resolutions.

Before the corporate amalgamation process is completed, the following additional documents are usually required: a copy of the regulatory approval from the CBB for the amalgamation, and a copy of the no objection letter from the foreign regulatory body in cases where the merging banks are foreign affiliates, even though they may be registered in Barbados as external companies to be able to carry on business locally.

In the latter case, a sale of a banking business will also require the approval of the CBB and, in this regard, the buying bank will need to satisfy the CBB in many respects. First, it will need to be one of the four types of banking institutions favoured by the CBB and identified above. Second, it will be required to follow certain established procedures, which will vary according to whether it is a qualified foreign bank or, to the contrary, one of the other three types of applicant.In both cases, the following submissions are required:

a the name of the proposed bank;
b the proposed date for the commencement of business;
c the proposed address of the place of business;
d the name and address of the attorney-at-law in Barbados who is or may be engaged with the formation of the company;
e the name and address of the proposed auditor in Barbados;

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f the name, address and telephone number of the person or persons to whom the CBB should refer in connection with the application;

g the approval of name reservation by the registrar of companies;

h a draft of the bank's articles of incorporation or articles of organisation for entities organised under the Societies With Restricted Liability Act;

i a certified copy of the parent company's articles of incorporation;

j a profile of every shareholder at the date of commencement of business; the number of shares, of all kinds, and the amount payable thereon; and the particulars of any loans with conversion or voting privileges that are to be allotted to each shareholder;

k a current financial statement of any person who, directly or indirectly, will possess or control 5 per cent or more of the voting power or 10 per cent or more of the non-voting shares of the proposed bank;

l particulars of any proposed or existing agreements dealing with the voting of shares or management of the affairs of the proposed bank, and of any agreements providing for the issue of options to acquire shares for a consideration other than cash;

m a complete corporate chart showing the relationship of the proposed bank to other affiliated companies, subsidiaries and partnerships, wherever resident;

n a confidential statement prepared by every individual shareholder and every person who is proposed to be appointed at the date of commencement of business as a director or executive officer;

o an outline of the business of the proposed bank and its general objectives, as well as the needs of the clients it intends to serve from Barbados, including copies of proposed policies on matters such as investments, loans, and asset or liability management;

p a projected financial statement containing a balance sheet income statement, and capital adequacy calculations prepared in the usual way for banks for the first three years of operation of the proposed bank, and outlining the method of assumptions that are used;

q the prospects of the proposed bank as an employer with information as to the number of persons likely to be employed in management and staff positions at the end of the three years, and the anticipated requirements for specially qualified personnel who are not resident in Barbados;

r the particulars of any pending application in Barbados or any other jurisdiction by the principals of the proposed bank, or by any affiliates, associates or other related companies; and

s a letter certifying the accuracy of the submitted information.

VIII THE YEAR IN REVIEW

The Barbados economy contracted in 2018 and it is expected in 2019 that growth will be flat. Real economic activity contracted by an estimated 0.6 per cent, and moderate gains in the tourism sector were outweighed by declining activity in the manufacturing and other service sectors. As regards the tourism sector, long-stay visitors' arrivals increased by 2.8 per cent over the previous year as a result of more intensive marketing and increased airlifts. However, output in the manufacturing sector remain depressed during 2018, and construction activity declined by 7 per cent. It is expected that during this year, construction and manufacturing activity will show very significant increases, particularly since there is a resurgence of investor confidence and many new projects are in the 'build-out' stage.

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Further to the legislative changes outlined in this chapter, Barbados has incorporated legislative changes to its companies, insurance and income tax legislation. Of interest, Barbados now has a corporate income tax for entities that are governed by the amended FIA and that have not been grandfathered under the IFSA, as seen in the table below:

Taxable income (Barbadian dollars)	Rate (%)
Up to Bd$1 million	5.5
More than Bd$1 million and up to Bd$20 million	3
More than Bd$20 million and up to Bd$30 million	2.5
Taxable income of more than Bd$30 million	1

IX OUTLOOK AND CONCLUSIONS

With the CBB sitting at the apex of its banking structure and regulating rigorously, Barbados continues to balance the needs of commerce and development with the requirements of business sobriety and holistic growth.

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Chapter 5

BELGIUM

Anne Fontaine and Pierre De Pauw[1]

I INTRODUCTION

From a regulatory perspective, 2018 was a relatively quiet year in the Belgian banking sector. The most noteworthy event was the issuance by the National Bank of Belgium (NBB) of a detailed governance manual introducing into the Belgian prudential framework the 26 September 2017 internal governance guidelines of the European Banking Authority (EBA).[2] The manual further clarifies the governance requirements applicable to Belgian credit institutions under the Banking Act.[3]

The Banking Act aims to integrate into Belgian law the three pillars of the EU Banking Union: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism and the common deposit guarantee schemes.

To this end, the Banking Act transposes into Belgian law several EU directives and regulations, including the Capital Requirements Directive of 26 June 2013 (CRD IV),[4] the Financial Conglomerates Directive of 16 December 2002,[5] the Bank Recovery and Resolution Directive of 15 May 2014 (BRRD),[6] the proposal for a Regulation on Banking Structural Reform of 29 January 2014,[7] the Directive of 16 April 2014 on Deposit Guarantee Schemes (DGSD)[8] and specific requirements of the second Markets in Financial Instruments Directive (MiFID II).[9]

Other relevant events in the area of banking regulation in 2018 included the issuance of several communications and circulars by the NBB on, inter alia, the prevention of money laundering and terrorist financing, the requirements applicable to the compliance function and the disclosure of liquidity coverage ratios (LCRs).

II THE REGULATORY REGIME APPLICABLE TO BANKS

Pursuant to the Banking Act, only the following types of entities may collect deposits of cash or other repayable funds from the public or offer such services to the public: Belgian credit

1 Anne Fontaine is a partner and Pierre De Pauw is an associate at NautaDutilh.
2 EBA/GL/2017/11.
3 Act of 25 April 2014 on the status and supervision of credit institutions.
4 Directive 2013/36/EU.
5 Directive 2002/87/EC.
6 Directive 2014/59/EU.
7 Proposal COM/2014/043.
8 Directive 2014/49/EU.
9 Directive 2014/65/EU.

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institutions (i.e., Belgian entities registered as credit institutions with the NBB), including Belgian subsidiaries of foreign credit institutions; credit institutions established in the EEA and holding an EEA passport (i.e., EEA credit institutions operating in Belgium either through a branch or pursuant to the principle of freedom to provide services); and branches of non-EEA credit institutions established in Belgium that are registered with the NBB.

An institution will be deemed to take deposits from the public in Belgium or to offer to do so if, to collect cash deposits or other repayable funds, it engages in any type of marketing activity (newspaper, radio or television advertising, standard documents addressed to potential clients, telephone or internet contact, etc.) targeting more than 50 people; makes direct or indirect use of one or more intermediaries; or directly solicits or has solicited on its behalf more than 50 people.

Only the above-mentioned types of institutions can refer to themselves as a credit institution or bank in their corporate name and purpose, their securities and other instruments or documents they issue, and in any marketing materials. Furthermore, these institutions may provide investment services (as defined in MiFID II) in Belgium without having to obtain a separate licence.

With the exception of certain types of loans for which separate registration is required (mainly consumer credit and mortgages), lending is not a regulated activity in Belgium and may therefore be conducted without a licence.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Supervision of the Belgian banking and financial sector is based on the twin peaks model. Since 1 April 2011, the NBB has been responsible for the prudential supervision of Belgian credit institutions. The Financial Services and Markets Authority (FSMA) (which replaced the former prudential bank regulator, the CBFA) is in charge of supervising the financial markets (including listed companies as well as financial products, services and intermediaries), and has heightened powers as regards consumer protection and financial information.

As regards the prudential supervision of credit institutions, the Banking Act must now be read in conjunction with the SSM Regulation of 15 October 2013,[10] which provides for the allocation of supervisory powers between the European Central Bank (ECB) and the NBB. For more information about the applicable rules, see the European Union chapter.

In practice, the ECB is responsible for the prudential supervision of significant credit institutions (i.e., those that meet one of the criteria set out in Article 6 of the SSM Regulation). In addition, the ECB has the power to grant and withdraw the licence of any credit institution, regardless of its size, and to assess the transfer or acquisition of qualifying holdings in a credit institution. In carrying out its supervisory duties, the ECB may apply not only European directives and regulations but also the Belgian legislation applicable to credit institutions, including the Banking Act. In principle, the NBB remains responsible for the supervision of less significant institutions. Practical arrangements for the implementation of SSM cooperation between the ECB and the national authorities (such as the NBB) are specified in the SSM Framework Regulation of 16 April 2104.[11]

10 Regulation (EC) No. 1024/2013.

11 Regulation (EC) No. 468/2014.

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At the macroprudential level, the NBB is, without prejudice to the powers of the ECB, responsible for ensuring the stability of the financial system as a whole. To achieve this objective, the NBB has been entrusted with the following tasks: the detection and monitoring of various factors and developments that may affect the stability and robustness of the financial system (e.g., an accumulation of systemic risks); and the issuance of recommendations on measures to be implemented by the competent national authorities, the ECB or other EU authorities to contribute to the stability of the financial system.

In addition, in carrying out its macroprudential duties, the NBB may use any of the following (non-exhaustive) measures: imposing additional or stricter own funds or liquidity requirements; imposing additional or stricter limits on the total level of activity of institutions as a percentage of their own funds (leverage ratio); or imposing asset valuation rules different from those normally imposed under the applicable accounting rules.

Before adopting any of these measures, the NBB must inform the European Systemic Risk Board, the European Commission and the ECB.

At the microprudential level, the supervisory authority (i.e., the ECB or the NBB, depending on whether the credit institution is considered significant under the SSM Regulation) is responsible for ensuring that credit institutions comply with all provisions of the Banking Act and its implementing decrees and regulations, and the directly applicable EU regulations. To fulfil its role, the supervisory authority may request any information concerning an institution's organisation, functioning, situation or transactions; carry out inspections at the institution's premises (including branches in another EEA Member State, provided the competent authority in the host state is informed beforehand) and make copies of all relevant information; and ask an expert to conduct investigations on its behalf at the institution's expense.

In addition, credit institutions must notify the supervisory authority in advance of any strategic decision they intend to take. The supervisory authority then has two months to object, which it may do if it considers the decision to violate any provision of the Banking Act or to be incompatible with sound and prudent management, or if it feels that the decision could have a significant impact on the stability of the financial system.

The supervisory authority may send a formal notice to a credit institution – whether systemically important or not – asking it to remedy a situation if it considers that the credit institution is not acting in accordance with the provisions of the Banking Act or its implementing decrees and regulations, the Capital Requirements Regulation (CRR),[12] the Markets in Financial Instruments Regulation[13] or the Commission Delegated Regulation supplementing MiFID II,[14] or if it considers that the credit institution could fail to comply with any of these instruments in the next 12 months. The supervisory authority may set a deadline by which the credit institution must remedy the situation.

If the credit institution has not remedied its situation, the supervisory authority may:

a impose additional or stricter own funds and liquidity requirements;

b require that all or some distributable profits be booked as reserves;

c order that variable remuneration be capped at a percentage of the institution's profits; or

12 Regulation (EC) No. 575/2013.

13 Regulation (EU) No. 600/2014.

14 Commission Delegated Regulation (EU) 2017/565.

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d require the credit institution to reduce the risks related to certain types of activities or products or to its organisation, if necessary by imposing the sale of all or part of its business.

In addition, the supervisory authority may, at any time, request the credit institution to implement all or part of a recovery plan.

If the institution fails to remedy the situation, the supervisory authority may take any of the following (non-exhaustive) measures:

a appoint a special commissioner to approve some or all of the institution's decisions;
b require the replacement of some or all of the institution's directors or managers, or appoint interim directors or managers;
c suspend or prohibit some or all of the institution's activities for a certain period of time (including the total or partial suspension of existing contracts);
d order the disposal of shareholdings held by the institution; or
e revoke the institution's licence.

If the supervisory authority takes any of the above-mentioned actions against a credit institution with a branch in another EEA Member State or that provides cross-border banking services in the EEA, it must inform the host country's competent authority of the measures taken, without delay.

If the supervisory authority finds that an EEA credit institution providing banking services in Belgium, either through a branch or on a cross-border basis, does not comply with its obligations in Belgium, it must notify the competent authority in the home country. If the credit institution continues to act in a way that is clearly prejudicial to the interests of Belgian investors or to the proper functioning of the markets, the supervisory authority may take any of the measures listed under points (a), (b) or (c), above, if the institution acts through a Belgian branch, or under (c) if the institution acts on a cross-border basis. With regard to the supervision of Belgian branches of non-EEA credit institutions, the NBB can exercise the same powers and tools as it does for Belgian credit institutions.

If a credit institution has ceased providing banking services for more than six months or has been declared bankrupt, the ECB will revoke the institution's licence.

ii Management of banks

To ensure the efficient and prudent management of their activities, credit institutions must have a solid and adequate business organisation. In particular, they must have:

a an appropriate management structure based on a clear and transparent allocation of functions, powers and responsibilities within the institution;
b an adequate administrative and accounting organisation, and appropriate internal controls;
c efficient procedures for the identification, assessment, management, monitoring and internal reporting of risks to which the institution is likely to be exposed, including the prevention of conflicts of interest; and
d adequate independent internal audit, risk management and compliance functions.

Each financial institution must prepare and update a corporate governance memorandum containing information about its internal organisation.

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In addition, credit institutions must establish four specialised committees within the board: audit, risk, remuneration and nomination. They are also required to establish a management committee. All members of the management committee must also be members of the institution's board of directors, which is responsible in this case for supervising the management committee's activities, determining a bank's general policy and strategy, and performing all other duties reserved to it by law. In particular, the board plays a key role regarding the implementation and control of the bank's risk appetite, assessment of its internal control mechanisms and verification of compliance by the institution with various regulations.

All managers and members of the board of directors must be natural persons. They are required to devote sufficient time to the exercise of their functions within the credit institution, and the external offices or functions they may hold or perform are subject to limitations. In addition, directors, managers and heads of independent control functions must be deemed fit and proper to carry out their duties at all times. An NBB circular of 18 September 2018 on the suitability of directors, members of the management committee, heads of independent control functions and senior managers of financial institutions provides additional insight into how the NBB interprets and assesses this requirement.

In December 2015, the NBB published a manual on the governance of credit institutions, describing the main governance requirements applicable to credit institutions with reference to all relevant policy documents (i.e., the Banking Act and its legislative history, Belgian regulations and circulars, European legislation and international standards). The NBB manual was updated in October 2018 to implement the EBA guidelines of 26 September 2017 on internal governance.

With respect to the remuneration of bank managers and employees, the Banking Act implements the requirements of the CRD IV. As a general rule, credit institutions must have a remuneration policy that ensures sound and prudent risk management and prevents excessive risk-taking. The remuneration policy should apply to all risk-takers (i.e., those whose professional activities have a material impact on the institution's risk profile (e.g., directors, managers, heads of independent control functions).

Annex II to the Banking Act provides that the variable remuneration of risk-takers must be capped at 50 per cent of their fixed remuneration when the latter exceeds €100,000. In addition, the Banking Act provides for penalties and clawback mechanisms in the event of considerable losses, non-compliance with the fit and proper standards, or participation in fraud. As regards golden parachutes, any compensation exceeding 12 months' remuneration must in principle be approved by the general meeting of shareholders. Furthermore, golden parachutes must reflect the actual performance of the beneficiary in the long term, and should not be granted in the event of shortcomings or irregular behaviour.

iii Regulatory capital and liquidity

The CRD IV and the CRR, which transpose the Basel III standards into EU law, entered into effect on 17 July 2013. The Banking Act implements these regulations into Belgian law.

As a general rule, a credit institution must have a liquidity and capital requirements policy that is appropriate to its activities. To this end, the board of directors must define a prospective management policy that identifies the current and future liquidity and capital requirements of the institution. The policy must take into account the nature, volume and characteristics of the institution's activities and the associated risks. It should be regularly

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assessed and updated when necessary. If the supervisory authority learns that an institution's policy is not in line with its risk profile, it may impose additional solvency, liquidity, risk concentration or risk position requirements.

The equity structure of credit institutions is currently divided into Tier 1 (Common Equity Tier 1 and Additional Tier 1) and Tier 2 items. Tier 1 capital is considered to be going concern capital and is intended to allow an institution to conduct its activities and prevent insolvency. Tier 2 capital is known as going concern capital and consists of hybrid instruments, undisclosed reserves and subordinated debt. Its purpose is to absorb losses and repay depositors and creditors if the institution fails.

The Royal Decree of 25 November 2015 approving the NBB's regulation of 24 November 2015 determining the rate of the countercyclical Tier 1 capital conservation buffer entered into force on 1 January 2016. The countercyclical capital buffer is defined by the NBB as a macroprudential instrument designed to mitigate cyclical systemic risk and counter pro-cyclicality in lending. On 24 November 2015, the NBB set the countercyclical capital buffer at zero per cent. This decision is reassessed quarterly. As of 1 April 2019, the countercyclical capital buffer was still set at zero per cent.

The main consequence of the implementation of the CRD IV and the CRR for liquidity supervision of Belgian financial institutions is the transition from the NBB's liquidity ratios to the European LCR. The LCR aims to ensure, on the basis of a stress test, that financial institutions have sufficient liquid reserves to cope with outflows for a period of 30 days.

iv Recovery and resolution

On 15 April 2014, the European Parliament adopted the BRRD, which provides common tools for addressing a banking crisis proactively and managing failures of credit institutions in an orderly way. The Banking Act, several royal decrees and the Act of 27 June 2016 amending the Banking Act transpose the provisions of the BRRD into Belgian law.

The Banking Act requires all credit institutions to implement and update a recovery plan. The plan must be analysed and approved by the institution's legal and administrative bodies, and should consider different scenarios (such as a serious financial or macroeconomic crisis) and provide for various measures – other than a state guarantee – to be implemented in the event of significant deterioration of the institution's financial situation. These measures should enable the institution to recover its financial position quickly and without negative effects. The recovery plan must be established within six months of the company being accredited as a credit institution, and must cover the credit institution as well as its Belgian and foreign subsidiaries. Its adequacy will be assessed by the competent supervisory authority, which may take specific measures if it finds that the plan does not meet the applicable statutory requirements (e.g., it may order the credit institution to adjust its risk profile or review its strategy and structure). On 21 March 2018, the NBB issued a communication setting out its expectations for the recovery plans of Belgian credit institutions and their parent undertakings. The communication also provides information on the structure and content of the plan.

The Act of 25 April 2014 on various provisions, which was adopted on the same day as the Banking Act, created a Resolution Authority within the NBB. The Resolution Authority is responsible for preparing the resolution plan provided for by the Banking Act. Rules on the functioning and organisation of the Resolution Authority are set out in the Royal Decree of 22 February 2015.

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Pursuant to the Banking Act, the resolution plan defines the measures, other than a state guarantee, that may be implemented by the Resolution Authority in the following circumstances:

a failure of the credit institution is confirmed or expected;

b when it is unreasonable to believe that prudential action could prevent the failure of the credit institution within a reasonable period of time; and

c if a resolution measure is necessary in the public interest to ensure the continuity of the institution's critical functions, avoid disruption of the Belgian and international financial systems, and protect insured deposits.

The resolution plan must cover the credit institution as well as its Belgian and foreign subsidiaries.

Pursuant to the BRRD, as from January 2016, bank failures are in principle resolved by contributions from shareholders and creditors of the failing institution (bail-in), and no longer by public intervention (bail-out). This measure is intended to minimise the cost of resolution for taxpayers, and to give bank shareholders and creditors a greater incentive to efficiently monitor the institution's financial situation. Further provisions on bail-in obligations were inserted in the Banking Act by the Royal Decree of 18 December 2015.

Rules on the transfer and mutualisation of *ex ante* contributions to be made by credit institutions to the Single Resolution Fund are provided for in a separate intergovernmental agreement entered into between 26 Member States of the Banking Union, including Belgium, on 21 May 2014. The Single Resolution Fund is the resolution financing arrangement for the Single Resolution Mechanism. It can only be used to the extent necessary to ensure effective application of the resolution tools and for specific purposes (e.g., to guarantee the assets or liabilities of, or make loans to, the institution under resolution).

This intergovernmental agreement was approved on 27 November 2015.

IV CONDUCT OF BUSINESS

i Conduct of business rules

There is no consolidated set of conduct of business rules applicable to institutions providing banking services in Belgium. However, applicable rules may be found in various pieces of legislation. Moreover, a number of professional associations have drawn up their own codes of conduct.

The legislation with which Belgian credit institutions, Belgian branches of foreign credit institutions and, in some cases, EEA credit institutions providing banking services in Belgium on a cross-border basis must comply when providing banking services in Belgium includes:

a the Act of 21 December 2013 on financing for small and medium-sized enterprises (SMEs), which creates a legal framework for credit facilities granted to SMEs. The purpose of this Act is to ensure easier access to credit for SMEs by imposing specific obligations on both lenders and borrowers (e.g., a duty of care and a duty to inform) and by ensuring greater transparency;

b Book VI of the Belgian Code of Economic Law (Market Practices and Consumer Protection), which sets out specific rules applicable to contracts for the provision of financial services entered into with consumers by remote means;

c Book VII of the Belgian Code of Economic Law (Payment and Credit Services), which contains specific provisions on payment services, consumer credit and mortgages;

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d the Act of 22 March 2006 on intermediation in banking and investment services and the distribution of securities, pursuant to which a regulated entity (such as a credit institution) that is considering using an intermediary in Belgium must ensure that its intermediary is registered with the FSMA, and all employees or representatives of a regulated financial entity who come into contact with the public must meet certain professional knowledge requirements;

e the Act of 2 August 2002 on the supervision of the financial sector and on financial services, which, inter alia, implements into Belgian law the MiFID II conduct of business rules (know your customer, best execution obligation, management of conflicts of interest, etc.) and its implementing Royal Decree of 19 December 2017;

f the Act of 16 June 2006 on public offers of investment instruments and the admission of investment instruments to trading on regulated markets (Prospectus Act), which generally requires the publication of a prospectus before a public offering of investment instruments; effective 21 July 2019, the Prospectus Act will be repealed and replaced by the Act of 11 July 2018 on public offers of investment instruments and the admission of investment instruments to trading on regulated markets;

g the Act of 14 December 2005 abolishing bearer securities and prohibiting the issuance or delivery of bearer securities in Belgium; and

h the Royal Decree of 25 April 2014, which imposes certain information obligations upon the distribution of financial products to retail clients.

ii Prohibition on proprietary trading

Since 1 January 2015, it is in principle prohibited for any credit institution to engage in proprietary trading activities, either directly or via a Belgian or foreign subsidiary. This prohibition covers, inter alia, positions in financial instruments held by the institution with the intent to generate short-term profits (e.g., through speculation on price fluctuations) or high-risk trading strategies that are likely to result in substantial losses. This prohibition is based on the principle that a credit institution may not use its clients' deposits for speculative purposes that make a limited contribution to the real economy.

The prohibition on proprietary trading does not apply to certain trading activities, such as the provision of investment services to clients, market-making activities, hedging, treasury management and long-term investments. However, these authorised activities are capped, and must comply with specific quantitative and qualitative requirements.

An NBB regulation of 1 April 2014, approved by the Royal Decree of 25 April 2014 establishes specific rules on permitted proprietary trading activities. On 30 March 2015, the NBB published a circular on periodic quantitative and qualitative reporting requirements with respect to proprietary trading. This circular applies to Belgian credit institutions whose deposits or issued debt instruments are covered by the Belgian deposit guarantee scheme, and contains specific instructions and templates for the quarterly quantitative and annual qualitative reporting obligations applicable to such institutions.

iii Bankers' liability

Belgian law does not contain specific rules on the liability of bankers. The liability of a banker is therefore determined pursuant to the general liability rules that clearly distinguish between contractual liability (contract claims) and extra-contractual liability (tort claims):

a contractual liability: a bank may be held liable for breach of any of the provisions of a contract entered into with a customer. The bank's liability is assessed in light of the

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nature and scope of its contractual (i.e., professional) obligations. A bank may also be held liable for abuse of right or breach of the duty to perform a contract in good faith; and

b extra-contractual liability: a bank may also be held liable for a tortious act that causes damage to a customer or even a third party if there is a causal link between the act and the damage (Article 1382 of the Civil Code). The act can be a violation of either a specific statutory rule or the banker's general duty of care, which is measured against the behaviour expected of a reasonably prudent professional.

As a general rule, an injured party cannot cite both contractual and extra-contractual liability to claim damages for the same harm or loss; however, as an exception to this rule, an injured party may base a claim on both contractual and extra-contractual liability under the following circumstances: during performance of a contract, the breaching party commits a wrongdoing that constitutes a breach of its general duty of care but not of a contractual obligation, and thereby causes damage that is different from that which would have resulted from improper performance of the contract. In any case, a banker's liability is assessed on a case-by-case basis, taking into account the banker's and the customer's level of expertise, the nature of the transaction, the specific circumstances and so on.

Under certain circumstances, a bank may limit or exclude its liability (both contractual liability and liability in tort) through an *ad hoc* contractual provision.

Based on the above-mentioned rules, and without prejudice to any conduct of business rules contained in specific legislation, banks have the following main duties to their customers under Belgian law:

a compliance with all applicable rules and regulations;

b compliance with the duties of skill and care expected of a banker (expertise, foresight, diligence, vigilance, prudence, etc.);

c the provision of adequate information to customers about the nature and characteristics of a transaction, having regard to the customer's expertise;

d provision of proper advice to customers without interfering with their business;

e verification of customers' financial situations, since a banker may be held liable for creating an impression of solvency by extending (or maintaining) credit to a customer that is in financial difficulties; and

f prudent action when terminating a contract with a customer. In particular, a bank should only terminate such a contract in accordance with the applicable contractual provisions, and should be careful not to act abusively in doing so.

iv Banking confidentiality

There is no formal bank secrecy in Belgium; however, under Belgian law, a banker has a general duty of confidentiality to the bank's clients. This duty is contractual and customary in nature, and is deemed to be an implied contractual term. Violation of this duty of confidentiality may give rise to breach-of-contract claims.

It is generally accepted, however, that this duty does not prevent a bank from disclosing information about its clients further to an official request by a Belgian court or if the client authorises the bank to do so. The duty of confidentiality is also not applicable, to a certain extent, in dealings with the tax authorities, which may request a bank to disclose

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any information that could be useful in determining the taxable income of a client of the bank, if the authorities have indications of tax fraud or if the client's taxable income is to be determined on the basis of signs and indications of greater wealth.

V FUNDING

Belgian banks fund their activities mainly through customer deposits, and Belgium is characterised by high savings rates.

In 2018, Febelfin, the representative association of the Belgian financial sector, published a report on the Belgian banking sector in 2016 and 2017. According to Febelfin, total deposits by Belgian customers (i.e., households, companies and public authorities) with credit institutions amounted to almost €550 billion for those years (mainly in the form of savings and current accounts).[15] Deposits by Belgian customers with Belgian credit institutions amounted to 121.9 per cent of GDP, compared to the eurozone average of 106.3 per cent for the same period.

Other sources of funding include interbank and capital markets transactions, central bank funds and, under certain circumstances, state guarantees.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The Acquisitions Directive[16] was transposed into Belgian law by the Act of 31 July 2009. The relevant provisions have now been implemented in the Banking Act.

If the acquisition or disposal of a shareholding in a Belgian credit institution would result in any of the following thresholds being crossed, the person, acting alone or in concert, wishing to acquire or dispose of the shareholding, must notify the NBB of its intention to do so. Belgium has not opted to set a notification threshold of one-third rather than the standard 30 per cent. The notification thresholds applicable in Belgium are thus 10, 20, 30 and 50 per cent. Upon receipt of a notification, the NBB must inform the ECB, which, under the SMM Regulation, has the power to assess the transfer or acquisition of qualifying holdings in a credit institution. For more information about the applicable rules and procedures, see the European Union chapter.

The following two documents supplement the Banking Act:

a an NBB communication to parties that propose acquiring or increasing a qualifying shareholding, containing all information necessary to ensure the smooth functioning of the assessment procedure and the various forms to be used; and

b a circular addressed to regulated financial undertakings covered by the Act of 31 July 2009 concerning their obligation to notify the NBB upon learning that a stake in their capital has been or will be acquired, increased, decreased or disposed of, thereby causing the 10, 20, 30 or 50 per cent thresholds to be crossed (upwards or downwards); undertakings must also notify the NBB annually of the identity of any parties holding such a qualifying stake in their capital.

15 Febelfin, Facts & Figures 2016–2017, available at www.febelfin.be.

16 Directive 2007/44/EC.

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ii Transfers of banking business

Pursuant to the Banking Act, any merger between credit institutions or between a credit institution and another financial institution, as well as any transfer between such entities of all or part of their business, must be approved by the competent supervisory authority, which has two months from notification of the proposed transaction to object. It may do so if it considers the decision to violate any provision of the Banking Act or to be incompatible with sound and prudent management, or if it feels that the decision could have a significant impact on the stability of the financial system.

The supervisory authority's authorisation must be published in the Belgian State Gazette. The Banking Act provides that a transfer of all rights and obligations arising from the business of a financial institution involved in a merger or other transaction (e.g., rights and obligations arising from deposits or loan arrangements) is enforceable against third parties as from publication of the supervisory authority's authorisation, without the need to obtain the clients' consent.

VII THE YEAR IN REVIEW

i Governance manual

On 23 October 2018, the NBB issued a circular on the introduction into the Belgian prudential framework of the EBA guidelines of 26 September 2017 on internal governance. The purpose of these guidelines is to further harmonise the governance requirements applicable to credit institutions and to provide guidance on the supervision of credit institutions with a view to ensuring their effective and prudent management. The guidelines cover various topics such as the role and composition of the management body and committees, the general governance framework, the risk culture and business conduct, the internal control framework and mechanisms and business continuity management.

The governance requirements applicable to credit institutions are set out in detail in the NBB's manual, which is available on its website.[17]

ii Prevention of money laundering and terrorist financing

On 24 January 2018, the NBB published a circular on the overall assessment of money laundering and terrorist financing risks.[18] The circular clarifies the NBB's expectations in terms of the overall risk assessment to be performed by credit institutions pursuant to the Act of 18 September 2017 on the prevention of money laundering and terrorist financing and on the restriction of cash payments (AML Act) to identify, manage and mitigate money laundering and terrorist financing risks. The AML Act implements into Belgian law the fourth Anti-Money Laundering Directive.[19]

On 8 February 2018, the NBB issued a communication announcing the creation of a new section of its website dedicated to the prevention of money laundering and terrorist financing and setting out the requirements applicable to Belgian credit institutions in this regard (e.g., legislation, guidelines, recommendations).

17 www.nbb.be.

18 NBB_2018_02.

19 Directive (EU) 2015/849.

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iii Compliance function

On 6 February 2018, the NBB adopted new rules on the expertise required by heads of the compliance function (i.e., compliance officers). The rules, which were approved by royal decree on 15 April 2018, specify the requirements applicable to compliance officers of credit institutions in terms of professional experience, knowledge and education.

A communication published by the FSMA on 8 May 2018[20] provides additional information on the continuing educational requirements applicable to compliance officers and the organisation of training for compliance officers.

iv LCR

On 28 February 2018, the NBB published a circular implementing the EBA guidelines of 21 June 2017 on LCR disclosure.[21] The guidelines aim to harmonise and improve the transparency and comparability of the LCR and other liquidity risk management information, in particular by providing credit institutions with harmonised templates and tables for LCR disclosure.

VIII OUTLOOK AND CONCLUSIONS

Most European directives and regulations adopted in the aftermath of the 2008 financial crisis have now been implemented into Belgian law. The structural reform of the Belgian banking and financial sector is nevertheless an ongoing process, the purpose of which is to continuously improve the stability of the financial system and the ability of banks to face future financial turbulence and challenges.

In a press release of 8 March 2018, the NBB indicated that the five-year financial sector assessment programme carried out by the International Monetary Fund (IMF) of the Belgian financial sector confirmed, based on specific stress tests, that the sector has become more robust in recent years and that Belgian credit institutions are now better able to absorb macrofinancial risks. Points for attention mentioned in the IMF's recommendations include challenges on the Belgian mortgage market and the level of prudential supervision of banking group subsidiaries.

On 30 November 2018, the NBB released its annual list of the country's systemically important banks. The eight banks on the list are the same as those indicated in 2017, namely BNP Paribas Fortis, KBC Group, Belfius Bank, ING Belgium, Euroclear, The Bank of New York Mellon, Argenta and Axa Bank Belgium.

20 FSMA_2018_05.

21 NBB_2018_06.

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Chapter 6

BRAZIL

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I INTRODUCTION

Brazil has a very sophisticated and solid banking system. As an extremely important component in fostering economic growth, the Brazilian banking industry and, consequently, Brazilian banking regulation, are constantly developing, providing local market participants with the tools required to enable them to structure complex and innovative products.

Banking regulation has played a crucial part in setting the limits and procedures that allow local players to operate in one of the most important markets in the international economy,[2] ensuring a secure environment for investors and for the public in general. Local regulators do not limit their activities to the issuance of rules and guidelines for the banking industry; they also closely supervise market participants to verify whether regulatory requirements are being duly complied with.

An example of this practice is the extensive amount of information that must be provided by banks and other entities to the regulators, sometimes several times in one day. As a result of this constant verification, in the past few years the Brazilian banking industry has not seen any unpredictable failing of local banks, as the Central Bank of Brazil (Central Bank) has intervened prior to the severe deterioration of a local bank. Banco Azteca do Brasil SA in 2016, Banco BVA SA in 2014 and Banco Cruzeiro do Sul SA in 2012 are examples of intervention and subsequent extrajudicial liquidation of local banks, which, even though not completely eliminating them, did help to reduce the effects of insolvency on stakeholders and mitigate the systemic risk that could arise thereunder.

The Brazilian banking system also provides mechanisms for liquidity problems faced by financial institutions. For instance, the Credit Guarantor Fund, a private non-profit organisation authorised to be incorporated by the National Monetary Council (CMN) and composed of local banks, which was originally intended to protect investors of insolvent financial institutions, has provided assistance to financial institutions with liquidity problems on more than one occasion.

In addition to the precautionary and reactive measures adopted by local regulators to prevent insolvency scenarios, the applicable rules also enable Brazilian banks to issue several types of funding instruments in Brazil and abroad to finance their operations, thereby maintaining acceptable liquidity levels. This variety of instruments is a result of market

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2 In 2017, Brazil had the eighth-largest economy in the world by gross domestic product according to data provided by the World Bank on its website (data.worldbank.org/data-catalog/GDP-ranking-table).

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demand and a positive response by regulators to the needs of market participants, which have recently resulted in new regulations permitting the issuance of new forms of funding instruments, as further addressed in Section V.

By doing business in such a regulated but rather secure financial environment, Brazilian banks have been able to succeed and, many times, foster results in the middle of the economic crises that Brazil has faced in the past.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i General aspects

An important aspect to consider when discussing banking regulation in Brazil is that there is no legal definition of bank under Brazilian law. The Banking Law,[3] which sets forth the basis of the national financial system (SFN),[4] defines in Article 17 the term financial institution as those public or private companies whose principal or secondary activity is the collection, intermediation or investment or custody of their own or third-party funds. It is therefore left to local regulators to determine the types of financial institutions and the activities that may be performed thereunder.

Banks are thus defined in terms of their permissible functions. The main categories of banks are:

a commercial: financial institutions whose main activities, inter alia, are receipt of time deposits, offering checking facilities, providing short-term lending, collection of trade acceptance bills and other credit documents, and accepting and processing utility bill payments;

b development: intended to foster the economic growth of specific regions or industrial sectors. Financing tends to be long-term and related to specific projects;

c multi-service: aggregate more than one type of banking activity, of which one must be either commercial or investment. Thus, a multi-service bank may, for instance, apply for one or more of the following:

- commercial bank licence (if the entity was originally established as an investment bank);
- investment bank licence (if the entity was established as a commercial bank);
- real estate finance licence;
- consumer credit licence;
- leasing licence; and
- foreign exchange authorisation; and

d savings: federal and state-owned financial institutions very similar to commercial banks, which accept savings from individuals by means of deposits in checking accounts for a fixed term or in savings accounts, provide loans and perform various services in the public interest, such as the receipt of federal taxes and charges.

3 Federal Law No. 4,595, of 31 December 1964.

4 Government-owned and private financial institutions form the Sistema Financeiro Nacional. Private financial institutions include commercial banks, investment banks, universal banks, exchange banks, credit, financing and investment companies, securities dealerships, brokerage firms, credit unions and leasing companies.

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All such types of institutions are highly regulated. Different from individuals or corporations, which under Brazilian civil law are authorised to undertake any act that is not expressly forbidden, regulated entities may only perform activities that have been expressly authorised by law or regulation. As such, the role of regulators has become very important in relation to this type of activity.

ii Regulators

There are three entities primarily entrusted with the role of regulating and overseeing financial institutions in Brazil, including banks, are the CMN, the Central Bank and the Brazilian Securities Commission (CVM).[5]

The CMN was created by the Banking Law, and is the highest authority in the Brazilian financial system. Among the CMN's responsibilities are supervising the monetary and currency exchange policies for the purpose of the economic and social development of Brazil, as well as operating the Brazilian financial system.

Among its duties, the Central Bank has the obligation to assure the stability of the purchasing of the national currency and the solidity of the national financial system. The Banking Law granted powers to the Central Bank to implement monetary and credit policies issued by the CMN, and to regulate public and private financial institutions and payment arrangements, arrangers and institutions.

The Central Bank is responsible, inter alia, for exercising control over credit and foreign capital, receiving mandatory payments and voluntary demand deposits made by financial institutions, engaging rediscount transactions and providing funding to financial institutions, as well as exercising its function as the depository of national gold and foreign currency reserves. It is also responsible for controlling and approving the incorporation, functioning, transfer of control and corporate reorganisation of financial institutions and payment institutions.

The third regulator, the CVM, was created by the Capital Markets Law,[6] which regulates the securities markets in Brazil. As securities activities are strictly connected with banking activities, especially investment banking, the CVM also has an important role as regulator of the banking industry.

Pursuant to the Capital Markets Law, the CVM shall implement policies pertaining to the organisation and operation of the securities industry. Accordingly, the CVM's responsibilities encompass the regulation and supervision of all securities activities, including issuance, distribution and trading of securities; the organisation and functioning of the stock exchanges; and practices in the management of securities portfolios and their custody.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

As indicated above, the Central Bank is the main regulator of banking activities, as it is responsible for supervising the banking activities of local banks and financial institutions. That supervision relies on the following principles: supervision focused on risk, continuous supervision and transparency.

5 If a bank opts to also have an investment banking department, it will be subject to CVM regulatory authority with respect to its investment banking activities.

6 Law No. 6,385, of 7 December 1976.

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Inspection is an essential element of the supervision process to assess the economic and financial situation of supervised entities, and their management and compliance with the applicable laws and regulations. It aims to identify the relevant risks of financial institutions and evaluate their respective controls.

As per the information made available by the Central Bank for the improvement of the processes of supervision of financial institutions and conglomerates whose businesses encompass subsidiary entities in other countries, various procedures are adopted, such as:

a elaboration of supervision agreements with foreign authorities;
b monitoring of activities of international organisations in matters related to supervision;
c exchange of information with foreign supervisory authorities;
d coordination, support and follow-up of missions by foreign supervisors in the country; and
e dissemination of the Brazilian supervision to the international context.

In addition to physical supervision, financial institutions are subject to regular reporting requirements to the Central Bank. Several types of detailed reports and financial information are submitted by local institutions to the Central Bank, enabling the authority to keep a very close eye daily on the financial situation of the market players.

In addition to the reporting and inspection requirements, the applicable rules are very restrictive on the management of banks. Prior to a final appointment as administrator of a financial institution, individuals must submit an exhaustive list of documents, information and declarations to the Central Bank, which may even prevent a person from being nominated if that person does not have a good reputation.

ii Management of banks

Pursuant to the organisation of a financial institution, it is important to highlight that with few exceptions, a financial institution, such as a bank, must be incorporated as a *sociedade anônima*, which is the corporate form that most closely resembles a joint-stock company or corporation. The legal requirements pertaining to joint-stock companies are governed by the Corporations Law.[7]

Joint-stock companies are managed by an executive committee and, if applicable, a board of directors. In addition, a board of auditors may be set up, either provisionally or permanently, to inspect the activities of the other management bodies. The executive committee and the board of auditors must be composed of individuals residing in Brazil and meeting the requirements prescribed by law. Members of the board of directors do not need to reside in Brazil.

Members of administrative bodies of financial institutions are subject to civil liability, similar to the potential liabilities to which administrators of any company are subject, in addition to further criminal and administrative liabilities applicable to managers of financial institutions.

Civil liability and exceptional rules

In the ordinary course of the transactions of financial institutions, the civil liability of administrators (including directors and officers) is regulated by the Corporations Law.

7 Law No. 6,404, dated 15 December 1976.

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Article 158 of the Law provides that an administrator will not be deemed personally responsible for the obligations incurred on behalf of the company and on account of a regular act of his or her administration. However, an administrator will be responsible under civil law for losses caused by acts carried out with guilt or malice, and in violation of the law.

An administrator will not be responsible for unlawful acts practised by other administrators except when, for connivance therewith, he or she fails to reveal them, or when, upon being aware thereof, he or she refrains from acting for the purpose of barring the practice thereof. There is joint liability of the administrators when the decisions are taken by collegiate bodies, such as the decisions taken by a board of directors. In this regard, any act or omission committed by a board is the personal responsibility of each of the members who form it, and to be exempt from any future responsibility, a dissident administrator should express his or her disagreement with the resolutions taken through a clear and express record in the minutes of the meeting of the relevant administrative body.

An administrator who agrees with the practice of acts in violation of the law or a company's by-laws will be deemed jointly liable for the losses resulting therefrom, and be compelled to provide indemnification for the losses caused.

The Corporations Law imposes the duty of diligence on administrators of institutions during the performance of their duties, providing that they shall be guided by the care and diligence that every active and honest person uses in the administration of his or her own business. Administrators are otherwise subject to the duty of loyalty to their company, and must maintain reserve and diligence when dealing with the company's affairs.

There are also some exceptional rules. Pursuant to the terms of Article 40 of the Bank Bankruptcy Law,[8] administrators of financial institutions under a special administration regime, intervention or extrajudicial liquidation are jointly responsible for the obligations undertaken by the institution during their terms of office until those obligations are actually satisfied (that is, liquidated). Pursuant to the terms of the sole paragraph of the aforementioned provision, the administrators' joint responsibility referred to therein shall be limited to the amount of the losses caused during their term of office.

Administrative responsibility

Administrative responsibility is subject to the same principles as criminal responsibility (i.e., it does not admit an agent's strict responsibility). This means that a penalty shall only be imposed on a person in the event that the act – commission or omission – is described in the law or the normative rule issued by the applicable authority, in particular the Central Bank of Brazil, as being an administrative infringement.

In fact, in the opinion of jurists and case law, it is incontestable that administrative responsibility is always individual and subjective. Only those (the financial institution, administrators or controllers) who practice the punishable act (which may be an act or an omission) may be punished.

8 Law No. 6,024, of 13 March 1974.

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iii Regulatory capital and liquidity

In March and October 2013, the Central Bank published a set of resolutions and official letters relating to the adoption of the Basel III global standards of capital requirements. The new rules aim at increasing the capacity of financial institutions to absorb shocks, increasing the strength of the financial system and promoting sustainable economic growth.

By this set of rules, financial institutions may determine presumed credit based on the provisions made for doubtful receivables in each calendar year, whenever credits arise from temporary differences resulting from provisions for doubtful receivables existing in the preceding calendar year, and from the balance of the accrued fiscal losses of the preceding calendar year. New rules were also issued concerning financial bonds pursuant to which companies shall compose the prudential consolidated balance to be used in assessing the capital and requirements as well as the possibility for the Central Bank to limit payment of dividends by financial institutions in the event that the latter should disregard the prudential requirements defined by the CMN.

The implementation of the new capital structures in Brazil began on 1 October 2013, and shall follow the agreed international time frame until the conclusion of the process on 1 January 2022. Changes regarding the capital ascertainment for credit risk that do not result in additional capital and that can easily be implemented by the institutions became effective as of the issuance of the new rules.

iv Recovery and resolution

The Bank Bankruptcy Law specifically governs the insolvency regimes of financial institutions. It essentially provides for two different regimes, both administratively conducted by the Central Bank: the intervention regime and the extrajudicial liquidation regime.

Intervention

If a financial institution is unable to stabilise and resume operations while overcoming a financial crisis, or carry out an orderly liquidation, the intervention may be converted into an extrajudicial liquidation or bankruptcy liquidation, as applicable.

The Bank Bankruptcy Law stipulates that intervention may be decreed *ex officio* by the Central Bank for a period of six months (which may be postponed for an additional six months) when a financial institution suffers a loss due to mismanagement that generates risk for its creditors, or repeated breaches of banking laws are verified and not rectified after orders from the Central Bank. The intervention process is conducted by an individual appointed by the Central Bank.

After the intervention period, the Central Bank may decide to cease the intervention and allow the bank to return to its normal activities; to decree the extrajudicial liquidation of the bank; or to authorise the intervener to file for voluntary bankruptcy liquidation of the bank.

Intervention has the following effects on the obligations of a financial institution:

a suspension of enforceability of matured obligations for the duration of the intervention;

b suspension of the flow or count of the term of maturity of the previously existing obligations;

c enforceability of all pre-intervention obligations is stayed for the duration of the intervention period; and

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d creditors are generally prohibited from enforcing and collecting their respective claims against the financial institution undergoing an intervention irrespective of the cause of the event of default and the nature of the claim.

Extrajudicial liquidation

Extrajudicial liquidation of financial institutions may be decreed by the Central Bank *ex officio* or at the request of the intervener, in the event that the relevant financial institution, inter alia:

a has its economic or financial conditions affected by relevant events, especially if it fails to punctually satisfy its commitments or could be declared bankrupt;
b seriously violates the legal rules and regulations; or
c suffers a loss that subjects its non-privileged creditors to an abnormal risk.

Extrajudicial liquidation is carried out by a liquidator appointed by the Central Bank, and may be defined as an administrative bankruptcy or liquidation proceeding.

The decree of extrajudicial liquidation will result in:

a the suspension of any action (for collection) or enforcement proceedings pending against a financial institution concerning its rights or interests (i.e., creditors will not be able to foreclose on respective collateral, since the assets of the financial institution will remain frozen until the end of the extrajudicial liquidation);
b automatic acceleration of the maturity of the obligations of the financial institution; and
c interruption of the satisfaction of any obligations assumed by the financial institution.

In addition, interest ceases to accrue on the obligations assumed by the financial institution.

The extrajudicial liquidation will cease:

a when the Central Bank accepts that the necessary guarantees are in place to allow the institution to take back control;
b with the approval of the final accounts of the liquidator and registration of those accounts in the appropriate registry to evidence the termination of the legal entity; or
c with the decree of the entity's bankruptcy when the assets of the entity are not sufficient to cover at least half of the non-preferred credits, or if there is evidence of bankruptcy crimes.

IV CONDUCT OF BUSINESS

As has previously been stated, banking activities are highly regulated, and require local financial institutions to comply with the extensive regulations issued by the CMN, the Central Bank and the CVM. An important aspect that local banks must observe is banking secrecy.

Banking secrecy and confidentiality have always been of major importance and are protected by the Brazilian Federal Constitution, which determines that intimacy and private life may not be violated. Exceptions to this constitutional right can be resorted to only in extreme cases, and as a rule require a judicial order.

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Banking secrecy was regulated in 2001 by the Bank Secrecy Law,[9] determining that financial institutions should maintain secrecy in all their passive and active transactions, as well as in any services rendered.

The Bank Secrecy Law, however, granted tax authorities a special authorisation to obtain banking information in the event that an administrative proceeding had been initiated. This exception was highly debated and discussed in a series of lawsuits contesting the constitutionality of referred permission, as it would, according to the arguments presented, result in a breach of the constitutional intimacy and privacy rights of individuals, among other things.

In February 2016, however, the Brazilian Supreme Court declared, under a majority of nine votes in favour and two votes against, the constitutionality of the authorisation for the Federal Revenue to access taxpayers' financial information under the Bank Secrecy Law. The Brazilian Supreme Court interpreted that the referred-to laws determined the sharing of information by the Central Bank and the Federal Revenue, but maintained secrecy obligations by both parties, which should not be considered a breach of individuals' rights.

Even in situations in which a financial institution is authorised to breach confidentiality, all measures required for the defence of the interests of individuals must be complied with. Thus, institutions must show sufficient duty of care in selecting the information to be disclosed and verifying whether the legal requirements for the disclosure have been met.

V FUNDING

Funding of Brazilian banks is traditionally composed of cash deposits and time deposits. Other alternatives, such as the issuance of bonds in the international markets or other forms of cross-border funding, have also been broadly adopted, as interest rates in foreign markets have been historically lower than local interest rates.

Nevertheless, to foster the funding of local banks, and especially in an effort to reduce banking interest rates in Brazil (which are among the highest in the world), local lawmakers and regulators have created new instruments to provide new funding alternatives to local banks.

In January 2015, Federal Law No. 13,097 was enacted, providing for the issuance of covered bonds (LIGs) in Brazil. The Law is a conversion of Provisional Measure 656, issued by the federal government in October 2014. Widely used in sophisticated markets (such as in Europe and the United States), LIGs have finally been regulated, having been eagerly anticipated by the local market for a number of years, and are expected to reduce funding costs for institutions acting in the real estate market and, by extension, expand the availability of real estate credit at a lower cost to consumers.

The main feature related to the LIG is the fact that the pool of assets (mainly real estate financing credits) backing the issuance of the LIG will be treated as a segregated pool of assets, by which the underlying credit rights as well as the other assets and rights relating to them will be kept separately from the issuer's own assets. Hence, in cases of default, intervention, extrajudicial reorganisation or bankruptcy of the issuer, the non-commingling pool of assets will not be affected and will thus be earmarked solely for settlement of the debts owed under

9 Complementary Law 105.

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the corresponding LIG. If the pool of assets is not sufficient to settle all debts owed to the relevant investors, these will be entitled to enrol their outstanding credits in the bankruptcy estate ranking *pari passu* with the other unsecured creditors of the issuer.

Another recently created funding alternative is the structured operations certificate (COE), which is similar to structured bonds negotiated in international markets. COEs are, pursuant to the applicable rules, certificates issued against an initial investment, and represent an indivisible group of rights and obligations with an income structure similar to derivative instruments.

In addition to the application of local indexes, COEs may have foreign indexes applied as references to their remuneration. Thus, financial institutions may issue COEs based on, inter alia, variations in foreign currencies, stock or commodities prices.

Although COEs were originally regulated in 2013, the rules relating to the public offerings of COEs were not enacted in their final form by the CVM until October 2015. As a result, we have seen an increasing offer of different types of COE in the local market since then.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

As a prerequisite to operate in Brazil, a financial institution must apply to the Central Bank for a prior authorisation. The documents that must be presented to the Central Bank include:

a a formal letter of application for authorisation of the intended transaction;
b a statement declaring the intent of the applicant to incorporate a financial institution;
c a statement of the non-existence of restrictions;
d a study of the financial and economic feasibility of the project, including a business plan;
e a definition of the corporate governance patterns;
f details of the controllers of the institution; and
g evidence of financial and economic capability.

The acquisition of a controlling or significant interest in an existing bank also requires prior approval from the Central Bank and entails, basically, the same procedures.

In addition to the ordinary documentation indicated above, the incorporation or acquisition of financial institutions by foreign entities or individuals must be submitted to the Presidency of the Republic for the issuance of an executive decree acknowledging the national interest underlying the proposed transaction. As a result, whenever a foreign entity intends to set up a financial institution in Brazil, or to acquire an equity interest in a domestic financial institution, the transaction may only be closed after the granting of a presidential decree.

VII THE YEAR IN REVIEW

Local regulators have continued to push for modernisation of the applicable rules, especially to increase competition and reduce spreads to foster the Brazilian economy. In addition, some updates have been implemented to adjust local rules to international standards. Some of the most relevant regulations enacted in 2018 are summarised below.

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i Limits of exposure per client within the SFN

On 31 July 2018, the CMN enacted Resolution No. 4,677, which sets a new regulatory regime that enhances the maximum limits of exposure per client and the maximum limit of concentrated exposures that must be observed by institutions that are part of the SFN. The Resolution introduces many significant changes, incorporating into the Brazilian legislation the recommendations disposed on the Supervisory Framework for Measuring and Controlling Large Exposures, published in April 2014 by the Basel Committee on Banking Supervision.

The regulation on large exposures aims to ensure the stability of the financial system, limiting the maximum loss that a financial institution could face in the event of default of a single customer or a group of connected customers. Therefore, the regulatory framework that controls large exposures works as a tool for the monetary authorities, establishing obligations and requirements to be accomplished by financial institutions, in a preventive way, to avoid unexpected losses adversely affecting the institutions and, consequently, the entire financial system.

The limits established by Resolution No. 4,677 must be complied with by financial institutions and other institutions authorised to operate by the Central Bank, except for the following entities: institutions not subject to the calculation of regulatory capital or simplified regulatory capital; consortium administrators; and payment institutions.

As per Resolution No. 4,677, the limits must be permanently observed in a consolidated way. If the limits are surpassed, new transactions are prohibited and, depending on the type of institution, a plan to reduce the excess may be required.

Resolution No. 4,677 shall become effective on 1 January 2019 or 1 January 2020, according to the segment of the institution.

ii Bilateral margin requirements for over-the-counter derivatives

On 25 May 2018, Resolution No. 4,662 was enacted by the CMN to regulate the bilateral margin requirements for derivatives transactions that are not settled through a central counterparty, held in Brazil or abroad by financial institutions and other institutions authorised to operate by the Central Bank.

Resolution No. 4,662 follows a trend of changes in the over-the-counter (OTC) derivatives market, which intends to increase the security and transparency of OTC derivative transactions. Such measures, among others, have been adopted by several countries since the global financial crisis between 2007 and 2008.

According to the new rules, derivative transactions that fulfil certain requirements provided for in Resolution No. 4,662 shall be guaranteed by two types of margins:

a the variation margin, which aims to protect from current exposures and must be determined according to the market value of the derivatives contracts; and

b the initial margin, which aims to protect from risks arising from respective potential future exposures, due to changes in the future prices of the underlying assets of such contracts.

Resolution No. 4,662 also provides that the financial instruments used as an initial guarantee margin must be segregated from the assets of the guarantor and guaranteed entities in order to ensure its availability in the events of insolvency or bankruptcy. In addition, it provides a prohibition on the disposal and reuse of financial instruments received in guarantee.

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To allow market participants to adapt their systems and processes according to the new framework, the new rule exempts transactions carried out until 31 August 2019 from the margin requirements.

iii New technology financial institutions

On 26 April 2018, the CMN enacted Resolution No. 4,656, providing for the setup and operation of two new types of financial institutions specialised in lending through electronic platforms: direct credit companies (SCDs) and interpersonal lending companies (SEPs), which must be organised as joint-stock companies (*sociedades anônimas*) with a minimum paid-up capital and net worth of 1 million reais.

The objective of this new regulation is to give greater legal certainty to the activities of lending fintechs, technology-intensive entities that operate in the credit market. From now on, lending fintechs that apply for an SCD or SEP licence shall be considered financial institutions for regulatory purposes, and therefore will be allowed to make loans and offer other funding mechanisms. Previously, la ending fintech making a loan or offering a funding mechanism would have to depend on an association with a traditional financial institution.

According to the Central Bank, this new regulatory framework should foster innovation in the SFN, improve competitiveness and increase competition among financial institutions in the credit market, thus creating the conditions for a reduction in interest rates. This measure was among the set of actions disclosed by Central Bank in late 2016.

As a related matter, Presidential Decree No. 9,544/18 was published on 30 October 2018, through which the government has demonstrated its interest in the participation of foreign investors in the equity ownership of SCDs and SEPs (up to 100 per cent of the capital stock of SCDs and SEPs is authorised to be held by foreign investors). It is important to mention that according to the Brazilian regulation, foreign participation in the capital stock of financial institutions may only be authorised in Brazil if it is in the interest of the government.

iv Cyber risk management and cloud outsourcing regulations for financial services

Pursuant to Resolution No 4,658, which was enacted by the CMN on 26 April 2018, financial institutions must now comply with cyber risk management and cloud outsourcing regulations, being guidelines for designing or adapting their internal control.

According to this new Resolution, the related policies and action plans to prevent and respond to cybersecurity incidents must be in place before 6 May 2019, and fully compliant by 31 December 2021.

v New rules on prevented transactions with related parties

On 29 October 2018, the CMN enacted Resolution No. 4,693, which regulates the conditions and limits relating to credit transactions with related parties carried out by financial institutions and lease companies. Such transactions were known as prevented transactions.

This rule was eagerly anticipated by the local market, considering that Law No. 13,506, which was enacted on 13 November 2017, has significantly amended the legal framework about this type of transaction.

In this context, the new rule defines the meaning of credit transactions to conform with the rule's standard, as well as the exceptions and respective limits and conditions applicable to the performance of such transactions with related parties.

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For example, among others, the following transactions are conspired credit transactions: loans and financing, advances, leasing operations and collateral. Additionally, Resolution No. 4,693 establishes transparency and control procedures that must be adopted by financial institutions in the execution of these transactions.

vi New rules on cards and payment arrangements in Brazil

Within the scope of Agenda BC+, the main goal of which is to pursue a more efficient financial system in Brazil, the Central Bank issued Circular No. 3,885, Circular No. 3,886 and Circular No. 3,887 on 26 March 2018. Among other subjects, these significantly change the current regulation on payment methods, and establish more flexible rules on supervisory requirements for payment arrangements and payment institutions, as well as on interchange fees charged by debit card issuers.

To reduce uncertainties, to facilitate the identification of sub-acquirers (participants in payment arrangements that enable the final recipient to accept a payment instrument issued by a payment institution or by a participating financial institution), Circular No. 3,886 establishes objective criteria to require the participation of sub-acquirers in centralised clearance. Considering that these entities are not settlors of payment transactions, the new rule establishes that they will only be obliged to adhere to the payments environment of the centralised clearing if, in the past 12 months, their accrued total transactions value is equal to or greater than 500 million reais.

Moreover, Circular 3,885 defines different models of payment institutions, and provides for the requirements and procedures for the organisation and authorisation of payment institutions that are part of the Brazilian payment system. Under the new rules, new companies that operate as issuers of electronic currencies, issuers of postpaid payments and accreditation companies do not need prior authorisation from the Central Bank. They will only be subject to advance authorisation to operate if they reach any of the following parameters: the payment transaction volume surpasses 500 million reais in a mobile window of 12 months; or the funds held in pre-paid accounts surpasses 50 million reais in a mobile window of 12 months.

On the other hand, Circular 3,887 establishes caps on interchange fees that can be charged for domestic payment agreements on purchase and cash deposit accounts: 0.5 per cent of the average interchange fee, weighted by the amount of transactions calculated on a quarterly basis; and 0.8 per cent as the maximum amount charged in any transaction.

VIII OUTLOOK AND CONCLUSIONS

Important trends in the financial market relate to the fintech industry, and its implementation in lieu of recent rules.

The new set of rules that formally regulates the fintech sector has brought greater legal certainty to the lending fintech industry by specifically regulating transactions in this incipient market segment and allowing it to detach from the traditional banking industry. It is expected that the setup and authorisation processes within this new sector will allow possibilities to develop at a reasonable pace so that lending fintechs may soon start doing business in the new formats created by the Brazilian monetary authorities. Moreover, the Brazilian market has received the new tools with enthusiasm, as they increase competition and innovation in the sector.

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Further, it is important to mention that sub-acquirers have a relevant role in the growth and consolidation of the payment services industry. They:

a enable an increase in the number of transactions;
b prospect and affiliate commercial establishments in new segments;
c act in niches; and
d offer complementary solutions to those provided by the accreditors.

Within the scope of Agenda BC+, it is clear that the Central Bank intends to foster competition among market players.

Bearing in mind all of the updates implemented in 2018 and the general economic scenario, it is likely that local authorities will remain active, and further improvements and innovations may be expected.

It is clear that new technology and its adoption by the local market will continue to be one of the main focuses of discussion in the next few years.

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Chapter 7

CAMBODIA

Bun Youdy[1]

I INTRODUCTION

The first privately owned Cambodian commercial bank was established more than 20 years ago, shortly before the country transformed itself from a mono-banking system to a two-tier banking system, along with the conversion from a planning economy to a market economy. The National Bank of Cambodia (NBC) launched an important reform between 1998 and 2001, which consisted of:

a the abolishment of the existing requirement of a 15 per cent NBC stake in all privately owned banks;

b a classification of banking and financial institutions into three categories: commercial banks, specialised banks and microfinance institutions; and

c an increase of the minimum capital of commercial banks from US$5 million to US$12.5 million, which resulted in numerous banks being forced into liquidation.

Even though the Cambodian banking system is still generally considered to be in its development phase, foreign banks continue to express great interest in the sector, taking into account the country's continuous economic growth and the entry of new investors in this emerging market located in one of the world's fastest-growing regions. In addition, the existing legal framework offers notable incentives to which foreign investors might not be entitled in neighbouring countries, including:

a no restriction on foreign ownership;

b no local joint venture requirement;

c the liberalisation of interest rates;

d the free repatriation of benefits;

e no exchange control; and

f minimum currency risk due to Cambodia's highly dollarised economy.

As of the end of 2018, there were 43 commercial banks, 14 specialised banks, five representative offices of foreign banks, 80 microfinance institutions (including seven microfinance deposit-taking institutions), 15 financial lease companies, five third-party processors, one credit bureau (Credit Bureau Cambodia), 14 payment service-providing institutions and 273 rural credit institutions in Cambodia.[2] The Rural Development Bank is the only state-owned

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2 See NBC Annual Report 2018, p. 41.

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specialised bank, whose principle role is to service and refinance loans to licensed financial institutions, associations, development communities and small and medium-sized enterprises that take part in rural development in Cambodia.

The Cambodian banking system is gradually shifting from a cash-based economy to an electronic payment culture as more financial institutions launch internet or mobile banking and expand their ATM networks. Financial services offered by banking and financial institutions are often limited to conventional products, such as deposits and loans; however, a significant diversification has taken place with the introduction of other sophisticated products involving trade finance, payment facilities, foreign exchange and financial leasing. Large loans are usually arranged through cross-border financing by the parent or affiliated company of foreign banks with participation from its locally incorporated subsidiary; however, it is rare to see syndicated loans jointly organised by different banks in the country.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Banking activities in Cambodia are mainly governed by:

a the Law on the Organisation and Functioning of the National Bank of Cambodia, promulgated in 1996 and amended in 2006;

b the Law on Banking and Financial Institutions (Banking Law) promulgated in 1999;

c the Law on Foreign Exchange promulgated in 1997;

d the Law on Anti-Money Laundering and Combating the Financing of Terrorism (AML Law) promulgated in 2007 and amended in 2013; and

e a number of implementing sub-decrees, regulations and circulars issued by the NBC.

In comparison with other sectors, the legal framework governing the banking industry is the most comprehensive, with the NBC's regular updates of existing laws and the introduction of new regulations. Nonetheless, there is no specific regulation that governs cross-border loans provided by overseas financial institutions to non-banking and financial institutions. Close monitoring of cross-border loans to banking and financial institutions is overseen by the NBC, particularly when those loans are subordinated loans that may increase the net worth of the banking and financial institutions.

The NBC performs the traditional role of a central bank, and all banking activities are under its exclusive jurisdiction. Its main functions are to:

a conduct monetary policy;

b act as the sole issuer of the national currency and as the supervisory authority of the banking and financial system, having the authority, inter alia, to grant operating licences to banking and financial institutions; and

c oversee the payments system.

The NBC has recently upgraded its supervision structure and is making good progress towards achieving full compliance with the 25 Basel Core Principles. Despite the country's considerable challenges in securing qualified human resources, the NBC has continued to improve building the capacity to cope with the increasing workload and complexity of the sector.

Even though under the existing regulations the NBC has the power to exercise consolidated supervision, current practice demonstrates that sectoral supervision prevails instead. The Securities and Exchange Commission of Cambodia (SECC) oversees the

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securities market, while the insurance sector is under the jurisdiction of the Financial Industry Department of the Ministry of Economy and Finance (MEF). Cambodia has yet to adopt the universal banking system, whereby a banking institution intending to conduct additional related financial services, such as securities or insurance business, is required to operate under separate entities and be governed by different supervisory authorities. Together, the NBC, the MEF and the SECC are working on a framework with the aim to move towards joint or coordinated supervision, commencing with information sharing. A memorandum of understanding on establishing information sharing was signed by the MEF, the NBC and the SECC in July 2014.[3]

The banking system in Cambodia consists of commercial banks, specialised banks, microfinance institutions, rural credit institutions, financial lease companies, third-party processors and payment service institutions. Specialised banks operate in the same way as finance companies, since they are not allowed to collect deposits but are permitted to provide credit facilities. Microfinance institutions and rural credit institutions have generally been regarded as banking for the poor. Microfinance institutions are generally not permitted to accept deposits unless they have obtained a separate licence from the NBC after fulfilling certain conditions including, inter alia, being in operation for at least three years.[4] As of the end of 2018, the NBC has granted licences authorising the collection of deposits to seven microfinance institutions. Financial lease companies provide the lease of all movable property except land and buildings to the public. There have been some adjustments to the characteristic of players under the current payment system; companies that can retain their legal form as third-party processors are limited to only those companies that conduct the payment service, specifically to remit money and receive money remittance order, by using a bank's premises. In contrast, payment service institutions are eligible to conduct a wider range of payment service transactions independently, such as:

a services that enable cash withdrawals and deposits into a payment account;

b payment transactions, including transferring money from a payment account to another payment account within the payment service institution, or to another payment account at another payment service institution;

c payment transactions where the funds are offered as a credit line to a payment service user;

d issuing payment instruments, including issuing electronic currencies and acquiring payment transactions;

e conducting local and international money remittance;

f providing payment initiation services; and

g other payment services as defined by the NBC.

Banks established in Cambodia must be either a locally incorporated entity or a branch of a foreign bank.[5] Foreign banks may also establish representative or liaison offices whose activities are strictly limited to conducting market research and gleaning information.[6] In theory, the representative office has a lifespan of two years, which may be renewed once only.

3 See IMF Country Report No. 15/307, p. 10.

4 Article 2 of the Regulation on Licensing of Microfinance Institutions Taking Deposits Institution dated 13 December 2007.

5 Article 12 of the Banking Law.

6 Id., Article 13.

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Every banking institution shall be incorporated as a public limited company and must comply with minimum capital requirements. The NBC recently raised the minimum capital of commercial banks, including foreign bank branches whose parent bank does not have an investment grade rating, from US$37.5 million to US$75 million, while the minimum capital of foreign bank branches whose parent bank is rated as investment grade is increased to US$50 million. An investment grade rating is confirmed to be valid for only one year from the reporting date to the NBC.[7] Likewise, the minimum capital of specialised banks has been increased from US$7.5 million to US$15 million. The NBC also requires any newly established microfinance institutions and existing microfinance institutions to have a minimum capital of US$1.5 million, which is much higher than the amount set by the previous regulation (US$62,500). Microfinance deposit-taking institutions are also subject to a new minimum capital requirement to increase their previous minimum capital from US$2.5 million to US$30 million.[8] The minimum capital requirement for financial leasing companies and rural credit institutions remains the same, at US$50,000.[9]

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The NBC acts both as the regulatory and supervisory authority of the banking and financial sector in Cambodia. The NBC has gradually changed its supervisory approach by shifting from compliance-based supervision to risk-based and forward-looking supervision (deploying stress tests and simulations) in order to focus on certain specific high-risk areas such as credit risk, liquidity risk, market risk and operational risk.[10] The NBC has also issued prudential regulations to strengthen good governance, policy compliance, customer protection and transparency, and the enhancement of financial education among all relevant parties. Thus, its supervisory work is carried out through both off-site examinations and on-site visits.

Banking institutions are required to comply with a series of disclosure obligations, namely periodical reports (including daily, weekly, monthly, quarterly and annual reports), as well as internal control reports, reserve requirement reports and audited annual financial reports.[11] In addition, the NBC also has the power to require covered entities to provide *ad hoc* reports whenever necessary. The NBC is developing its supervisory report template, which aims at harmonising the content of the reports and improving the capture of information. The report submission process has been greatly improved, as their filing can now be done online.

7 Article 1(1) of Circular on Implementation of Minimum Registered Capital for Banking and Financial Institution dated 28 June 2016.

8 Articles 3, 4, 5, 6 and 7 of Regulation on Minimum Registered Capital of Banking and Financial Institutions dated 22 March 2016.

9 Article 3 of the Regulation on Licensing of Financial Lease Companies dated 27 December 2011.

10 See NBC Annual Report 2012, pp. 12–15.

11 Article 1 of the Regulation on Reporting Date for Commercial Banks and Specialized Banks dated 13 September 2006, Article 1 of the Regulation on Reporting Date for Microfinance Institutions dated 13 September 2006, and the NBC's Notification on Date and Duration for Submission of Reports by Banking and Financial Institutions dated 22 March 2012.

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The transparency of banking and financial institutions is generally much more significant compared to companies operating in other financial sectors in Cambodia. Every bank is required to publish its annual audited financial report no later than 30 June of the following year, and such report is available to the public.

ii Management of banks

The management of banking and financial institutions is organised pursuant to the Regulation on Corporate Governance of Banking and Financial Institutions dated 25 November 2008 (Regulation on Corporate Governance), which also defines key good governance principles to be adhered to. Their usual structure consists of a board of directors (except foreign bank branches) and compulsory committees, namely audit and risk committees, as well as other specialised committees as needed or required by the NBC.[12]

The independent director is an important feature of the management of banking and financial institutions. The board of directors of commercial banks shall be composed of at least two independent directors, while at least one-third of the total number of board members of specialised banks and microfinance institutions shall be independent directors.[13] The audit committee and compensation committee, if any, shall each be chaired by an independent director.[14]

The Regulation on Corporate Governance vaguely defines an independent director as a person capable of exercising judgement independent of the views of management, any political interests or any inappropriate outside interests.[15] The NBC's current interpretation of a non-independent director includes any person exercising any function within an affiliated entity of a company, including overseas subsidiaries. An independent director of an overseas-affiliated entity of a company, however, is permitted to act as an independent director of the relevant bank in Cambodia. Due to the limited availability of qualified people, an independent director is not required to be a resident or a Cambodian national.

The relevant regulation requires the strong autonomy of the boards of directors and management of all locally incorporated banks, including foreign subsidiaries. All decision-making, including credit approval, shall be made locally. Such requirements have not been fully implemented by some foreign subsidiary banks, which have long depended on their headquarters due to the lack of adequate resources on the ground.

While a branch of foreign bank in Cambodia does not have a separate board of directors, it is still required to adopt good governance policies and procedures aimed at complying with the principles set forth in the Regulation on Corporate Governance, including the strength of local governance through the enhancement of management autonomy granted by foreign headquarters to local executives.[16]

All banking and financial institutions are required to have internal audit and compliance officers. In the case of outsourcing, which is permitted under the current regime, the internal audit cannot be performed by the same firm as the one in charge of the external audit.[17] Any

12 Article 7 of the Regulation on Corporate Governance.

13 Id., Article 6.

14 Id., Article 8 and 19.

15 Article 6 of the Regulation on Licensing of Microfinance Institutions dated 10 January 2000.

16 Id.

17 Article 7 of the Regulation on Internal Control of Banking and Financial Institutions dated 18 September 2010.

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designation, dismissal, removal or resignation of the head of internal audit and compliance must be reported to the NBC.[18] Recently, the NBC has issued a new Regulation on Customer Complaint Settlement of Banking and Financial Institutions. The Regulation requires all banks and financial institutions to set up a new section or unit for the management of customer complaints, which is to be monitored by a senior customer relations officer who is a senior manager appointed by the board of directors to oversee the implementation of this new measure.[19]

With respect to remuneration policies, the board of directors is allowed to determine the company's compensation policies and practices as long as they are consistent with the institution's corporate culture, long-term objectives and strategy, and control environment.[20] In other words, there is no specific restriction on the remuneration package, except that the NBC has the authority to recommend institutions to review decisions that are considered not to be aligned with the above-mentioned principles. The NBC's current focus is on the financial situation of each institution.

iii Regulatory capital and liquidity

The NBC recognises the importance of adhering to international banking supervision standards, and is working to harmonise its standards and regulations in accordance with the Basel Accords. Cambodian regulatory capital standards are not fully in compliance with Basel II, but the current standards are seen as a mixture of elements found in Basel I, Basel II and Basel III. The compliance process is progressing from a banking supervision technical standpoint, but a number of new regulations still need to be introduced. The process is time-consuming, as the full implementation of the new standards requires sufficient resources, including a number of qualified personnel within the entire banking sector.

All regulatory capital requirements described below apply equally, without discrimination, to all banks operating in the country whether they are locally incorporated or branches of foreign banks.

Net worth calculation

The NBC has amended its method of calculation of net worth to be in line with Basel III.[21] The sum of paid-in capital and net worth must at least be equal to or larger than the minimum capital.[22] Net worth is composed of two components: Tier 1 capital (core capital) and Tier 2 capital (supplementary capital).[23]

For commercial specialised banks and microfinance deposit-taking institutions:

a Tier 1 capital must include:

- paid-in capital;
- reserves;
- share premium;

18 Id., Article 8.

19 Articles 4 and 8 of Regulation on Customer Complaint Settlement of Banking and Financial Institutions dated 27 September 2017.

20 Article 18 of the Regulation on Corporate Governance.

21 The old calculation method set in Regulation on Calculation of Banks' Net Worth dated 16 February 2000 was repealed by Regulation on Calculation of Banks' Net Worth dated 15 October 2010.

22 Article 2 of the Regulation on Calculation of Banks' Net Worth dated 15 October 2010.

23 Id., Article 4.

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- audited net profit for the last financial year;
- profits as recorded on intermediate dates (subject to the NBC's approval); and
- retained earning limited to 20 per cent Tier 1 capital;

b Tier 1 capital must deduct:

- own shares held by the bank;
- accumulated losses;
- intangible assets;
- loans to related parties; and
- losses determined on dates other than regular year-ends;[24] and

c Tier 2 capital, which must not exceed 100 per cent of Tier 1 capital, must include:

- re-evaluation reserves;
- provisions for general banking risks;
- subordinated debt instruments not exceeding 50 per cent of Tier 1 capital;
- a general provision of 1 per cent foreseen; and
- other items with prior approval of the NBC.

Deducted items include equity participation in banking or financial institutions, and other items including deferred charges.[25]

The Tier 1 capital of microfinance institutions[26] is composed of an almost identical structure to that applicable to commercial, specialised banks and microfinance deposit-taking institutions, except that there is no restriction on the retained earnings, and a provision for general banking risks is included (with the prior agreement of the NBC).

Unlike the structure of Tier 2 capital applicable to commercial, specialised banks and microfinance deposit-taking institutions, the Tier 2 capital of microfinance institutions must include:

a re-evaluation reserves;

b provisions for general banking risks (with the prior agreement of the NBC);

c subordinated debt instruments not exceeding 100 per cent of base net worth and with prior agreement of the NBC; and

d other items with prior agreement of the NBC.

Capital buffer

In February 2018, the NBC introduced another prudential regulation to determine the capital buffer, which includes the capital conversation buffer and the countercyclical capital buffer, in order to increase the resilience of banks and microfinance deposit-taking institutions.

Capital conservation buffer

The capital conservation buffer is designed to ensure that banks and microfinance deposit-taking institutions build up capital buffers under normal financial situations that can be drawn down when losses occur. The requirements for the capital conservation buffer are

24 Id., Article 5.

25 Id., Article 6.

26 Regulation on Calculation of Microfinance Institutions' Net Worth dated 27 August 2007.

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as follows: the capital conversation buffer must be equal to 2.5 per cent of the risk-weighted assets; and the sum of the Tier 1 capital ratio (7.5 per cent) plus the capital conservation buffer (2.5 per cent) must not be less than 10 per cent of the risk-weighted assets.

Countercyclical capital buffer

A countercyclical capital buffer is designed to ensure that banks and microfinance deposit-taking institutions have sufficient capital to bear losses where the NBC has found that credit has excessively grown in a manner that would lead to systematic risk. The NBC may consider the setting of the countercyclical buffer requirement at a level between zero and 2.5 per cent of the risk-weighted assets. Based on Circular No. B7-018-001 on the implementation of the regulation of capital buffers, this countercyclical capital buffer ratio is currently set at zero per cent.

Regarding the implementation of capital conservation buffers, banks and microfinance deposit-taking institutions shall implement at least 50 per cent of the conservation buffer by 1 January 2019 and be fully compliant by 1 January 2020. The implementation of countercyclical capital buffers will be determined by particular circular to be issued by the NBC.

Solvency ratio (capital adequacy ratio)

Banks and microfinance deposit-taking institutions must not let their solvency ratio slip below 15 per cent.[27] Prior to December 2004, the solvency ratio was 20 per cent, and one of the main reasons for scaling down the solvency ratio was to boost credit transactions. The minimum solvency ratio of microfinance institutions is also 15 per cent.[28]

The numerator of the ratio is the net worth, and the denominator of the ratio consists of the aggregate of assets and off-balance-sheet items. Assets are subject to a weighting system according to their risks. So far, Cambodia's risk-weighting system takes into account only credit risks, while Basel II requires two additional factors: market risks and operational risks.

The weighting system includes the following:

a zero per cent: cash, gold, claims on the NBC, assets collateralised by deposits 100 per cent lodged with a bank, and claims on or guaranteed by sovereigns rated AAA to AA-;

b 20 per cent: claims on or guaranteed by sovereigns rated A+ to A-, and claims on or guaranteed by banks rated AAA to AA-;

c 50 per cent: claims on or guaranteed by sovereigns rated BBB+ to BBB-, and claims on or guaranteed by banks rated A+ to A-;

d 120 per cent: traded securities; and

e 100 per cent: all other assets.

Off-balance sheet items applicable to microfinance institutions are treated with full risk (100 per cent). However, off-balance-sheet items applicable to commercial and specialised banks are classified into the following categories: 100 per cent of their value if they carry full risk; 50 per cent of their value if they carry medium risk; and 20 per cent of their value if they carry moderate risk. Items carrying low risk are not taken into account.

27 Amendment of Regulation Relating to the Banks' Solvency Ratio dated 29 December 2004 and Regulation on Capital Buffer dated 22 February 2018.

28 Regulation on Microfinance Institutions' Solvency Ratio dated 27 August 2007.

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A review is being conducted to harmonise the standard of loan classification and provisioning to comply with the anticipated implementation of the International Financial Reporting Standards applicable to financial institutions.

Capital guarantee

Cambodia has yet to establish any deposit insurance scheme, but to help protect depositors the NBC has imposed a capital guarantee on banking and financial institutions. Commercial banks and specialised banks must permanently deposit 10 per cent of their registered capital with the NBC as a capital guarantee. This amount was increased in 2001 from 5 per cent.[29] Deposits made in riel by commercial banks and specialised banks bear interest at half of the six-month refinancing rate set by the NBC, whereas deposits in foreign currencies will bear interest at one-fourth of the six-month London Interbank Offered Rate (LIBOR).[30] Microfinance institutions and financial lease companies are required to permanently deposit 5 per cent of their registered capital. Deposits made in riel by microfinance institutions bear interest at half of the six-month refinancing rate set by the NBC, whereas deposits in foreign currencies will bear interest at three-eighths of the six-month LIBOR.[31] However, deposits made by financial lease companies either in riel or in foreign currencies bear no interest.[32] Payment service institutions and rural credit institutions are also required to deposit 5 per cent of their registered capital with the NBC as a capital guarantee.[33] A depositing institution may get a refund of its capital guarantee after its liquidation and the settlement of all liabilities.

Reserve requirement

Under one of the monetary tools available to it, the NBC demands commercial banks to maintain with the NBC reserve requirements against deposits and borrowings at a daily average balance equal to 8 per cent in riel and 12.5 per cent in foreign currencies.[34] The reserve requirements had previously been increased to 16 per cent to curb booming credit activities and to limit lending to real estate-related transactions.

The reserve requirements are 5 per cent[35] for microfinance institutions and 8 per cent[36] for microfinance deposit-taking institutions.

29 See Article 16 of the Banking Law.

30 Article 5 of the Regulation on Bank's Capital Guarantee dated 15 October 2001 as amended by Regulation on the Determination of interest rate on Fixed Deposit, Reserve Requirement and Capital Guarantee in USD.

31 Article 13 of the Regulation on Licensing of Microfinance Institutions dated 11 January 2000 as amended by Regulation on Amendment to Regulation on Licensing of Microfinance Institutions dated 13 September 2006.

32 Article 10 of the Regulation on Licensing of Financial Lease Companies dated 27 December 2011.

33 Article 15 of the Regulation on the Management of Payment Services Institution dated 14 June 2017 and Article 6 of the Regulation on Granting Certificate to Rural Credit Institution adopted on 25 October 2017.

34 Article 1 of the Regulation on Maintenance of Reserve Requirements against Commercial Banks' Deposits and Loans dated 29 August 2018.

35 Article 1 of the Regulation on Maintenance of Reserve Requirements for Microfinance Institutions dated 25 February 2002.

36 Article 3 of the Regulation on Licensing of Microfinance Deposit-taking institutions dated 13 December 2007.

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The NBC additionally imposes reserve requirements against borrowing funds. Such reserve requirements are 8 and 12.5 per cent applicable on borrowing funds derived from local and foreign currencies, respectively.

Previously, the NBC also provided interest fees on reserve requirements maintained with the NBC. The first 8 per cent of the reserve requirements bears zero per cent interest, while the remaining 4.5 per cent of reserve requirements in foreign currencies bears an interest rate set by the Regulation on Term Deposit Interest Rate Determination, Deposit on Reserve Requirements and Banks Capital Guarantee in US dollars. At present, these reserve requirements in foreign currencies no longer bear any interest.[37]

Large exposure and related-party transactions

Large exposure refers to gross exposure larger than 10 per cent of banking and financial institutions' net worth.[38] A banking and financial institution's total credit exposure to a single beneficiary is limited to 20 per cent of its net worth.[39] Banking and financial institutions are required to maintain a maximum ratio of 300 per cent between total large exposure and net worth.[40] As for the purpose of identifying the beneficiary of large credit exposure, two or more individuals or legal entities will be considered as a single beneficiary if:

a one of them exercises control over the other, whether directly or indirectly;

b they are subsidiaries of the same parent company;

c they are under the same *de facto* management; or

d one of them holds an equity interest of more than 10 per cent of the other and they have a special business relationship.[41]

In the event a large exposure is guaranteed by another bank or international financial institution, with the prior approval of the NBC, the exposure will be reduced to half when calculating the solvency ratio.[42] Furthermore, the NBC may increase the large exposure ratio to up to 35 per cent of the net worth upon request from the bank, if the NBC finds that the banking and financial institution is satisfactory given by the NBC's internal rating, or benefits from an investment grade rating by an international rating agency, and provided that the borrower's financial health is strong (the latter includes good business perspectives, solvency, profitability and management).[43]

Recently, the NBC extended its control over large exposure not only on individual and legal entities, but also over sectoral concentration, in order to capture the overall risk and keep up with developments in the banking sector.

Related parties are any individual or legal entities who directly or indirectly hold 10 per cent of capital or voting rights, or any person who participates in the administration, direction, management or internal control; and the external auditor.[44] Outstanding loans

37 Regulation on the Maintenance of Reserve Requirements against Commercial Banks' Deposits and Borrowings, dated 29 August 2018.

38 Id., Article 1.

39 Article 2 of the Regulation on Controlling Banking and Financial Institutions' Large Exposure dated 3 November 2006.

40 Id., Article 7.

41 Id., Article 4.

42 Id., Article 5.

43 Id., Article 6.

44 Article 49 of the Banking Law.

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granted to related parties cannot exceed 10 per cent of the net worth of the banks and microfinance institutions,[45] and 3 per cent of the net worth for microfinance deposit-taking institutions.[46] Even though, in accordance with the existing applicable regulation, banks shall submit reports on related parties' loans on a quarterly basis, in practice the NBC requires that a report is made on a monthly basis. Recently, the NBC also extended its supervision coverage on the basis of entire transactions conducted between related parties instead of on the basis of loan transactions.

Liquidity coverage ratio

NBC has previously imposed a minimum liquidity ratio of 50 per cent on commercial banks, specialised banks and microfinance deposit-taking institutions. Banks can satisfy such minimum liquidity ratio requirement but have a shortfall of maturing assets over maturing liabilities in the next 30 days. The International Monetary Fund (IMF) has opined that although a large portion of banks' balance sheets are invested in liquid assets, they may face short-term liquidity risks.[47] Taking into consideration this liquidity risk, the NBC has increased the minimum liquidity ratio imposed on all deposit-taking banks and financial institutions from 50 to 100 per cent.[48] The minimum liquidity coverage ratio (LCR) of 100 per cent is set to be fulfilled and maintained within institutions from 1 January 2020. The NBC requires all institutions to comply with the minimum LCR within the following timelines:[49]

a minimum LCR of 60 per cent from 1 September 2016;
b minimum LCR of 70 per cent from 1 September 2017;
c minimum LCR of 80 per cent from 1 September 2018;
d minimum LCR of 90 per cent from 1 June 2019; and
e minimum LCR of 100 per cent from 1 January 2020.

Equity participation

Each banking and financial institution may hold up to 15 per cent of its net worth in each equity participation, provided that the maximum total equity participation is restricted to 60 per cent of their own net worth.[50] Under the Cambodian banking regime, equity participation is defined as holding at least 10 per cent of the capital or voting rights of another company.[51]

Securities trading

All banking and financial institutions, with the exception of microfinance institutions and financial lease companies, are permitted to trade and hold the securities listed on the securities exchange. Based on daily mark-to-market positions held, each institution can hold securities equalling up to 20 per cent of the institution's net worth. The tradable securities'

45 Article 4 of the Amendment of Regulation on Loan to Related Parties dated 7 June 2002.
46 Article 3 of the Regulation on Licensing of Microfinance Deposit-taking institutions dated 13 December 2007.
47 See IMF Country Report No. 15/307, p. 10.
48 Article 4 of the Regulation on Liquidity Coverage Ratio dated 23 December 2015.
49 Id., Article 5.
50 Article 33 of the Banking Law.
51 Id., Article 32.

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positions held by the institutions are marked-to-market on a daily basis and determined by using the official closing prices showed by the securities exchange.[52] The NBC has also launched negotiable certificates of deposit (NCDs), a new securities product, to enable banks to convert surplus deposits into securities. This mechanism allows banks to utilise those securities as collateral for interbank loans. The NCDs is designed to help the banks maintain their liquidity in times of economic crisis. It also facilitates the work of banks with deposit shortages by allowing them to borrow funds from other banks with short-term surpluses.

Credit risk grading and provisioning on impairment

In the past, the NBC imposed a different measure for asset classification and provisioning of bank and microfinance institution, as banks' assets are classified into five categories:

a normal: with provisioning of 3 per cent for banks and zero per cent for microfinance institutions;

b special mention (not applicable for microfinance institutions): with provisioning of 3 per cent for banks;

c substandard: with provisioning of 20 per cent for banks and 10 per cent for microfinance institutions;

d doubtful: with provisioning of 50 per cent for banks and 30 per cent for microfinance institutions; and

e loss: with provisioning of 100 per cent for both banks and microfinance institutions.

However, from 1 December 2017, all banks and financial institutions are required to maintain the same credit risk grading and classification. Credit risk grading and classification are divided into five categories, and vary depending on the duration of the facilities:[53]

a facilities with an initial term exceeding one year:
- normal: the facilities are duly repaid on time and there is no suspicion regarding the future repayment capacity;
- special mention: the repayment is overdue by 30 days or more;
- sub-standard: the repayment is overdue by 90 days or more;
- doubtful: the repayment is overdue by 180 days or more; and
- loss: the repayment is overdue by 360 days or more;

b facilities with an initial term below or equal to one year:
- normal: the facilities are duly repaid on time;
- special mention: the repayment is overdue by no more than 30 days;
- sub-standard: the repayment is overdue by no more than 60 days;
- doubtful: the repayment is overdue by no more than 90 days; and
- loss: the repayment is overdue by no more than 180 days.

The provisioning of the above classifications are 1 per cent (normal), 3 per cent (special mention), 20 per cent (substandard), 50 per cent (doubtful) and 100 per cent (loss), respectively.[54]

52 Articles 4 and 6 of the Regulation on Prudential Limits and Regulatory Requirements Applicable to Banking and Financial Institutions Trading in Securities dated 31 December 2012.

53 Article 17 of the Regulation on Credit Risk Grading and Provisioning on Impairment dated 1 December 2017.

54 Article 72.

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iv Recovery and resolution

There are currently no specific regulations or measures in place requiring banks to draw up recovery and resolution plans, or living wills. Banking and financial institutions are, however, advised to make their own necessary arrangements.

As part of the crisis prevention and resolution initiative, the authorities are developing a legal framework to empower the NBC and other relevant authorities to take action against failed banks. Pending the adoption of such regulations, any liquidation of failed banks must follow the provisions of the Law on Insolvency, and the NBC is entrusted to oversee the process.

IV CONDUCT OF BUSINESS

The Banking Law prohibits banks, as well as their personnel, from disclosing information related to their clients to any person except the NBC, auditors, provisional administrators, liquidators and the courts.[55] Banks may share clients' negative credit information with other banks for the purpose of sound credit activities and risk management[56] provided that the banks obtain prior approval from the clients on exclusive utilisation of the information for assessing creditworthiness.[57]

Pursuant to the AML Law, banks, through their services, must not participate in the conversion or transfer of proceeds of offences, and must immediately report those transactions to the Financial Intelligence Unit (FIU) as soon as they become aware of such circumstances.[58] The FIU has implemented an electronic reporting system that enables reporting entities to report cash transactions and suspicious transactions more efficiently. Banks are also required to conduct due diligence prior to doing business with clients, and establish internal programmes to prevent money laundering according to guidelines stipulated by the FIU.[59] Failure to do so can result in criminal liabilities punishable by imprisonment from six days to one year and monetary fines from US$25 to US$1,250. Proceeds resulting from such violations may also be confiscated.[60]

The AML Law was amended in June 2013. The amendment touched three articles of the AML Law (Articles 3, 29 and 30). Under the new Article 3, the definitions of property and predicate offence were expanded. In addition, penalties on money laundering and terrorist financing were added in the new Article 29, and penalties for legal persons were added with reference to the Criminal Code. Pursuant to the new Article 30, the National Coordination Committee on AML/CFT (Committee) can freeze suspicious property relating to the predicate offence before obtaining a court order, or can confiscate suspicious property following receipt of a court order. The new Article 30 also allows the Committee to freeze the funds of terrorists, as designated by United Nations Security Council Resolutions 1267, 1373 and successive resolutions. Following the amendment, the FIU cooperated with the Ministry of Justice to prepare a draft of a Sub-Decree on Freezing of Property of Designated Terrorists and Organizations aiming to establish the details of mechanisms and

55 Article 47 of the Banking Law.

56 Article 1 of the Regulation on Utilisation and Protection of Credit Information dated 10 May 2006.

57 Id., Article 14.

58 Article 12 of the AML Law.

59 Id., Article 16.

60 Id., Articles 29 and 30.

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procedures for freezing the assets of terrorist-related organisations, which was later adopted on 10 March 2014. Having noted Cambodia's progressive development of effective tools to combat money laundering and the financing of terrorism, the Financial Action Task Force (FATF) has removed the country from its grey list. As such, Cambodia is no longer under the FATF's close observation. The FIU was accepted as a member of the Egmont Group of Financial Intelligence Units on 10 June 2015.[61] The FIU has also published its national strategy regarding anti-money laundering (AML) and countering of the financing of terrorism (CFT) for the period running from 2019 to 2023.[62]

Should banking or financial institutions contravene any provision of their governing laws and regulations, or fail to comply with any injunction imposed by the NBC, the NBC may inflict disciplinary sanctions including:

a a reprimand;
b a prohibition on certain operations;
c the suspension or forced resignation of executives;
d the setting up of a provisional administrator;
e withdrawal of a licence; or
f the imposition of a fine not exceeding the minimum capital of the relevant banking or financial institution.[63]

V FUNDING

The core funding of banking and financial institutions is generally sourced from:

a shareholders' capital;
b cash deposits;
c borrowed capital from third-party banking and financial institutions; and
d offering their shares and bonds to public investors.

There is no restriction on capital flows between Cambodia and the rest of the world, unless in the event of a foreign exchange crisis, where exchange control may be put in place by the NBC for up to three months.[64] If there is a need to prolong the period of exchange control, an approval from the Prime Minister is required. To date, no exchange control has ever been enforced.

Since the launch of the securities market, the Cambodia Securities Exchange (CSX), in 2012, some banking and financial institutions, with the prior approval of the NBC, may go public to source required funds, provided that the number of shares to be listed does not exceed 20 per cent of the total voting right share or the number of bonds to be listed does not exceed 20 per cent of the total assets.[65] However, the NBC clearly stipulates that the listing in the CSX must not be a reason to avoid the obligation regarding minimum registered capital applicable to the shareholder.[66]

61 See NBC First Semester Report 2015, p. 43.
62 See NBC Annual Report 2018, p. x.
63 Article 52 of the Banking Law.
64 Article 5 of the Law on Foreign Exchange dated 22 August 1997.
65 Article 5 of Prakas on Conditions for Banking and Financial Institutions to be listed in CSX dated 27 September 2017.
66 Id., Article 6.

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VI CONTROL OF BANKS AND TRANSFER OF BANKING BUSINESS

There is no restriction on the control structure of banks except that, to prevent capital manipulation, the Banking Law[67] explicitly prohibits the practice of chain shareholding companies, where each is holding shares in the others. Under the existing regulations, a transfer of ownership in shares of banking and financial institutions is subject to different notification and approval regimes depending on the amount of shares affected by the relevant transaction:

a less than 5 per cent: no prior notification is required;
b more than 5 but less than 10 per cent: prior notification is required; and
c 10 per cent and above: prior approval is required.[68]

Nevertheless, in practice the NBC applies only one single regime, which is to require prior approval of any transfer of shares. As part of the approval process, the NBC mainly focuses on the background of the transferee, and no detailed business plan is required in connection with the application for such approval. Any significant change[69] in the shareholding structure of the parent company of a foreign branch operating in Cambodia shall be notified to the NBC.

The NBC levies a fee equivalent to 0.5 per cent of the face value of all transferred shares, 0.03 per cent of the face value of all added shares, and 1 per cent of the face value of all deducted shares.[70]

The NBC has issued a regulation to set out the conditions for banking and financial institutions that intend to offer their shares and bonds on the securities market. It is expected that more specific rules will be introduced to govern these exercises.

VII THE YEAR IN REVIEW

Despite the instability of the region's economic growth, Cambodia's economic growth has increased to 7.3 per cent in 2018.[71] The banking sector is considered to be the main factor in boosting Cambodia's economic growth and stabilising the macroeconomics of Cambodia.

In general, the banking sector's performance in 2018 was strong, with an increase of total assets to 163.1 trillion riel (a 19.4 per cent increase from 2017).[72] Funding from borrowings increased by 23 per cent to 16.8 trillion riel and the capital increased by 23.8 per cent to 19.3 trillion riel. Loans and deposits grew by 18.8 per cent to 99.1 trillion riel and 15.3 per cent to 79.5 trillion riel respectively.[73]

In 2018, the NBC issued a significant number of regulations, such as:

67 Article 20 of the Banking Law.
68 Articles 2, 3 and 4 of the Regulation on Transfer of Shares of Banks dated 8 November 2001.
69 Article 7 of the Regulation of Transfer of Shares of Banks dated 8 November 2001. A significant change is defined as any change that requires an authorisation of the supervisory authority of the relevant parent company.
70 Articles 11, 12, and 13 of the Regulation on Fees Determination for Banking and Financial Institutions dated 30 May 2013.
71 See NBC Annual Report 2018, p. i.
72 See NBC Annual Report 2018, p. 42.
73 Id.

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a the Circular on the Implementation of Regulations on Credit Risk Grading and Impairment Provisioning (adopted on 16 February 2018) was adopted for the purpose of providing further guidance to the implementation of some requirements (i.e., the submission of financial statements, the review and classification of facilities, the revision of credit policies, etc.);[74]

b the Regulation on Capital Buffers of Bank and Financial Institution (adopted on 22 February 2018), which aims to set out capital buffers, including capital conservation and countercyclical capital, to strengthen the durability of banks and financial institutions;

c the Circular on Implementation of Regulations on Capital Buffers of Banks and Financial Institutions (adopted on 7 March 2018);

d the Regulation on Maintenance of Reserve Requirements Against Commercial Banks' Deposits and Borrowings (adopted on 29 August 2018); and

e the Regulation on the Usage of New Forms of Bank Cheque (adopted on 26 September 2018).

Recently, the NBC commenced the soft launch of the Cambodian Shared Switch (CSS) system, with five financial institutions becoming members. Other commercial banks and microfinance deposit-taking institutions, upon becoming members, will subsequently launch the system in phases.[75] The CSS system simplifies the interbank payment operation for the use of debit cards in ATMs and point-of-sale machines to accelerate the effectiveness of payment services and reduce the flow of currency in the market.[76]

Meanwhile, to meet fund demands in a timely manner, commercial banks and 42 microfinance institutions have officially launched the Fast Payment system, seven of which launched the service under their mobile banking operations. The NBC encourages member financial institutions to continue developing the Fast Payment system for mobile transactions, online transactions and other payment instruments in order to widen its adoption and to facilitate customers' needs.[77]

Additionally, the NBC is developing a real-time gross settlement system to smooth the processing of and mitigate the risks in large interbank transactions, especially financial market transactions. The NBC has completed testing the functioning of the system, and is preparing rules and procedures for managing its operation and risks.[78]

VIII OUTLOOK AND CONCLUSIONS

At a macro level, to help maintain price and financial system stability, the NBC continues to promote riel over the short and medium term, and de-dollarisation in the long term. Differential treatment between riels and US dollars, under measures similar to the current regime and applicable to reserve requirements, will be further introduced to promote the use

74 Regulation on Credit Risk Grading and Impairment Provisioning (adopted on 1 December 2017).

75 See NBC Annual Report 2018, p. 58.

76 See NBC Annual Report 2017, p. 52.

77 See NBC Annual Report 2018, p. 58.

78 See NBC Annual Report 2018, p. 58.

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of the riel. There is also a plan to offer investment products in riels, such as Treasury bills to local people and entities, and reserve eligible government securities to banks seeking to meet the reserve requirement without using cash reserves that bear zero interest.

While the NBC is pursuing compliance with the 25 Basel Core Principles, the readiness of the banking system and regulatory structure to meet such requirements will require a reasonable amount of time, taking into account the different sizes of banking and financial institutions, as well as the types of risks relevant to the Cambodian market.

Although the number of financial institutions continues to increase steadily, data on banking transactions as a percentage of GDP suggests that there is still plenty of room for growth in the sector, in particular for new players who could bring innovative financial products and technology, and a solid source of funds. The current fierce competition among banks has not resulted in any negative consequences. It rather results in positive outcomes in terms of liquidity and the quality of services and products offered to consumers. However, with the aim of preventing destabilising effects that may be caused by excessive competition and that may, in turn, undermine the sustainability of the banking system, the NBC will likely adopt stricter policies, based on the IMF's recommendations, with respect to licensing. These policies will restrict, if not entirely prohibit, the entrance of new players.

The voluntary banking code adopted by the Banking Association, which is applicable to its members, is a specific guideline on consumer protection in the financial sector. The law on consumer protection is being drafted, and will be adopted and applicable to all BFIs at some stage in 2019.[79] With its implementation, the conduct of business landscape is expected to be significantly changed.

Moreover, several other drafted regulations will also be prepared and studied by the NBC in the coming year, such as:

a a regulation on net-worth calculations of payment service-providing institutions;
b a regulation on the management of agents of banking and financial institutions;
c a regulation on the protection of customers of payment service-providing institutions; and
d a regulation on AML-CFT.[80]

The macro financial risks caused by rapid credit growth has been alleviated by policy measures, increased financing by foreign banks, and greater exposure to the real estate and construction sector. The IMF has recommended that the NBC take measures in four areas: safeguarding fiscal sustainability, managing macro-financial risks, supporting inclusive growth, and addressing governance vulnerabilities and corruption.[81] Owing to the increase in the minimum capital requirement, we anticipate that some banking and financial institutions will be consolidated, acquired, face voluntary dissolution or have their licence downgraded.

Fintech is developing in Cambodia. Through the Bakorng project, the NBC is finalising the issuance of digital currencies by using blockchain technology. The objectives of this project are encouraging electronic payments to achieve a cashless economy, and financial inclusion. [82]

79 See Financial Sector Development Strategy 2016–2025, p. 56.
80 See NBC Annual Report 2018, p. 59.
81 See IMF Country Report No. 17/405, p. 9.
82 See NBC Annual Report 2018, p. 60.

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Growth is expected to remain around 7 per cent over the next few years and inflation to be within control.[83] The bank credit-to-GDP gap is expected to remain close to the Bank for International Settlements threshold of 10 percentage points. While banks' capital adequacy has increased, vulnerabilities remain. Financial institutions continue to draw on external funding, suggesting liquidity risks as global financial conditions tighten, with the average loan-to-deposit ratio being at around 100 per cent in June 2018.[84] Economic activity is projected to remain robust, supported by stronger manufacturing exports, construction and tourism activity. Growth is expected to decline over the medium term owing to moderations in the credit and real estate cycles and challenges in improving economic diversification and competiveness.[85]

Credit growth remains strong and is increasingly concentrated in the construction and real estate sectors. Further policy measures are needed to address elevated financial prudential measures, such as raising risk weights for real-estate lending, introducing a crisis management framework with a deposit insurance scheme, and continued upgrading of regulation and supervision.[86]

Cambodia has made significant progress towards establishing sustainable development goals due to years of impressive economic growth and reforms. The level of income growth in Cambodia has outpaced that of other countries in the region, poverty has declined and the economy has begun to gradually diversify. To entrench these gains and enhance productivity growth, the NBC should accelerate implementation of structural reforms aimed at supporting inclusive growth.[87]

The NBC continues to maintain prices and financial stability, and develop the banking sector, to support and strengthen economic growth. The NBC is also continuing to develop and improve the payment system, in particular by cooperating with the FAST system member institutions to expand the FAST system, monitor the integration of CSS system of member institutions, and prepare to launch the official operating system and cooperate with the Korean government through KOICA to implement the interbank fund payment service development plan.

To mitigate financial stability risks and bolster financial stability, the NBC has adopted key macroprudential policy measures, including a capital conservation buffer to be implemented in phases, a liquidity management framework, and an improvement of banks' loan classification and provisioning rules.[88]

83 See IMF Staff Report on Cambodia 2018, p. 5.

84 See IMF Staff Report on Cambodia 2018, p. 10.

85 See IMF Staff Report on Cambodia 2018, p. 16.

86 See IMF Staff Report on Cambodia 2018, p. 17.

87 See IMF Staff Report on Cambodia 2018, p. 17.

88 Statement by Juda Agung, Executive Director for Cambodia, NBC Annual Report 2018, p. 3.

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Chapter 8

CHINA

Shengzhe Wang and Fugui Tan[1]

I INTRODUCTION

The banking system in the People's Republic of China (PRC)[2] used to be monopolised by the People's Bank of China (PBOC),[3] first as the only bank, then later as the central bank of the PRC. After China started its economic reform and began opening up in 1978, and since the early 1980s, China has gradually opened its banking industry to embrace diversified ownerships and sophisticated businesses. The Chinese banking system is still evolving under various reforms.[4]

In the early 1980s, the government allowed four state-owned specialised banks to accept deposits and conduct banking business, namely:

a the Industrial and Commercial Bank of China (ICBC);[5]
b the China Construction Bank (CCB);[6]
c the Bank of China (BOC);[7] and
d the Agricultural Bank of China (ABC).[8]

In 1986, the Bank of Communications (BCM)[9] opened for business after being restructured into the first state-owned joint-stock commercial bank. Since then, ICBC, CCB, BOC, ABC and BCM have secured their position as the five largest commercial banks in the PRC measured by gross assets. In addition, the Postal Savings Bank of China (PSBC)[10] is now regarded as the sixth state-owned large commercial bank according to the latest official list

1 Shengzhe Wang is counsel and Fugui Tan is an associate at Hogan Lovells International LLP.
2 For the purposes of this review, the PRC excludes Taiwan and the special administrative regions of Hong Kong and Macau.
3 http://www.gov.cn/centralbank/ accessed on 11 February 2019.
4 For a good overview of the history of banking reform in China see chapter 2, 'the Evolution of the Banking Sector in China', 2017, C Jiang and S Yao, *Chinese Banking Reform*, The Nottingham China Policy Institute Series, DOI 10.1007/978-3-319-63925-3_2.
5 http://www.icbc.com.cn/ICBC/en/default.htm accessed on 11 February 2019.
6 http://www.ccb.com/en/home/indexv3.html accessed on 11 February 2019.
7 http://www.boc.cn/en/index.html accessed on 11 February 2019.
8 http://www.abchina.com/en/ accessed on 11 February 2019.
9 http://www.bankcomm.com/BankCommSite/shtml/zonghang/en/3153/list.shtml accessed on 15 February 2019.
10 http://www.psbc.com/en/index.html accessed on 18 February 2019.

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of banking institutions in 2019.[11] These six banks have all conducted initial public offerings (IPOs) and have diversified their state ownership to the public. Despite these IPOs, they are all still majority-owned by the central government.

Apart from the six big banks, since the mid-1990s there have been 12 nationwide joint-stock banks, including CITIC Bank,[12] Hua Xia Bank[13] and Minsheng Bank,[14] which have diverse equity structures comprising state ownership and private or foreign shareholding, as well as 134 city commercial banks.[15] Since 2014, the government has also promoted the participation of private capital in the financial sector. To date, 17 privately owned banks have been approved, including internet banks, such as the Zhejiang E-Commerce Bank and the Shenzhen WeBank. These two banks were founded by the internet giants Alibaba and Tencent to provide internet financial services.

To encourage constructional, industrial and agricultural development, in 1994 China established three policy banks to fulfil special lending services for construction projects, import and export companies and the agricultural sector.[16] There are also banks in China dedicated to rural areas of the country.[17] In addition, foreign banks are allowed to establish subsidiaries and branches in China, and to make strategic investments in Chinese-funded commercial banks.[18]

By the end of 2018, the total assets of the Chinese banking system were 261.4 trillion yuan. This volume marked an increase of 6.4 per cent year-on-year, with the five-largest commercial banks controlling 92.7 trillion yuan, or approximately 35.5 per cent of the total assets.[19]

Banking business in the PRC is primarily supervised and regulated by the China Banking and Insurance Regulatory Commission (CBIRC) (formerly known as the China Banking Regulatory Commission),[20] together with the central bank, the PBOC, which is responsible, among other things, for formulating and implementing monetary policy. In addition, non-banking financial institutions, such as trust companies, financial leasing companies, foreign exchange companies, consumer financial companies and automobile financial companies, are also under the administration of the CBIRC.

11 List of Banking Financial Institutions issued by CBIRC on 11 February 2019.

12 http://www.citicbank.com/en/ accessed on 11 February 2019.

13 http://www.hxb.com.cn/en/about-hua-xia-bank/general-description/bank-profile/index.shtml accessed on 11 February 2019.

14 http://en.cmbc.com.cn/ accessed on 11 February 2019.

15 List of banking financial institutions issued by CBIRC on 11 February 2019.

16 The policy banks are the Agricultural Development Bank of China and the Export-Import Bank of China, each of which is dedicated to a specific lending purpose. The China Development Bank, as the financial institution for the development, is not only committed to policy financial programmes but also to commercial financial services.

17 By the end of 2018 there were 1,427 rural commercial banks and 30 rural cooperative banks in China (statistics from the official list of banking financial institutions, issued by CBIRC on 11 February 2019).

18 By the end of 2018 there are 41 foreign-funded banks in China (statistics from the official list of banking financial institutions, issued by CBIRC on 11 February 2019).

19 http://www.cbrc.gov.cn/chinese/home/docView/6B4D8373010B4DDC96F4B67A41A69584.html accessed on 11 February 2019.

20 The CBIRC was founded in April 2018 to replace the CBRC.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

Companies planning to conduct banking business or the business of taking deposits in the PRC are required under the PRC Law on Regulation and Supervision over Banking Industry (Banking Regulation Law) to be approved by the CBIRC.

i Main regulatory body

The CBIRC was formed via the merger of the CBRC and the China Insurance Regulatory Commission (CIRC) as part of the efforts of the central government to improve the efficiency of financial regulation and eliminate regulatory arbitrage. The CBIRC is responsible for drafting and promulgating the rules and regulations governing the banking and insurance sectors in China. It also examines and oversees banks and insurance companies, collects and publishes statistics on the banking system, approves the establishment or expansion of banks, and resolves potential liquidity, solvency or other problems that might occur to individual banks.

The CBRC (now the CBIRC) was founded in 2003 to play the role of supervisor and regulator in the banking sector, which role previously was performed by the PBOC. Nonetheless, the PBOC still has considerable influence over the PRC banking system. Aside from the typical central bank responsibility of monetary policy and representing the PRC in international forums, the PBOC is also in charge of reducing overall financial risk and promoting the stability of the financial system. Its supervision over interbank markets, foreign exchange markets, the payment and settlement system and the credit information system interim is crucial to the operation of banks in the PRC. Moreover, according to the Statement on the State Council's Institutional Reform Plan (2018),[21] some authorities for drafting key regulations and prudential oversight of banking and insurance companies has been transferred from the CBRC (now the CBIRC) to the PBOC.

ii Banking regulation structure

The PRC banking regulation structure is three-tiered.

At the top level sits legislation enacted by the National People's Congress, including Banking Regulation Law (2006), People's Bank of China Law (2003) and the Law of the PRC on Commercial Banks (2015) (Commercial Banks Law). Further important regulations concerning foreign banks were formulated by the State Council, namely the Regulations on Administration of Foreign-Funded Banks (2015) (Foreign-Funded Banks Regulations). The then-CBRC (now the CBIRC) subsequently issued interpretive rules to implement these Regulations.

The second tier consists of regulatory policies issued by the CBIRC, which reiterate the legislative principles set out in the legislation enacted by the National People's Congress and the State Council. A range of policy matters were addressed by the then-CBRC. These are guidelines to the CBIRC's regulatory and supervisory directions over the medium to long term. The medium-term goal of the CBIRC focuses on a prudential framework, whereas the long-term goal is to establish a fair and competitive market.

The third tier consists of the CBIRC's guidance, notices and rules. Most of the CBIRC's regulatory rules fall into this category. As China finds specific measures more helpful than

21 http://www.gov.cn/guowuyuan/2018-03/17/content_5275116.htm accessed on 11 February 2019.

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a principles-based approach, the guidance, notices and rules are prescriptive in content and abundant in number. In general, the third tier of regulatory rules serves as the bottom rung of China's banking regulations, and deals with contemporary regulatory issues.

iii Licensing of banks

In terms of licensing, banks in the PRC are divided into two general categories: Chinese-funded banks and foreign-funded banks. The division is based on the status that the individual bank gained at its establishment. In other words, if foreign investors buy into an established Chinese-funded bank as promoters or strategic investors, that bank would keep its original status as a Chinese-funded bank in respect of its supervision and regulation by the CBIRC.[22]

Licensing for Chinese-funded banks

Commercial banks in the PRC are primarily governed by the Commercial Banks Law, and are licensed to undertake banking activities by the CBIRC or its local counterparts. To implement licensed bank activities, the CBIRC has promulgated the Implementing Measures for Administrative Licensing Matters Related to Chinese-funded Commercial Banks (Chinese-funded Commercial Banks Measures),[23] which apply to the six aforementioned biggest commercial banks, joint-stock commercial banks, urban commercial banks and the like, and the Implementing Measures for Administrative Licensing Matters Related to Rural Small and Medium-sized Financial Institutions,[24] which apply to rural commercial banks, rural cooperative banks, rural credit cooperatives, county banks, etcetera. According to these two sets of measures, the establishment, transforming or termination, and the business scope, of a commercial bank, as well as of its domestic and overseas branches, are subject to the approval of the CBIRC or its local counterparts. If a commercial bank intends to raise or issue debts and capital supplement instruments, or operate foreign exchange business, derivative products transaction business, credit card business, offshore banking business and other business, it shall seek approval from the CBIRC or its local counterparts separately. The PBOC's approval is required if commercial banks intend to conduct the business of settlement and sale of foreign exchange.

Licensing for foreign-funded banks

According to the Foreign-Funded Banks Regulations, foreign financial institutions are allowed to establish wholly foreign-owned banks or Sino–foreign joint venture banks in the PRC, provided the sole or major foreign investor is a commercial bank with no less than US$10 billion of assets and meets the prudential requirements as specified by the CBIRC. Foreign commercial banks are also allowed to establish branches, subsidiaries and representative offices in the PRC in accordance with different prudential requirements as specified by the CBIRC. For example, to establish branches in the PRC, a foreign commercial bank shall have no less than US$20 billion of assets, and shall meet other prudential requirements as specified by the CBIRC.

22 Article 11 of Chinese-funded Commercial Banks Measures, effective from 17 August 2018.

23 First promulgated by the then-CBRC on 5 June 2015 and last revised by the CBIRC, effective from 17 August 2018.

24 Ibid.

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Similar to Chinese-funded banks, foreign-funded banks shall obtain the CBIRC's approval for its establishment, any changes to its shareholders and business scope, and its termination. Foreign-funded banks shall seek separate approval from the CBIRC for debts and capital supplement instruments issuance, yuan business, derivative products transaction business, credit card business and other business, and shall seek separate approval from the PBOC for the business of settlement and sale of foreign exchange. However, foreign banks' branches are excluded from conducting agency collection and payment, credit card business and yuan business towards Chinese citizens, except absorbing fixed-time deposits from Chinese citizens in an amount of no less than 1 million yuan. The representative offices are only allowed to engage in non-business operations related to the foreign banks represented by such offices, such as liaison, market survey and consultation activities.

iv Securities activities

The Chinese bond market is now one of the largest in the world (only second to the US), with an estimated US$12 trillion as at June 2018.[25] The China interbank bond market (CIBM) was established on 6 June 1997. It is the market for securities trading and repurchasing for institutional investors (including commercial banks, rural credit unions, insurance companies and securities companies). The interbank bond market comprises the China Foreign Exchange Trading Center, the National Inter-bank Borrowing Center and the Central National Debt Registration and Settlement Company. The PBOC is the supervisory body of the CIBM.

Six major kinds of bonds are available in the inter-bank bond market:

a treasury bonds issued by China's Ministry of Finance;

b bonds issued by the PBOC;

c policy bank bonds issued by policy banks;

d financial bonds, including commercial bank bonds and non-bank financial institution bonds;

e corporate bonds issued by non-financial enterprises, commercial paper and medium-term notes;

f other types of bonds such as local government bonds issued by provincial or city governments, asset-backed securities and foreign bonds issued by foreign entities.[26]

Financial institutional issuers such as policy banks, commercial banks, finance companies and financial institutions with legal person status within the territory of China need to obtain approval from the PBOC to issue financial bonds. Foreign banks' branches allowed to engage in yuan business upon approval of the PBOC are also qualified to engage in debt trading in the CIBM.[27]

Foreign institutions incorporated outside of China are also permitted to issue bonds, also called Panda bonds, subject to the fulfilment of certain conditions and requirements. The government has further loosened the thresholds for foreign issuers by issuing new Panda

25 https://www.bloomberg.com/news/articles/2019-01-04/overseas-investors-boost-china-bond-holdings-by-most-since-june accessed on 11 February 2019.

26 China's Bond Market https://csopasset.us/markets/bond-market accessed on 11 February 2019.

27 Measures for the Administration of Bond Transactions in the National Inter-Bank Bond Market (Bond Transaction Measure) (PBOC), effective from 30 April 2000.

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bond measures in 2018.[28] Currently, all types of issuers (except for financial institutions) are only required to apply for registration with the National Association of Financial Market Institutional Investors (NAFMII), a self-regulation body.[29] On the other hand, overseas financial institutions are subject to stricter requirements when issuing Panda bonds, and have to meet demands set out in the new Panda bond measures.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

All banks in the PRC shall strictly observe the rules of prudent operation, including risk management, internal control, capital adequacy, asset quality, loan loss provisioning, risk concentration, connected transactions and liquidity management of assets. The CBIRC would conduct off-site and on-site supervision of business operations and the risk profile of banks.

The CBIRC has established a rating system and an early-warning mechanism for the continuous supervision of banks. The CBIRC has the power to require banks to submit their balance sheets, profit statements, other financial accounting statements, statistical reports, and information concerning business operations and management, as well as audit reports prepared by certified public accountants. The CBIRC may also enter the premises of banks, interview staff, check and make copies of or seal up banks' documents and materials, and examine computer systems, as required for prudent supervision.

ii Management of banks

The CBIRC closely controls the appointment and removal of the directors and senior executives of banks. All directors and senior executives shall meet the requirements specified by the CBIRC and be approved by the CBIRC or its local counterparts before taking office. The chair of a board of directors and senior executives of a wholly foreign-owned bank shall not concurrently serve as senior executives in a foreign bank's branch that engages in the foreign exchange wholesale business.[30]

The CBIRC or its local counterparts would examine candidates' qualifications with regard to:

a their experience, knowledge and skills;

b their reputation, character, competence, soundness of judgement and diligence;

c whether they have a record of non-compliance with non-statutory codes or have disciplinary records;

28 The Administration of Issuance of Overseas Institutional Bonds in the National Inter-bank Bond Market Interim Measures, effective from 8 September 2018.

29 The NAFMII is a self-regulation organisation under the approval of the State Council of China. Members include policy banks, commercial banks, credit cooperative banks, insurance companies, securities houses, fund management companies, trust and investment companies, finance companies affiliated with corporations, credit rating agencies, accounting firms and companies in non-financial sectors. NAFMII aims to propel the development of the Chinese over-the-counter financial market, which is composed of the inter-bank bond market, inter-bank lending market, foreign exchange market, commercial paper market and gold market.

30 Measures for the Administration of the Office-holding Qualifications of the Directors (Council Members) and Senior Managers of Banking Financial Institutions (CBRC), effective from 18 December 2013.

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d their involvement as a director in any companies wound up by the court; and
e their business record and financial soundness and strength.

In addition, the CBIRC may interview a person to be appointed before making its decision. According to the Corporate Governance Guidance for Commercial Banks,[31] the board of directors is ultimately responsible for the operation and management of a bank, including liquidity risk management.[32] The CBIRC may, if necessary for performing its duties, hold supervisory consultations with the directors and senior executives of a bank, and ask them to explain important matters concerning its business operations and risk management. Directors and senior executives are responsible for the misconduct of banks, and in the event of the misconduct of a bank may receive a lifetime ban on working in the banking sector.

iii Regulatory capital and liquidity

Capital adequacy ratio

In implementing the Basel III capital regulations, the CBIRC has set up a uniform regulation system of the capital adequacy ratio of commercial banks.[33] The requirements also apply to the branches of foreign banks in the PRC.

The minimum requirements for the capital adequacy ratio of a commercial bank include the following: the core Tier 1 capital adequacy ratio shall not be lower than 5 per cent; the Tier 1 capital adequacy ratio shall not be lower than 6 per cent; and the capital adequacy ratio shall not be lower than 8 per cent. Based on the minimum capital requirements, a commercial bank shall accrue reserve capital at 2.5 per cent of its risk-weighted assets fulfilled by the core Tier 1 capital. Under specific circumstances, a commercial bank shall also accrue countercyclical capital based on the minimum capital requirements and the reserve capital requirement. The countercyclical capital shall be zero to 2.5 per cent of its risk-weighted assets, and would be fulfilled by the core Tier 1 capital. A systemically important bank is required to accrue supplementary capital at 1 per cent of its risk-weighted assets fulfilled by the core Tier 1 capital. In addition, the CBIRC is entitled to specify more prudent capital requirements under the second pillar framework to ensure that the capital fully covers the risks.[34]

Unconsolidated and consolidated capital adequacy ratio

The CBIRC imposes capital requirements on commercials banks on both an unconsolidated and a consolidated basis. The calculation on an unconsolidated basis covers all domestic and overseas branches of a PRC-incorporated commercial bank, while the calculation on a consolidated basis covers a commercial bank itself as well as the financial institutions in which it directly or indirectly invests. Commercial banks and investee financial institutions shall jointly constitute a banking group.

31 Article 19 of the Corporate Governance Guidance for Commercial Banks (CBRC), effective from 19 July 2013.

32 Article 8 of the Measures for the Liquidity Risk Management of Commercial Banks (CBIRC), effective from 1 July 2018.

33 Administration Measures for the Capitals of Commercial Banks (for Trial Implementation) (CBRC), effective from 1 January 2013.

34 Article 26 of the Administration Measures for the Capitals of Commercial Banks (for Trial Implementation) (CBRC), effective from 1 January 2013.

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A commercial bank shall report both its unconsolidated and consolidated capital adequacy ratios to the CBIRC. The consolidated capital adequacy ratio must be submitted once every six months, while the unconsolidated capital adequacy ratio shall be submitted on a quarterly basis.[35]

Composition of capitals

The core Tier 1 capital is the sum of paid-up capital or common shares, capital reserve, surplus reserve, general risk reserve, undistributed profits and a portion of the minority shareholders' capital. Additional Tier 1 capital of a commercial bank includes other Tier 1 capital instruments and their premiums as well as a portion of the minority shareholders' capital. The Tier 2 capital of a commercial bank is the sum of Tier 2 capital instruments and their premiums, reserve for loan loss in excess[36] and a portion of the minority shareholders' capital.

The principal deductible items in calculating the capital adequacy ratio include:

a business goodwill;

b other intangible assets;[37]

c net deferred tax assets caused due to operating losses;

d shortfall in the loan loss reserve;

e proceeds from sales of asset securitisations;

f the net amount of pension assets with confirmed beneficiaries;

g shares held directly or indirectly in the commercial bank itself;

h cash flow reserves formed by hedging against items that are not measured at fair value in the balance sheet;[38] and

i unrealised gains and losses caused by changes to the fair value of the liabilities of the commercial bank due to changes in its own credit risks.[39]

Liquidity risk

On 23 May 2018, the CBIRC issued the Measures for the Liquidity Risk Management of Commercial Banks (Liquidity Risk Management Measures) to replace its prior trial version.[40] The Liquidity Risk Management Measures introduce three new indicators for liquidity risk supervision in response to Basel III reforms, namely, the net stable funding ratio (NSFR), the liquidity matching ratio and the adequacy ratio of high-quality liquid assets (HQLA), to join the original two indicators: liquidity coverage ratio (LCR) and liquidity ratio.

According to the Liquidity Risk Management Measures, a commercial bank with an asset size of 200 billion yuan and above shall continuously meet the minimum supervisory standards for LCR (at 100 per cent), NSFR (at 100 per cent), liquidity ratio (at 25 per cent) and liquidity matching ratio (at 100 per cent). A commercial bank with an asset size

35 Article 148 of the Administration Measures for the Capitals of Commercial Banks (for Trial Implementation) (CBRC), effective from 1 January 2013.

36 It will be up to 1.25 per cent of the risk-weighted assets for credit risks if adopting the weighting approach; it will be up to 0.6 per cent if adopting the internal ratings-based approach.

37 The land-use rights are not included.

38 Positive cash flow reserve shall be deducted, while a negative one shall be reversed.

39 Article 32 of the Administration Measures for the Capitals of Commercial Banks (for Trial Implementation) (CBRC), effective from 1 January 2013.

40 Measures for the Liquidity Risk Management of Commercial Banks (CBIRC), effective from 1 July 2018.

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of less than 200 billion yuan shall continuously meet the minimum supervisory standards for adequacy ratio of HQLA (at 100 per cent), liquidity ratio (at 25 per cent) and liquidity matching ratio (at 100 per cent).[41]

iv Recovery and resolution

When a commercial bank has suffered or will possibly suffer a credit crisis, thereby seriously affecting the legitimate rights and interests of the depositors and other clients, the CBIRC may take over the bank or procure its restructuring.[42] The purpose of a takeover is to protect the interests of depositors and to enable the bank to resume normal business through taking such measures as are necessary. The debtor–creditor relationship with regard to the taken-over bank would not change as a result of the takeover.[43] The CBIRC should decide upon and arrange the implementation of such takeover.[44] From the date of the takeover, the administrator executing the takeover shall exercise the powers of operation and management of the taken-over commercial bank.[45] The maximum period of time for a takeover shall be two years.[46] A takeover would terminate when the takeover period expires, or when the bank regains its capacity for normal business or is merged or declared bankrupt prior to the expiration of takeover period.[47]

If a bank violates the law or is not properly operated and managed, thereby seriously threatening the financial order and undermining the public interest unless it is closed, the CBIRC has the power to close and liquidate it. If a commercial bank is unable to pay its debts as they fall due, a PRC court may, after obtaining the consent of the CBIRC, declare it bankrupt and arrange for liquidation with the involvement of the CBIRC. When liquidation is carried out for a bankrupt commercial bank, payment of the principal and interests of the savings deposits of individuals shall be given priority after the liquidation expenses, wages owed to employees and labour insurance premiums have been paid.[48]

To date, two banks (Hainan Development Bank and the credit cooperatives of Shang Village in Hebei Province) have been approved to be declared bankrupt when they were definitively unable to pay their debts. However, in the end the government took over the debts to avoid losses of non-professional depositors.[49] In May 2015, the State Council issued the Deposit Insurance Regulation, which prescribes that deposit insurance is subject to a

41 In avoidance of adverse impact brought about by a sudden shift, the Liquidity Risk Management Measures have set a schedule buffer for the transition. First, the LCR of a commercial bank shall reach 100 per cent by the end of 2018. During the transitional period, it shall not be lower than 90 per cent. Second, a commercial bank shall implement the supervisory requirements for the liquidity matching ratio from 1 January 2020. Before 2020, the liquidity matching ratio is the monitoring indicator. Third, the adequacy ratio of HQLA of a commercial bank shall reach 100 per cent by the end of June 2019. During the transitional period, it shall reach 80 per cent by the end of 2018.

42 Article 38 and Article 64 of the Commercial Banks Law.

43 Article 64 of the Commercial Banks Law.

44 Article 65 of the Commercial Banks Law.

45 Article 66 of the Commercial Banks Law.

46 Article 67 of the Commercial Banks Law.

47 Article 68 of the Commercial Banks Law.

48 Article 71 of the Commercial Banks Law.

49 The debts of the Hainan Development Bank were taken over by the ICBC under the instruction of the PBOC (announcement of the PBOC from 21 June 1998): https://zh.wikipedia.org/wiki/%E6%B5%B7%E5%8D%97%E5%8F%91%E5%B1%95%E9%93%B6%E8%A1%8C accessed on 11 February 2019;

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coverage limit of up to 500,000 yuan.[50] This means there will be no more unlimited guarantee from the government for larger debts. The bankruptcy of banks will be likely implemented following the Western market practice.

IV CONDUCT OF BUSINESS

i Conduct of business rules

One key element of PRC banking regulations is that all banking products or services fall within the regulatory framework. Prudential regulation is not only applied to banking institutions, but also to their banking business products and services. Apart from deposit and loan services, which are generally regulated under the Banking Regulation Law (2006) and the Commercial Banks Law (2015), wealth management, structured deposits and national debts are also ruled by special regulations. The Wealth Management Measures outline a clear structure for a bank to avoid shadow banking and to control a concentration risk of capital.[51] According to the Measures, commercial banks issuing structured deposits must have the required derivative product trading business qualifications, and must comply with the CBIRC's regulation of derivatives.[52]

Overall, the CBIRC takes a broad and rigorous approach to the regulation of banking products and services. As mentioned above, approval of core banking products must be sought from the CBIRC on a case-by-case basis.

ii Potential sources of liability

The potential sources of liability for banks include but are not limited to the Banking Regulation Law (2006) and the Commercial Banks Law (2015). The Criminal Law (2018) and the Measures for Prohibiting illegal Financial activities (1999) regulate the crime of undermining the orderliness of financial management and the crime of financial fraud.[53]

The Anti-Money Laundering Law (2007) and the Provisions on Anti-money Laundering of Financial Institutions (2007) require financial institutions to establish and continually improve a system indentifying clients' identities and information, and a reporting system for large-sum transactions and doubtful transactions. Organs and functionaries of banks are also obliged to submit a report on large-sum transactions or doubtful transactions.[54]

The administrative punishments in the Administrative Punishment Measures of the then-CBRC (2015) will be triggered when there are violations of the banking supervision provisions. Banks may face warnings, fines, the confiscation of illegal gains and other

the debts of the credit cooperatives of Shang Village were paid through the funding of the Union of credit cooperatives of Suning County of Hebei Province: http://www.chinanews.com/cj/2012/08-19/4117014.shtml accessed on 11 February 2019.

50 Article 5 of Deposit Insurance Rule (The State Council), effective from 1 May 2015.

51 Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks (CBIRC), effective from 26 September 2018.

52 Article 75 of the Wealth Management Measures.

53 Part 2 Chapter 3 Sections 4 and 5 of the Criminal Law of PRC; Measures for the Prohibition of illegal Financial institutions and illegal Financial Business activities (The State Council), effective from 13 July 1998.

54 Chapter 1 of Anti-Money Laundering Law (2007).

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punishments when they violate the Foreign Exchange Administrative Regulations on Crimes of Defrauding through, inter alia, illegal arbitrage, evasion, or illegal purchases or sales of foreign exchange.

As the Chinese banking regulator, the CBIRC has tightened its reins, and a regulatory storm has been seen since 2017. In 2017, 3,452 fine tickets were issued, covering 1,877 financial institutions and 1,547 responsible persons and amounting to nearly 3 billion yuan, nearly three times more than financial institutions were fined in 2016.[55]

iii Banking confidentiality

As banks hold large online databases of personal information, data protection has been a major issue in the banking sector. Under the basic principle of customer information confidentiality, commercial banks should keep the secrecy of depositors when handling individual saving deposits. Commercial banks have the right to refuse any individual's or entity's inquiries about private data, and not to freeze, deduct or transfer funds an individual's savings deposits, unless this is otherwise prescribed by law.[56]

All transactions and information recordings of any bank cards shall be checked only with a password, and a card-issuing bank shall explain the importance of password and the responsibility for their loss to the cardholders in the relevant articles of association on bank cards or the directions for use.[57]

According to the Cybersecurity Law (2017), banks should require clients to provide their true identity, and check that information by sending a code via a message before conducting the relevant services. Portable platforms like telephone banking and online banking apps are under even more strict checks regarding fingerprints and facial identifiers.

The Cybersecurity Law also provides that making disaster recovery backups of important systems and databases, establishing emergency response plans for cybersecurity incidents and organising drills on a periodical basis could be helpful to protect confidential information.[58]

V FUNDING

Financial institutions, including banks, may raise funds through equity injections, loans, deposit taking, bond issuance, financial leases and obtaining refinancing from the PBOC.[59] A branch may raise funds through an allocation of operational capital by its parent bank, loans and deposit taking (if allowed under its business scope). The capital instruments issued by a commercial bank shall meet the eligibility criteria specified in Appendix 1 of the Capitals Measures.

Customer deposits are the most important source of funding for retail banks in the PRC. Chinese people's propensity to save has been the main cause for keeping customer deposit rates at a high level. Banks taking deposit are required to set aside a yuan deposit

55 http://finance.sina.com.cn/money/bank/bank_hydt/2018-01-22/doc-ifyqwiqi1836097.shtml accessed on 11 February 2019.

56 Articles 29 and 30 of the Commercial Banks Law.

57 Notice on Issuing the Measures for the Administration of Bank Card Business (PBOC), effective from 1 March 1999.

58 Article 34 of the Cybersecurity Law, effective from 1 June 2017.

59 Financial Rules for Financial Enterprises was promulgated by the Ministry of Finance, effective from 1 January 2007.

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reserve[60] or a foreign currency deposit reserve,[61] or both, and in each case deposit the same with the PBOC. Under the Deposit Insurance Regulation,[62] all deposit-taking financial institutions incorporated in the PRC are required to participate in the deposit insurance scheme. The deposit insurance scheme protects depositors from the loss of their funds, and eliminate the possibility of a run on a bank if rumours spread about that particular bank. However, the Deposit Insurance Regulation excludes its application to branches of foreign banks, and is silent as to whether a branch is able to participate in this deposit insurance system on a voluntary basis. In practice, this is not feasible at the moment.

In terms of loans, a bank may borrow loans through the PRC inter-bank lending market in accordance with the terms of the Administrative Rules on Inter-bank Lending.[63] A bank may also borrow foreign debts (including foreign loans, foreign inter-bank lending, foreign inter-bank deposits, dealings between overseas affiliated banks or affiliates, deposits by non-residents and other forms of foreign debts). Proceeds received under foreign debts cannot be used for the settlement of exchange (i.e., conversion into yuan), to pay debts or interest, or to purchase other foreign exchange.[64] As mentioned above, banks can also raise funds through issuing bonds in the inter-bank bond market under the supervision of the PBOC.[65] In October 2018, the PBOC announced that it will introduce the tripartite repurchase transaction into the inter-bank bond market, which is a common type of bond transaction in developed markets but unknown in the Chinese market.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

In January 2018, the CBIRC issued the Interim Measures for the Equity Management of Commercial Banks, which aims at persons who hold more than 5 per cent of the total capital of a bank, or less than 5 per cent of the total capital but having a significant impact on the business management of a bank. One focal point is the transparency between shareholders and their holding companies or other concerned persons, and another the origins of the purchasing funds. With regard to the procedure, an investor intending to initially or accumulatively hold more than 5 per cent of the shares of a bank shall file an application with the CBIRC in advance, while an investor holding from 1 to 5 per cent shall, within 10 working days of the date of obtaining the corresponding equities, report to the CBIRC. The shareholding ratio of a shareholder and its affiliates and the persons acting in concert will be calculated on a consolidated basis.

The same investor and its affiliates and persons acting in concert shall not purchase shares of more than two commercial banks as a major shareholder or control more than

60 Article 32 of the Commercial Banks Law and Article 39 of Foreign-Funded Banks Regulation.

61 Article 3 of the Regulations on Foreign Currency Reserve of Financial Institution (PBOC), effective from 29 October 2004.

62 Regulations on Deposit Insurance (The State Council), effective from 1 May 2015.

63 Administrative Rules on Inter-bank Lending was promulgated by PBOC from 7 March 2007.

64 Administrative Rules of Foreign Debts Raised by Foreign Invested Bank in the PRC was promulgated by National Development and Reform Committee (NDRC), PBOC and CBRC, effective from 26 June 2004.

65 Measures for the Issue and Trading of Corporate Bonds, effective from 15 January 2015.

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one commercial bank, unless their purchase is authorised by the State Council. A major shareholder of a commercial bank shall not transfer any equity it holds within five years from the date of obtaining the equity. In addition, there are some general principles about preventing conflicts of interest.

A detailed business plan is neither required in connection with an application for regulatory approval of an acquisition of a significant stake in a commercial bank, nor where the proposed acquisition is of a significant stake in a holding company of a commercial bank.

The Interim Measures apply to all the kinds of commercial banks in China, including state-owned, postal savings, joint-stock and city commercial banks, and in principle also to foreign-funded banks. For the last, there are some further special demands on the capital amounts of foreign investors.

ii Transfer of banking business

Commercial banks cannot transfer their deposits without the assent of their clients, for they are the creditors. On the other side, and in line with the general regulations of the Contract Law, a bank as creditor should be able to transfer its loan arrangements to another bank without the agreement of its clients as debtors.[66] However, according to a notice of the CBRC on the transferring of credit assets (December 2010), the consent of clients is essential for this kind of business, unless it is agreed in advance in the loan contracts. If there is a guarantor for the loan, the guarantor must be consulted about the transfer. When the guarantor does not agree to it, the transfer and the debtor (client) need to look for a new guarantor or a new mortgage.[67]

In addition, when the transferee is a non-financial institution, the transferring of loan arrangements also needs the approval of the administrative authorities.[68] All transferring business must be reported to the regulatory authorities within 30 days.[69]

VII THE YEAR IN REVIEW

i Creation of the CBIRC

The CBIRC was founded amid the government's institutional reform from a separate sector regulation approach toward an integrated regulation approach, with an aim to improve the efficiency of financial regulation and stamp out regulatory arbitrage. However, not many changes in regulatory approach have been witnessed since the CBIRC came into operation in April 2018, as the official team in charge of banking regulation remains unchanged. It remains to be seen what real impact will be brought about by the merger of the CBRC and CIRC.

66 Article 80 of the Contract Law.

67 Notice on the transferring of credit assets (CBRC), effective from 3 December 2010.

68 Reply on the problems of transferring of loan arrangements (PBOC), effective from 30 July 2001.

69 Notice on the transferring of credit assets (CBRC), effective from 3 December 2010.

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ii Further opening up to foreign investment in the banking industry

One notable development in the banking industry in 2018 was the further opening up of the banking industry to foreign investment. Several measures have been taken:

a the CBIRC issued the Notice on Foreign-funded Banks[70] in April, which loosens the licensing requirements for foreign-funded banks, including allowing foreign-funded banks to carry out agency issuance, agency redemption and the underwriting of government bonds without obtaining licensing from the CBIRC;

b several restrictions on foreign investment in Chinese-funded banks were lifted in July;[71] and

c the Measures for the Administration of Equity Investment by Overseas Financial Institutions in Chinese-Funded Financial Institutions were repealed by the CBIRC in August, marking a further step in levelling the playground for domestic and foreign competitors.

iii Implementation of the revisions of Basel III 2017 in China

China has not yet taken steps in direct response to the revisions of Basel III 2017 (Revisions), as the newly revised standards will not come into force until 2022. However, some regulations issued by the Chinese regulator in the past few years, such as those regarding the leverage ratios,[72] liquidity risks[73] and large exposure,[74] concentrated on some of the shared focuses under the Revisions.

Commercial banks in China still need to accept the standardised measurement approach under Basel III, which to date is not generally used in practice in China. According to the renewed framework, many banks in China should increase their capital. It can be expected that some more detailed regulations concerning the whole banking regulatory system of China in implementing the Revisions will be released in the near future.

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70 Notice on Further Loosening Market Access Restrictions on Foreign-funded Banks (CBIRC), effective from 27 April 2018.

71 Under the Negative List of the Catalogue of Industries for Guiding Foreign Investment (2017 Revision), a single overseas financial institution and the affiliated parties under its control or joint control are allowed to invest in not more than 20 per cent of the shares of a single Chinese-funded commercial bank as promoters or strategic investors; multiple overseas financial institutions and the affiliated parties under their control or joint control are only allowed to invest in a total of not more than 25 per cent of the shares of a single Chinese-funded commercial bank as promoters or strategic investors; overseas financial institutions investing in rural small and medium-sized financial institutions shall be banking financial institutions; and overseas investors that establish branches of foreign banks, wholly foreign-funded banks or banks in the form of Sino-foreign equity joint ventures, and their sole or controlling shareholders, shall be overseas commercial banks, while their non-controlling shareholders may be overseas financial institutions. These restrictions were all removed from the 2018 version of the Negative List issued by the NDRC and Ministry of Commerce, effective from 28 July 2018.

72 Measures for the Administration of the Leverage Ratio of Commercial Banks (CBRC), effective on 30 January 2015.

73 Measures for the Liquidity Risk Management of Commercial Banks (for Trial Implementation) (CBIRC), effective from 1 July 2018.

74 Measures for the Administration of the Large Exposures of Commercial Banks (CBIRC), effective from 1 July 2018.

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iv Three major tasks of the Financial Stability Committee

On 14 July 2017, President XI outlined three major tasks at a national financial work conference: serving the real economy, forestalling financial risks and deepening financial reforms,[75] which form the guidelines for the central government's banking regulation.

Following this instruction, the State Council established on 8 November 2017 the Financial Stability Committee, which aims to ensure financial stability in China. Its duties include coordinating financial reform; development and regulatory activities; unifying monetary, financial, fiscal and industrial policies; and analysing international and domestic financial situations to prevent international and systematic financial risks.[76]

v New regulations of bad or non-performing loans

According to a notice of the then-CBRC,[77] the loan loss provision coverage ratio has been lowered from 150 per cent, to between 120 and 150 per cent, and the loan loss provision ratio requirement has been lowered from 2.5 per cent, to between 1.5 and 2.5 per cent. Lowering these two ratios could release more net capital of commercial banks, which would encourage banks to speed up their disposal of current non-performing loans while allowing banks to have more funds to support the real economy.

vi New regulations of securities and futures

On 22 October 2018, the CSRC issued new measures regarding securities and futures[78] that establish more comprehensive regulations for the private equity industry, including regarding custodian duties, the risks of administrators, improvements in system costs and the promotion of responsible behaviour. For example, the Securities and Futures Business Institutions Measure has for the first time specifically clarified the obligations of custodian institutions, such as supervising the investment operations of managers, refusing enforcement after finding that managers' investment or liquidation orders violate the law and administrative regulations.[79]

VIII OUTLOOK AND CONCLUSIONS

The outlook for the PRC banking system remains positive, as the industry continues to grow robustly and the country further opens up to the foreign and international market. We anticipate a more level playing field for domestic and foreign banks, and more opportunities for foreign banks to develop in the PRC. We also anticipate that the regulatory style will be loose in general but tight in key areas.

75 http://www.gov.cn/xinwen/2017-07/15/content_5210774.htm accessed on 11 February 2019.

76 China establishes financial stability and development committee: http://english.gov.cn/news/top_news/2017/11/08/content_281475936107760.htm accessed on 11 February 2019.

77 Notice on Adjusting the Supervision Requirements for Commercial Bank Loan Loss Preparation (CBRC), effective from 6 March 2019.

78 Measures for the Administration of the Privately Offered Asset Management Business of Securities and Futures Business Institutions, effective from 28 July 2018.

79 Article 13 of the Securities and Futures Business Institutions Measure.

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Chapter 9

DENMARK

Morten Nybom Bethe[1]

I INTRODUCTION

The Danish banking industry has seen an increasing concentration in the financial market since the late 1980s, even though Denmark is still characterised by its significant number of small and medium-sized banks compared with other European countries. The market share of these small and medium-sized banks is, however, of a size that still indicates a Danish banking sector dominated by a few very large financial conglomerates.

The international financial crisis from 2008 also made its impact on the Danish banking sector, with the consequence that the number of banks has almost halved since 2008. However, the Danish banking sector has now moved on from the financial crisis.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Under Danish law, banks are defined as undertakings that receive deposits or other funds from the public, which are to be repaid, and grant loans at their own expense. The general regulation of banking activities is set out in the Danish Financial Business Act (FBA) and executive orders and guidelines issued pursuant thereto.

Responsibility for the authorisation, regulation[2] and supervision of banks and other financial undertakings, as well as the interpretation of rules set out in the FBA and other rules applicable to banks, has been placed on the Danish Financial Supervisory Authority (FSA), which is a government agency under the Ministry of Industry, Business and Financial Affairs. Other main objectives of the FSA are market supervision; an independent obligation to ensure compliance with regulations on insider trading, price manipulation, conduct of business rules and good marketing practice; and collecting and publishing information about the financial sector. The FSA has announced that its current primary focus is to ensure continued financial stability and confidence in financial undertakings and markets. In recent years, this has meant increased attention to compliance with the fit and proper requirements applicable to the management of banks and, more frequently, visits to banks to ensure compliance with, inter alia, capital requirements. Since the financial crisis of 2008, the FSA has continuously emphasised that it applies a risk-based approach to the supervision of Danish financial institutions.

1 Morten Nybom Bethe is a partner at Gorrissen Federspiel.

2 Almost all guidelines and executive orders issued under the FBA have been issued by the FSA.

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The FSA is supervised by a board of directors appointed by the Ministry of Business and Growth. The board has an active role in deciding the policies and focus of the FSA as well as a general oversight function.

i Banking and credit institution activities

Pursuant to Section 7 of the FBA, banks in Denmark are required to be licensed. This requirement is triggered by deposit-taking activity from the public. Licensed banks are entitled to carry out the banking activities listed in Annexes 1 and 4A to the FBA and activities that are ancillary thereto. The act of commercial lending on a stand-alone basis is not subject to a licensing requirement.

ii Securities activities

Undertakings that offer securities trading services commercially to third parties are required to hold a licence as a securities dealer, as stipulated in Section 9 of the FBA. Licensed activities are listed in Annex 4 of the FBA. As part of its banking licence, a licensed bank can carry out the same activities as a securities dealer without a separate licence as a securities dealer.

iii Regulated activities in Denmark by non-Danish entities

Credit institutions duly licensed in other EEA Member States may, in accordance with the passport notification procedures laid down in the Credit Institutions Directive, passport their licence into Denmark and offer activities included in their home state licence to customers in Denmark on a cross-border basis or through the establishment of a branch in Denmark.

In line with the foregoing, credit institutions and other undertakings that are duly licensed in other EEA Member States may also passport a licence to carry out investment service activities in Denmark and offer such activities to Danish customers on a cross-border basis or through the establishment of a branch in accordance with the passport notification procedure laid down in the Markets in Financial Instruments Directive (MiFID and MiFID II).

Finally, credit institutions and investment firms that have been authorised in a country outside the EEA can obtain a licence from the FSA pursuant to Section 33 of the FBA to carry out investment service activities in Denmark. If investment services are to be provided to retail clients, the institution in question must establish a Danish branch office. The establishment of a branch office is subject to a separate approval regime pursuant to Section 33a of the FBA.

The provisions governing the public offer of securities in Denmark are laid down in Chapter 3 of the Danish Act on Capital Markets and executive orders issued pursuant thereto, implementing the Prospectus Directive.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The FSA's supervision of banks is primarily carried out through inspection visits to a bank, its branches and other undertakings that may hold relevant information on behalf of the bank (such as parties to outsourcing arrangements with the bank). In addition, banks are under a general obligation to provide the FSA with adequate information for effective supervision, and the ability to ask for such information and conduct supervision on that basis is a tool

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frequently used by the FSA. The FSA prepares and publishes a report on its website after an inspection visit. The bank that is the subject of the report is also required to make it publicly available.

The FSA may also obtain information from foreign banks conducting business in Denmark on a cross-border basis to assist financial supervisory authorities in other countries.

The FSA is authorised to impose various sanctions on banks if supervision shows non-compliance with the applicable legislation. Available sanctions include payment of administrative fines; withdrawal of a banking licence; or an order to a bank to dismiss a managing director or to order a member of the board of directors to resign. Breaches of financial regulation are also subject to criminal sanctions. Generally, breaches of the FBA are punishable with fines and, in more serious cases, by imprisonment for up to four months. A new regulation was introduced in late 2016 with the intended purpose of generally increasing the level of fines imposed on Danish financial institutions, as the previous regime was considered too lenient when compared with those under international trends. As this new legislation has not had any significant impact on the level of fines actually imposed for breaches of the FBA, the Danish political environment continues to focus the sanctions (or the lack of the same) being imposed on financial institutions. The highest fines imposed for breaches of financial regulation are still related to anti-money laundering (AML) compliance, not compliance with the FBA.

As a direct consequence of the financial crisis, the powers of the FSA have been extended in an attempt to try to reduce the number of distressed banks in Denmark. The FSA has therefore been granted the authority to assess the business models of financial entities to ensure that such entities will not become distressed. The FSA has also been vested with powers to intervene at an early stage if there is a risk that a financial undertaking will become distressed: for example, in the event of a large increase in a bank's lending activities or where a bank has heavy exposure to the real estate sector. Intervention could be by way of ordering a cut in loans to a specific branch or by way of requiring an increase in own funds.

Finally, the FSA is subject to an obligation to advise the Danish Consumer Ombudsman about cases of breaches of the conduct of business rules, and particularly when customers may have suffered a financial loss. The Consumer Ombudsman has the power to sue banks that have breached the conduct of business rules and may be appointed as group representative in group litigations (class actions). There has so far been only a limited number of examples in practice where this right to pursue class actions has been used by the Consumer Ombudsman.

The financial undertakings subject to supervision pay an annual fee to the FSA, as the costs of the FSA are intended to be covered by the financial undertakings subject to supervision. Danish banks pay the most significant part of these costs.

ii Management of banks

Rules on the management of banks are set out in Chapter 8 of the FBA and an executive order issued pursuant thereto by the FSA.

Danish banks must be established as public limited liability companies, and are managed by one or more managing directors and a board of directors. A person cannot be a managing director and board member at the same time. Larger banks are required to employ an internal auditor to assist the external auditors. Managing directors and board members are required to comply with the FSA's fit-and-proper requirements.

As part of the post-financial crisis regulatory reforms, extended fit and proper requirements have been introduced, including a requirement to use the time needed to fulfil

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the job undertaken. In addition, banks whose shares are traded on a regulated market or that have had an average of 1,000 employees during the past two years are required to establish a nomination committee with the responsibility, inter alia, to evaluate the board on an ongoing basis, suggest new board members, and ensure that the board has adequate diversity in terms of gender, competences and qualifications.

The board of directors must define the major areas of activity of the bank and determine a risk profile for the bank stating, inter alia, possible substantial risks and how to deal with them. Banks that must have a committee as mentioned above should also have a risk committee, whose primary tasks would be to assist the board when determining the risk profile, and to ensure that remuneration policies and the daily business comply with the determined risk profile. Further, the board of directors is required to prepare policies on the most substantial activities of the bank, including policies on credit risk and liquidity. Written guidelines to management are prepared by the board on the basis of these policies. These guidelines determine the situations in which decision-making powers lie with management, when management is required to report to the board and when the prior approval of the board is required before a final decision is made.

Each bank is required to have in place an effective risk-management strategy, including written procedures for all significant areas of activity, and effective procedures to identify, manage, monitor and report the risks to which the bank is or may be exposed. The FBA and the above-mentioned executive order describe in detail the minimum requirements applicable to banks in relation to, inter alia, their organisation, internal controls, accounting practices, board meetings, credit organisation, credit risks, market risks and conduct of business.

The frequency of board meetings is not explicitly determined, but the FBA requires that the board of directors meet when it is considered necessary, and all members are required to be summoned. The external auditor and the chief internal auditor have a right to be present at board meetings when issues relevant to auditing or financial reporting are being addressed.

A bank is subject to an obligation to immediately inform the FSA of matters that are of material significance to the continued operations of the bank. Board members, managing directors and the responsible actuary may all be held individually responsible in the event of non-compliance, and they are required to immediately inform the FSA if they have cause to believe that the bank does not comply with the applicable capital and solvency requirements.

Prior approval of the parent company

Certain decisions may be made subject to the prior approval of the parent company of a bank, but a general delegation of decision-making by the board of directors is not possible. Nor can the board of directors delegate its liability. It is not permissible for employees of a bank's parent company to participate in board meetings on a permanent basis. In addition, Danish bank secrecy rules prevent the disclosure of information about private customers to a parent company.

Restrictions on bonus payments

Another direct consequence of the financial crisis was the implementation of new restrictions on remuneration in financial undertakings. Many of these derive from EU legislation, including the European Capital Requirements Directive, which introduced new rules on remuneration in the financial sector. These have been implemented in the FBA, pursuant to

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which banks are required to have remuneration policies and practices satisfying the effective level of risk management. Remuneration policies are subject to a say on pay principle, meaning that they must be approved by the general meeting.

Variable remuneration in banks, including bonus payments, has been significantly restricted, and the variable part of the remuneration of managing directors and members of the board of directors may not exceed 50 per cent of the fixed basic remuneration, including pension. In addition, management is required to determine a suitable limit on variable remuneration of employees with a significant influence on the risk profile of a bank: the variable remuneration of those employees is set at a maximum of 100 per cent of the fixed remuneration, including pension, with a possible increase to 200 per cent if so decided by the general meeting and if certain additional requirements are complied with. At least half of the variable remuneration is required to be granted in shares, share-linked instruments or other instruments reflecting the creditworthiness of the bank. Stock option programmes may not constitute more than 12.5 per cent of the variable and fixed remuneration paid to the managing directors and the board of directors. At least 40 per cent of a variable remuneration must be paid to employees over a period of at least three years (four years if the recipient is a managing director or a board member). This requirement increases to 60 per cent if the variable remuneration is particularly high. In addition, payment of variable remuneration may only be effected if a bank's financial situation has not significantly worsened since the variable remuneration was granted.

iii Regulatory capital and liquidity

The experiences of the financial crisis have also led to an update of the rules on capital and liquidity requirements.

The final versions of the CRD IV Regulation[3] and the CRD IV Directive,[4] adopted in June 2013, entered into force on 1 January 2014. CRD IV was implemented into Danish law with effect from 1 April 2014. The phasing-in of the capital requirements follow the path as set out in the CRD IV Regulation and CRD IV Directive, the latter by implementation through the FBA.

The Danish implementation of CRD IV has resulted, inter alia, in the previous requirements on base capital applicable to banks being replaced by a separate own funds requirement, which is defined in accordance with the CRD IV Regulation. The requirement now is to calculate an individual solvency need, calculated as the adequate amount of separate own funds as a percentage of the total risk exposure, but never less than the own funds requirements and the initial capital requirement, as set out in the CRD IV Regulation. The FSA may determine that an individual bank should comply with a higher own funds requirement. Further, the new additional capital buffer requirements set out in CRD IV have been implemented into Danish law. Both the capital conservation buffer and countercyclical buffer rate, used to determine the institution-specific countercyclical capital buffer, were gradually phased in, reaching full effect on 1 January 2019.

All in all, the Danish implementation of the CRD IV Directive in general mirrors the Directive, which means that requirements on the appointment of systemically important

3 The Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms.

4 The Directive of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms.

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financial institutions (SIFIs) have also been implemented in line with the Directive. The appointed SIFIs are currently Danske Bank A/S, Nykredit Realkredit A/S, Nordea Kredit Realkreditaktieselskab, Jyske Bank A/S, Sydbank A/S, SparNord Bank A/S and DLR Kredit A/S. The appointed SIFIs will also have to fulfil a systemic risk buffer, which will be between 1 and 3 per cent of the amount of the SIFIs' total risk exposure. The systemic risk buffer will be determined individually for each SIFI.

Consolidated supervision

The FSA exercises consolidated home state supervision in respect of Danske Bank, and established collective supervision of Danske Bank in 2009. Further, the FSA participates in the collective supervision of Nordea, SEB, Svenska Handelsbanken, TrygVesta and NASDAQ OMX.

Liquidity

Danish banks are required to have appropriate liquidity at all times according to Section 152 of the FBA.

With effect from 1 October 2015, new liquidity coverage requirements entered into force via the liquidity coverage requirement (LCR) ratio. The LCR ratio is a requirement that credit institutions should have enough high-quality liquid assets in their liquidity buffer to cover the difference between the expected cash outflows and the expected cash inflows over a 30-day stressed period. Subject to CRD IV Regulation, the LCR ratio has been implemented progressively and was fully phased in on 1 January 2018. Further, the FSA has imposed specific liquidity requirements on each Danish SIFI based on their individual business model.

The FSA has also laid down requirements on, inter alia, the rules of procedure relating to the preparation of stress tests. These requirements apply to, inter alia, Danish banks and branches thereof, and branches of banks incorporated outside the EEA area and the European Union.

iv Recovery and resolution

As previously mentioned, the international financial crises materially affected the Danish banking industry: no less than five bank packages have been introduced by the government with the overall aim of securing the financial stability of the Danish banking sector. Whereas the first bank packages were mainly focused on supporting the liquidity and regulatory capital positions of the banks, the subsequent focus has been on the resolution of failed banks in an orderly manner to ensure financial stability and confidence in the Danish banking industry.

As part of these bank packages, procedures have been introduced to facilitate the controlled winding up of stressed Danish banks to ensure that it is possible to transfer and continue their day-to-day banking operations in the event that emergency procedures are required to be implemented. As part of this procedure, banks are required to maintain policies and procedures to ensure that, in the event of distress, they are able, within no more than 24 hours, to provide the required, among other things overviews of customers and accounts to facilitate an expedient transfer. Danish banks are thus required to maintain detailed recovery and resolution plans to facilitate a transfer.

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The recovery and resolution regime set out in the Bank Recovery and Resolution Directive (BRRD)[5] was implemented into Danish law with effect from 1 June 2015 through the enactment of a new act on the recovery and resolution of Danish banks, mortgage credit institutions and certain investment firms. The appointed Danish resolution authority is Financial Stability, which, as part of the introduction of the new regime, was converted from a private limited liability company to a public authority. At the same time, responsibility for Danish deposits and investor guarantee schemes was transferred to Financial Stability. The Danish implementation of the BRRD, as was the case with CRD IV, in general mirrors the requirements of the Directive.

IV CONDUCT OF BUSINESS

i Conduct of business rules

Pursuant to Section 43 of the FBA, Danish banks and foreign banks offering cross-border services in Denmark are required to comply with applicable good business conduct rules within the relevant field of activity. The Executive Order on Good Business Conduct (Conduct of Business Order), issued pursuant to Section 43 of the FBA, sets out detailed requirements in this respect. The majority of the provisions therein apply only when dealing with private customers.

The Conduct of Business Order contains a general requirement for banks to act fairly and loyally to their customers, and sets out information requirements applicable to the marketing of financial services. Prior to offering any services to private customers, banks are required to assess to what extent specific advice to each client is required, and banks are always required to inform clients of the most important features of a specific product or service. Documentation of all material agreements with clients is a prerequisite, and customer agreements must describe the important rights and obligations of the parties and the financial services covered by the agreement. A bank is required to inform customers of commission received by the bank or individual employees.

The Danish Marketing Act imposes a general standard of good marketing practice, according to which all marketing must be fair and clear, and must not contain any untrue or misleading statements or omissions. Written or oral statements that are deliberately incorrect or negligently made may result in criminal or civil sanctions (or both). Restrictions apply to cold calling by telephone as well as to unsolicited marketing approaches by email, fax and post. Breaches of the Conduct of Business Order and the Marketing Act are punishable with fines.

ii Danish bank secrecy rules

The Danish bank secrecy rules are set out in Sections 117 to 123 of the FBA.

Pursuant to Section 117 of the FBA, employees of a bank may not, without due cause, disclose or use confidential information obtained during the performance of their duties. This duty of confidentiality applies to any person receiving confidential information during the course of his or her business. A bank is allowed to disclose usual information on customer matters to entities that need such information for administrative purposes (e.g., information to a group company assisting with advice on pension schemes), but information on purely

5 Directive 2014/59/EU.

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private matters can generally not be disclosed without the customer's consent. Usual information on customer matters includes names, addresses, social security numbers and email addresses. Administrative purposes do not encompass sales and marketing activities.

It is possible for a bank to disclose information about a customer (excluding information on purely private matters) to its parent company for the purposes of risk management within the group, provided that the parent company is a financial undertaking or a financial holding company. Irrespective of this, information about private customers can only be disclosed for the purpose of risk management if the information relates to exposures that are or may become significant.

A bank is required to prepare publicly available guidelines describing to what extent information may be disclosed by the bank.

V FUNDING

Traditionally, the funding of Danish banks has been based on customer deposits, but from 2004 until the beginning of the financial crisis there was materially stronger growth in lending compared with the growth in deposits from the non-financial sector. The collapse of Roskilde Bank in the summer of 2008 resulted in negative attention from foreign banks and a noticeable decline in lending from foreign banks by the end of 2008. During 2009, the deficit in the balances of Danish banks between deposits and lending was markedly reduced, and in recent years, an increase in deposits from the non-financial sector and from private individuals wishing to consolidate themselves has once again provided the funding of Danish banks, which to a large extent is based on customer deposits. As a consequence of the continued low-interest environment, Danish banks generally do not have funding issues.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Requirements applicable to large shareholdings of Danish banks are set out in Sections 61 to 63 of the FBA and an executive order issued pursuant thereto, both of which implement the Acquisitions Directive into Danish law.

The acquisition of a qualifying interest in a Danish bank is subject to the prior approval of the FSA. A qualifying interest is a direct or indirect ownership of 10 per cent or more of the capital or the voting rights, or ownership of an interest that provides the opportunity to exercise significant influence on the management of the bank. Prior approval is also required in the event that an additional acquisition results in a qualifying interest that equals or exceeds a threshold of 20, 33 or 50 per cent respectively of the share capital or voting rights, or results in the bank becoming a subsidiary undertaking.

The approval procedure under Danish law is similar to that set out in the Acquisitions Directive, except that the FSA is required to provide an answer to an applicant within a total of 80 business days (60 business days plus an additional 10 business days plus another additional 10 business days, the latter two only if additional information is required).

The FSA may withdraw the acquired voting rights if the requirements for prior notification and approval are not complied with by the person or entity acquiring the qualifying interest. Similarly, the FSA may withdraw the acquired voting rights and is authorised to impose administrative sanctions if a qualifying interest has been acquired without approval from the FSA.

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Disposal of interests in a Danish bank that have the result of the owner no longer reaching the above-mentioned thresholds requires advance notification of the FSA.

In addition to the investor notification requirement, banks are subject to a notification requirement when an investor acquires an interest in a bank and, as a result, meets the above-mentioned thresholds. Banks are also required to submit a list to the FSA every February, showing holders of qualified interests and the percentage they hold.

ii Transfers of banking business

A transfer of all or parts of a bank's business requires the prior approval of the FSA. Pursuant to Section 204 of the FBA, a bank may not amalgamate with another financial undertaking or a specific business function of another financial undertaking without prior approval. The transferring bank is the entity required to file the application to the FSA, and the applicant must be notified of the FSA's decision no more than two months after receipt of an application that holds the required information. Whether customer consent is required for a transfer depends on the general principles of Danish law. If a transfer involves only the substitution of the creditor, customer consent is generally not required, but if the transfer involves a substitution of the debtor, customer consent is generally required. Customer consent may also be required prior to a transfer of confidential customer information.

VII THE YEAR IN REVIEW

The past year has yet again been, and the foreseeable future will be, generally characterised by an increasing number of amendments to the financial regulations, mostly based on EU initiatives. The Danish implementation is still in progress, and the new requirements have not finally been settled in the banking sector.

The general view is that financial institutions in Denmark have landed on their feet after some extremely difficult years, and that the additional requirements imposed (and to be imposed) on banks will provide for a stable financial sector that should be better prepared for any new challenges the future might bring. The most significant challenges for Danish banks in recent years, apart from adapting to a new regulatory framework, have been those challenges faced by the Danish agricultural sector. Even though that sector has shown signs of improvement, it will still be exposed to increases in interest rate levels, in particular. This has resulted in significant write-downs, especially for some Danish regional banks, which traditionally have had a significant focus on this sector. We may not have seen the last distressed bank in Denmark, but the additional regulation and increased internal and external supervision should help to locate those in financial difficulties a lot earlier, thereby increasing the chances of finding a solution.

Furthermore, in 2018 the Danish banking sector was dominated by a significant focus on AML compliance, and the words 'money laundering' were voted the words of the year in the Danish press. In particular, Danske Bank A/S has attracted significant attention from both the FSA and the Danish media due to AML compliance issues, in particular in its Estonian branch office. This resulted in the resignation of both its CEO and the chairman of the board of directors, and the next steps of the Danish authorities in the matter are currently pending. In the autumn of 2018, a small Danish bank, Københavns Andelskasse, had its license revoked on the basis of non-compliance with both the several provisions of the FBA and the Danish AML regulations.

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VIII OUTLOOK AND CONCLUSIONS

Following the collapse of several Danish banks, litigation in various forms was initiated against former members of management or the auditors of some of the collapsed banks. Examinations are being carried out by the prosecution service to assess whether there is a basis for initiating criminal proceedings against them.

The main cases have now been decided by the Danish courts in the first instance. In general, it has proven very difficult to impose liability for general mismanagement of a bank. Any liability has thus been based on negligence related to specific credit cases. As a consequence of these decisions, the majority of the cases have been appealed to the Danish Supreme Court. The final result for these court cases will thus not be available until 2020 at the earliest.

As a consequence of the significant focus on compliance issues in respect of Danish AML regulation, it is likewise expected that AML will attract the significant attention of both the Danish regulatory authorities and the government. The ongoing cases with Danish banks for their non-compliance with the AML regulations is also expected to result in some of the largest, if not the largest, fines imposed on Danish financial institutions.

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Chapter 10

EGYPT

Hossam Gramon and Karima Seyam[1]

I INTRODUCTION

The growth and gradual diversification that the Egyptian economy has witnessed throughout the past year has been coupled with and simultaneously sustained and reinforced by a number of developments in the Egyptian banking sector that have, in turn, reflected the country's general economic reform agenda. The expansion of the banking sector has been and remains one of the central pillars on which economic growth in Egypt has been based. Moreover, and as an indicator of an increased sense of confidence in the banking sector in 2018, Moody's Investor Services Limited (Moody's) changed the outlook for Egypt's banking system from stable to positive. This change in outlook came as a response to Egypt's growing economy, strong loan demand and improved operating environment. In 2019, Moody's has maintained its positive outlook on the Egyptian banking system. According to Moody's, banks in Egypt will continue to have good access to stable, deposit-based funding, and hold large volumes of liquid assets, especially in local currency.[2]

The move towards adopting internationally recognised banking standards has been driven largely by the desire to create a more stable and safe banking industry that will in turn serve the greater social goal of achieving financial stability in Egypt. The Central Bank of Egypt (CBE), acting as the sole regulatory body governing the Egyptian banking sector, has continuously reaffirmed its objective of ensuring the safety, soundness and efficiency of the banking system. In line with the move towards adopting international banking standards, the CBE issued a circular dated 24 February 2019 on the regulations governing the implementation of IFRS 9 accounting standards by banks operating in Egypt starting from January 2019. The most recent circular issued by the CBE, dated 7 April 2019, outlines the requirements and procedures for the management as well as calculation, evaluation and mitigation of concentration risks by banks, including branches of foreign banks, operating in Egypt, and which are to be implemented starting from March 2019. The circular represents a step towards augmenting the implementation of the second pillar of Basel II (Supervisory Review). Moreover, the circular outlines the means of calculating the additional capital requirements for banks necessary for facing concentration risks (both for individual as well as sectoral concentration risks). Moreover, a more robust set of laws and regulations, particularly the new banking law, are expected to be introduced throughout 2019 with the aim of further reforming as well as restructuring the Egyptian banking sector.

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2 Moody's Investor Services Limited (Moody's, 2019), https://www.moodys.com/research/Moodys-Buoyant-Egyptian-economy-drives-Moodys-positive-outlook-for-the--PBC_1161341.

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The recent cuts introduced to the CBE's prevailing interest rates represent the most significant change to the banking sector, and are a visible reflection of a move towards a more liberalised banking industry. A press release dated 14 February 2019 and published on the CBE website stipulates that the Monetary Policy Committee (MPC), which is a sub-committee of the CBE, had decided to cut the CBE's overnight deposit rate, overnight lending rate and the rate of the main operation by 100 basis points to 15.75 per cent, 16.75 per cent, and 16.25 per cent, respectively. The discount rate was also cut by 100 basis points to 16.25 per cent. Such cuts were introduced in response to a decline in headline inflation to 15.7 per cent in November 2018 from 17.7 per cent in October 2018 as well as a decline in core inflation to 7.9 per cent in November 2018 from 8.9 per cent in October 2018, recording the lowest rate since February 2016.[3] Moreover, an increased sense of confidence in the Egyptian market's foreign currency liquidity and foreign currency's reserve position has led the CBE to terminate its repatriation mechanism for any new foreign currency portfolio investments wishing to enter the local currency Egyptian T-Bills, T-Bonds market and the stocks listed on the Egyptian Stock Exchange. The repatriation mechanism was previously put in place by the CBE to reassure foreign investors that they would be able to repatriate foreign currencies outside of Egypt at any point in time. The move is largely expected to further improve the position of the Egyptian pound throughout 2019.

With respect to the operations of banks in Egypt, a recent report published by the CBE dated September 2018 stipulated that the top five largest banks in Egypt, other than the CBE, held a total amount of E£3,364,608 million in assets, whereby the total balances held with banks abroad amounted to E£82,148 million. The total deposits made with the five largest banks amounted to E£2,256,349 million. According to the report and the income statements for each of the top five banks, the net profit for all five banks amounted to E£21,315 million, while the accrued net interest amounted to E£37,635 million.[4] However, the report did not disclose the names of the five largest banks operating in Egypt on whose financial and income statements the report was based.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The main legislation governing the banking sector and entities engaged in banking activities in Egypt is the Banking Law[5] and its executive regulations issued by virtue of Presidential Decree No. 101 of 2004. The Banking Law appoints the Central Bank of Egypt (CBE) as an autonomous regulatory body supervising the banking sector and assuming the authorities and powers vested therein by the Banking Law. In addition to the provisions of the Banking Law, the banking sector is governed by the provisions of the banking supervision regulations (Supervision Regulations), as well as the circulars and decisions published by the CBE on a regular basis and which govern the various aspects of the banking industry and the entities operating within the sector.

The CBE's paid capital is 4 billion Egyptian pounds, which can be further increased through direct contributions from the Egyptian Central Treasury by virtue of an agreement

3 The Monetary Policy Committee, The Central Bank of Egypt (CBE, 2019), http://www.cbe.org.eg/en/Pages/HighlightsPages/MPC-Press-Release-14-February-2019.aspx.

4 Central Bank of Egypt, Banking Supervision Sector, Off-Site Supervision, M.I.S Unit, The Central Bank of Egypt (CBE, 2019), http://www.cbe.org.eg/en/BankingSupervision/Pages/Reports.aspx.

5 Law No. 88 of 2003 on the central bank, the banking sector and the monetary system.

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between the Governor of the CBE and the Minister of Finance. The Banking Law stipulates that the funds of the CBE are considered private funds. According to the Banking Law, the main objectives and functions of the CBE are as follows:

a realising price stability and ensuring the soundness of the banking system;
b formulating and implementing monetary, credit and banking policies;
c issuing banknotes and determining their denominations and specifications;
d supervising the banking sector;
e managing the gold and foreign currency reserves of the country;
f regulating the functioning of the foreign exchange market;
g supervising the national payments system; and
h recording and following up on Egypt's external debt (public and private).

In addition to the above-stipulated functions, the CBE is entrusted with the role of financial adviser and agent of the government. Moreover, the CBE shall, in accordance with the provisions of the Banking Law, act as the government's bank, and shall charge for the services it renders to both the government and public legal persons based on a fee list for said banking services as determined by the board of directors of the CBE (Board). Additionally, the CBE shall extend to the government, upon its request, the financing required to cover seasonal deficits in the state's budget, provided that such financing does not exceed 10 per cent of the average revenue of the state's budget for the previous three years.

With respect to the structure of the CBE, the Governor of the CBE and the Governor's two deputies are appointed directly by the President of Egypt for a renewable four-year term. The CBE has three subcommittees, which are the MPC, the Investment and Capital Markets and Banking Reform Committee, and the Audit Committee. Moreover, the Board is the authority responsible for the realisation of the objectives of the CBE, in addition to formulating and implementing monetary, credit and banking policies. The Board comprises nine members, including the Governor of the CBE, the Governor's deputies, a representative of the Ministry of Finance and the Chair of the Egyptian Financial Regulatory Authority. To these ends, the Board is vested with the necessary powers, particularly regarding:

a determining the means and instruments pertaining to the adopted monetary policy, and its implementation procedures, as well as determining credit and discount rates and the fees applicable to banking operations as carried out by the CBE;
b determining the regulatory and supervisory standards to guarantee the sound financial positions of banks and their efficient performance, as well as issuing the necessary decisions for their implementation, and evaluating the efforts exerted in connection with guaranteeing the soundness of bank credit, and ensuring the application of standards of credit quality and financial soundness;
c approving the budget, financial statements and reports to be prepared by the CBE on its financial position and the outcomes of its activities;
d approving the organisational structure of the CBE. Such structure may encompass units of a special nature, enjoying technical, financial and administrative independence; and
e issuing the internal by-laws and procedures pertaining to the financial, administrative and technical affairs of the CBE, the regulations governing auctions and tenders, and the regulations pertaining to the CBE's personnel.[6]

6 Article 14 of the Banking Law.

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With respect to undertaking banking activities in Egypt, Article 31 of the Banking Law defines banking activities as 'any activity comprising, basically and habitually, the acceptance of deposits, the obtainment of finance, and the investment of these funds in providing finance and credit facilities and contributing to the capital of companies, and all that is considered by banking tradition as a banking activity.'[7] A general prohibition is placed on engaging in any banking activities inside Egypt without obtaining the necessary licence from the CBE in accordance with the provisions of the Banking Law. Accordingly, banks and entities engaged in the provision of banking services and operating in Egypt are required to abide by the provisions of the Banking Law, the Supervision Regulations and circulars and decisions issued by the CBE, and are required to obtain the necessary licences from the CBE prior to engaging in any banking activities in Egypt.

Article 32 of the Banking Law outlines the requirements to be met by entities wishing to undertake any banking activities in Egypt as follows.

A bank shall adopt any of the following legal structures:

a Egyptian joint-stock companies, all shares of which are nominal shares;

b public legal persons, encompassing within their purposes the exercise of banking activities; or

c branches of foreign banks, the head office of which enjoys a defined nationality and is subject to supervision by a monetary authority in the country where its head office is situated.

In addition to the above outlined structures, a foreign bank can set up a representative office in Egypt. However, the activities that can be undertaken by representative offices in Egypt are limited to market studies and the study of potential investment opportunities in Egypt. Representative offices are not authorised to engage in the provision of any banking or commercial services in Egypt.

Banks' issued and fully paid-up capital shall not be less than 500 million Egyptian pounds, and the capital appropriated for the activities of the branches of foreign banks in Egypt shall not be less than US$50 million or its equivalent in free currencies. However, significant changes in the minimum capital requirements are expected to be introduced by the new banking law, which is expected to be issued throughout 2019.

The Governor of the CBE, following the Board's approval, shall approve the statute of a bank, and the management contracts to be concluded with any party entrusted with its management. Such approvals shall also be required in the event of any renewal or modification to the statutes or management contracts.

Furthermore, the executive regulations of the Banking Law as well as the Supervision Regulations outline in more detail the exact procedures and the necessary documents required for the setting up of banks, branches, subsidiaries or representative offices in Egypt. The branches and agencies of licensed banks shall be registered with the CBE in the register maintained for that purpose. The current market practice reflects a toleration on the part of the CBE with respect to lending into Egypt from offshore to the extent that such lending is undertaken on a non-recurring basis or on a low-profile basis to targeted entities, and without any visible marketing or solicitation. Such toleration on the part of the CBE remains largely subject to the CBE's discretion, and may therefore vary depending on the prevailing social, economic and political conditions.

7 Ibid., Article 31.

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III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

As further detailed under Section II, one of the main functions of the CBE is determining the regulatory and supervisory standards necessary to guarantee the sound financial positions of banks operating in Egypt as well as their efficient performance. The CBE is also vested with substantial powers pertaining to the evaluation of efforts exerted in connection with guaranteeing the soundness of bank credit and ensuring the application of standards of credit quality and financial soundness.

The provisions of the Banking Law grant the CBE various roles that enable it to directly supervise as well as monitor the various aspects of the banking sector, particularly with respect to the supervision of the management and boards of directors of banks. To this end, banks operating in Egypt are required to disclose to the CBE any changes introduced into their founding documents or their statutes, and changes to any of the information provided by banks in their registration forms as received by the CBE. Such changes to any of the above-mentioned documents shall not take effect until they are approved by the CBE. Moreover, banks operating in Egypt are required to disclose to the CBE on a regular basis, as detailed further under Section VI (Control of Banks and Transfers of Banking Business), the names of the shareholders who own more than one percent (1 per cent) of the bank's capital. With respect to a bank's day-to-day operations, banks are obligated to present to the CBE monthly data reflecting the bank's financial position as well the required financial and audit-related data. The CBE retains the right, as provided for under the Banking Law, to examine the books and registers of banks operating in Egypt whereby it ensures the obtainment of the data and clarifications it deems necessary for realising its purposes.

For the purpose of ensuring the continuous provision of banking services to customers in Egypt, the prior approval of the Board must be obtained by any bank operating in Egypt and wishing to cease its operations and activities. Moreover, any bank may merge into another bank only after having obtained the required licence for such merger from the Board and after having met the requirements for such as issued by the Board.

To this end, and for the purpose of ensuring the efficient operations of the various types of banks in Egypt, Article 56 of the Banking Law stipulates that the Board shall determine:

> *(1) the minimum capital adequacy requirements; (2) the maximum limits of concentration of a bank's investments abroad; (3) the maximum limits of the debt due abroad and the limits on guarantees provided against any finance payable abroad; (4) the maximum limits of the lending value of the collateral/guarantees provided against finance and credit facilities, and the determination of maturities; (5) a determination of the liquidity and reserve ratios; (6) the maximum limits of a bank's investments in securities, in real estate finance, and in credit extended for consumption purposes; (7) the regulations governing the opening accounts, and conducting banking transactions; (8) the standards followed in determining the value of each type of the bank's assets; (9) the rules governing disclosure, and the data to be disseminated, as well as the means of dissemination; (10) the rules concerning the maximum limit of the bonds each bank may issue or guarantee, and the conditions governing the issuance of bonds and guarantees; and (11) the maximum limits of exposure to one customer and his connected parties.*

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Additionally, the Board shall determine the standards to be upheld by banks in classifying the finance and credit facilities extended to customers. The Board shall also determine the liquidity ratios to be upheld by banks operating in Egypt, in addition to determining the fields in which banks can invest and those fields in which banks are prohibited from investing in.

The aim of the CBE's supervisory process is to sustain an attentive approach and develop an early warning system. This allows the CBE to take proactive approaches to ensure the safety and soundness of the banking system, that banks comply with the Banking Law and Supervision Regulations, and that banks develop risk management systems and enhance their internal control practices. To this end, the banking supervision sector of the CBE is composed of a number of units that are collectively responsible for implementing the CBE's supervisory objectives and principals to ensure the stability, integrity, soundness and efficiency of the banking system. The banking supervision sector is comprised of the following units:

a on-site supervision unit;
b off-site supervision unit;
c licensing supervision unit;
d macroprudential unit;
e regulations unit;
f central credit registry and legal cases unit; and
g Basel II implementation unit.

ii Management of banks

With respect to the corporate governance requirements formulated by the CBE, the Banking Law stipulates that 'the Governor of the CBE shall be consulted on the appointment of the chairman and members of the bank's boards of directors, as well as the executive directors in charge of credit, investment, portfolio management, and external transactions including swaps; and internal inspection.' Moreover, the Governor of the CBE may request the removal of one or more of the persons nominated by the bank in question to fill any of the aforementioned positions. Such a request for removal shall be issued by the Governor of the CBE in the event that the investigation undertaken by the CBE reveals that such banks are in violation of the rules pertaining to depositors' safety and those pertaining to the bank's assets.

The Supervision Regulations have two chapters dedicated to an extensive overview of the internal audit requirements in addition to the governance standards and regulations to be upheld by banks operating in Egypt.

The CBE published a number of circulars outlining the corporate governance as well as internal audit requirements to be adhered to by banks operating in Egypt. The most extensive of these was the circular published by the CBE and dated 23 August 2011, which was further amended by a number of more recently issued circulars. The aforementioned circular issued in 2011 provides a comprehensive set of requirements, procedures and standards pertaining to, among other things:

a banks' board of directors, their composition and their obligations, as well as the evaluation of boards' efficiency;
b the relationship between a bank's board of directors and the bank's upper management, including a clear division with respect to the powers and obligations of each;
c transparency and disclosures; and
d the relationship between a bank's board of directors and the bank's shareholders.

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Moreover, the aforementioned circular requires that banks operating in Egypt disclose to the CBE the net amount (based on a monthly average) received by the 20 most highly paid (including both wages and bonus payments) employees in the bank.

For the purpose of ensuring the efficient operation of a bank's management, the CBE issued a circular in September 2018 increasing the frequency of a bank's board meetings to 12 per year and permitting board members to attend up to four board meetings per year by way of video conference or teleconference. In January 2019, the CBE issued a circular amending the frequency of board meetings to eight times per year, with board members permitted to attend up to two board meetings per year by video conference or teleconference.

iii Regulatory capital and liquidity

With respect to the capital adequacy requirements (CAR), which is the ratio of banks' minimum capital requirements in relation to their risk-weighted assets to be maintained by banks operating in Egypt, the CBE dedicated a chapter in the Supervision Regulations to outlining the minimum CAR to be maintained by local banks as well as those requirements to be maintained by branches of foreign banks. The circular stipulates that Egyptian banks are required to maintain a minimum CAR of 10 per cent.

To further ensure that banks operating in Egypt hold adequate capital to cover any losses as well as support the relevant risks, particularly in times of financial and economic crisis, the CBE issued a circular on 17 April 2016 outlining the capital conservation buffer (CCB) ratio to be applied by banks operating in Egypt starting from 2016. The aforementioned circular introduced a new CCB of 0.625 per cent, raising the minimum Tier 1 ratio to 6.625 per cent (from the previous 6 per cent) and the total CAR and CCB to 10.625 per cent (from the previous 10 per cent). Moreover, the circular stipulated that the CCB would be raised gradually every year to reach 2.5 per cent by January 2019, thus raising the minimum total CAR and CCB to 12.5 per cent, and the minimum Tier 1 to 8.5 per cent.

Moreover, a circular issued by the CBE dated 2 July 2016 outlined the Basel III requirements pertaining to the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) to be upheld by banks operating in Egypt, starting from July 2016. The circular stipulated that the minimum LCR to be maintained by banks for both local and foreign currency is 70 per cent in 2016, and shall be increased to 100 per cent in 2019.

To this end, the implementation of the LCR and the NSFR has been finalised in Egypt.

iv Recovery and resolution

For the purpose of ensuring the continuous and efficient operation of banks as well as safeguarding the rights of banks' depositors, the Banking Law requires that banks maintain with the CBE a credit balance as reserve, whereby such balance represents a ratio of the total reserves held a bank as determined by the Board. Additionally, the Banking Law stipulates that a bank operating in Egypt are required to have funds inside Egypt equivalent to their total payable obligations in addition to an amount of no less than the bank's minimum issued and paid capital requirements stipulated under the Banking Law. The aim of the requirements are to ensure that banks, at all points in time, are able to meet their obligations as they become due and payable, thus limiting the possibility of failure. Moreover, the Banking Law further stipulates that in the event that a bank operating in Egypt is believed to be facing financial difficulties that may affect the bank's financial position, the Board shall intervene and require that the bank's board of directors make available the necessary financial resources in the form of an increase in paid capital or through the injection of support funds. Moreover, the Board

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shall determine the procedures for such increase in paid capital or injection of funds as well as determine the time limit for undertaking such procedures. In the event that such procedures are not undertaken by the bank within the specified period of time, the Board shall determine the increase in capital that it deems necessary and offer it for subscription; issue a decision for the merger of the bank into another bank after having obtained the approval of the bank with which it will be merging; or delist the bank facing financial difficulties in accordance with the regulations governing said delisting.

To this end, Article 79 of the Banking Law stipulates that:

> *a bank shall be considered exposed to financial difficulties upon occurrence of any of the following events: (1) the insufficiency of the bank's assets to cover its liabilities in a way prejudicing the funds of depositors; (2) a tangible drop in the bank's assets or revenues, due to a violation of the laws, or as a result of engaging in any risky practices not in accordance with the bases of banking business; (3) the pursuance of improper methods in managing the banks" activity, which result in a tangible reduction of the shareholders equities, or affect the rights of depositors and other creditors; (4) the existence of strong evidences establishing that the bank will not be able to meet the depositors' demands or fulfil its obligation in normal conditions; or (5) a decline in the value of the equities of the shareholders at the bank below the provisions required to be formed.*

Banks operating in Egypt shall, according to the provisions of the Banking Law, be delisted by virtue of a decision issued by the Board in the event that:

a it is established that a bank is in violation of the provisions of the Banking Law or its implementing regulations, and has not removed the violation during the period and under the conditions set by the Board;

b a bank adopts policies that would harm the general economic interest, or the interests of depositors or shareholders;

c a bank ceases its operations;

d a bank becomes bankrupt or undergoes liquidation; or

e a bank's licence is found to have been based on erroneous data submitted to the CBE.

IV CONDUCT OF BUSINESS

As further detailed under Section II, there are a number of requirements to be met by banks wishing to engage in the provision of banking services to customers in Egypt. However, and despite the existence of such requirements and procedures, the CBE has not issued a new banking licence to any entity for the past 20 years, and has therefore restricted engagement in banking activities to banks already licensed and operating in Egypt. It is expected that with the expected introduction of the new banking law in 2019, the CBE will likely begin issuing new banking licences particularly to foreign banks wishing to provide banking services to customers in Egypt. With the increased sense of confidence in the Egyptian economy coupled with stronger loan demand, it is expected that a number of renowned international banks will begin to look towards setting up branches in Egypt.

A chapter in the Banking Law is dedicated to the obligations placed on banks operating in Egypt with respect to maintaining the confidentiality of accounts.

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V FUNDING

The activities that can be undertaken by banks operating in Egypt and through which banks usually fund their activities are outlined in the provisions of the Commercial Code issued by virtue of Law No.17 of 1999. Banking activities, as stipulated under the Commercial Code, are:

a monetary deposit-taking;
b debentures deposit-taking;
c leasing of safes;
d pledging of securities;
e bank transfers;
f issuing letters of credit;
g discounting;
h issuing letters of guarantee; and
i opening of current accounts.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Several regulatory requirements and procedures govern persons controlling or having significant stakes in banks operating in Egypt. The Banking Law stipulates that Egyptians as well as foreigners shall have the right to own stakes in banks operating in Egypt whereby there is no maximum limit on the ownership of such stakes. Such requirements are put in place with the aim of maintaining efficient and undisrupted banking operations. On the one hand, the Supervision Regulations issued by the CBE require that banks disclose to the Audit Committee, a subcommittee of the CBE, on a monthly basis the names of all shareholders who own more than 1 per cent of the banks' capital. Shareholders who own less than 1 per cent of a bank's capital are to be grouped together under the title 'miscellaneous'. While on the other hand, the prior approval of the Board is to be obtained by persons, whether legal or natural, wishing to own more than 10 per cent of a bank's issued capital or any per cent that would lead to achieving actual control over the bank in question. The person wishing to acquire the shares is required to obtain the approval of the Board at least 60 days before the date of acquisition of the shares. The application to be presented by a person wishing to acquire 10 per cent or more of a bank's issued capital shall be accompanied by a detailed report outlining the reasons for the acquisition, the goals and objectives of the acquisition, the person's plan with respect to the management of the bank and the policy to be adopted for the management of the bank's affairs.

In reviewing applications presented by persons for the acquisition of 10 per cent or more of a bank's capital, the CBE is required, as per the provisions of Article 12 of the Banking Law's executive regulations, to ensure the following prior to approving the acquisition:

a the non-existence of any conflict of interests between the applicant and the bank;
b the degree of the influence and actual control provided for by such ownership over the bank with respect to the appointment of members of the board of directors, or over the decisions issued by the board or the general assembly;
c the extent of participations by the applicant and the connected parties in the bank to which the applicant applies for ownership of its shares, as well as its participation in other banks and financial institutions in Egypt;

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d the applicant's ability and readiness to provide the bank with the necessary financial or technical support, or both, in the event that he or she owns more than 10 per cent of the issued capital, or any percentage leading to actual control over the bank, according to what is determined by the board of directors of the CBE;

e such ownership shall not decrease competitiveness or lead to disturbances in the banking market;

f there is no final court ruling passed against the applicant for an offence involving honour or trust, or any of the crimes prescribed under the Banking Law or the anti-money laundering law; and

g the existence of legal capacity, efficiency and practical experience.[8]

The Banking Law further stipulates that the calculation of shares owned by the natural persons in question shall include those shares held by their relatives to the fourth degree. With respect to the calculation of shares owned by legal persons, such calculation shall include shares held by any member of its board of directors as well as those held by any of its shareholders.

ii Transfers of banking business

No regulatory restrictions are placed on banks wishing to transfer all or part of their business (comprising debts, and possibly loan arrangements and other assets) to another entity without the consent of the customers concerned. However, the approval of the regulator is usually sought, and is highly recommended for good relations. The existing market practice in the Egyptian banking sector is that banks incorporate an article in all agreements executed with customers by virtue of which banks are granted the unilateral right to transfer their rights and obligations under the executed agreements to another entity without the need to obtain the prior approval of the concerned customers.

VII THE YEAR IN REVIEW

The banking sector in Egypt has witnessed a number of important developments in banking and banking regulation throughout the past year. Such changes and restructuring processes have largely been introduced by circulars and decisions published by the CBE that govern the various aspects of the Egyptian banking industry. The introduced changes have been particularly geared towards achieving internationally recognised standards with respect to governance and internal audits. The most recent example of such changes is the introduction by the CBE of new regulations requiring banks operating in Egypt to undertake quality assurance tests with respect to internal auditing procedures at least once every five years.

Since the liberation of the exchange rate in 2016, the CBE has maintained a policy of non-intervention in the foreign exchange market. However, one of the most significant changes to the banking regulatory regime in Egypt was the very recent termination of the CBE's repatriation mechanism, meaning that the CBE will no longer be responsible for the repatriation of any foreign currency outside of Egypt for any fresh foreign currency portfolio investments wishing to enter the local currency Egyptian T-Bills, T-Bonds market and the

8 Article 12 of the Banking Law.

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stocks listed on the Egyptian Stock Exchange. The termination of the CBE's repatriation mechanism reflects an increased sense of confidence in the market's liquidity as well as the position of the foreign currency reserves.

The past year witnessed a significant move towards achieving higher levels of financial inclusion, whereby an initiative to create a joint database for all banks operating in Egypt was introduced by virtue of a circular published by the CBE and dated 2 September 2018. The most recent development in banking regulations pertaining to governance and management of banks was introduced in 2019 by virtue of a CBE circular requiring that the board of directors of any bank operating in Egypt hold regular meetings at least eight times per year to ensure sound and effective governance procedures in banks. This year, we expect to witness a number of new initiatives, requirements and procedures applicable to the boards of directors of banks operating in Egypt.

VIII OUTLOOK AND CONCLUSIONS

The banking sector in Egypt is expected to witness very profound reform and restructuring processes throughout 2019, particularly with respect to the creation of a more diversified, resilient and efficient banking industry geared towards achieving financial stability in Egypt. One of the most highly anticipated pieces of legislation in Egypt this year is the new banking law, which is expected to be approved by Parliament throughout the second quarter of 2019. The new banking law will revoke Law No. 88 of 2003, and is expected to restructure the current banking regime as well as introduce a number of new requirements to which licensed banks operating in Egypt will be required to adhere. The new banking law is expected to confer onto the CBE a much broader supervisory role over the banking sector in Egypt and over entities engaged in the provision of banking services in Egypt. The new banking law is expected to raise the minimum capital requirements for banks operating in Egypt.

Moreover, and with the upcoming introduction of the new banking law, it is expected that the CBE will change its longstanding negative stance on the issuance of new banking licences to entities, particularly branches of foreign banks wishing to engage in banking activities in Egypt, thus allowing for a more diversified banking sector. The potential move towards the issuance of new banking licences represents a clear move towards increased levels of confidence in the Egyptian banking industry. However, the exact role to be conferred by the new banking law onto the CBE remains largely unknown.

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Chapter 11

EUROPEAN UNION

Jan Putnis, Emily Bradley and Tamara Raoufi[1]

I INTRODUCTION

This chapter provides an introduction to the most important EU legislation affecting the regulation of banks. It also analyses developments that have led to the concentration of certain regulatory powers in a series of EU supervisory authorities.

The development of this legislation since 2011 took place against the background of the eurozone crisis, which highlighted concerns about the prudential position of eurozone banks and related threats to financial stability in the eurozone and beyond.

The legislative response to the eurozone crisis can be characterised as consisting of two different approaches. First, an urgent and necessary fire-fighting operation was carried out to shore up embattled eurozone economies and banks. Second, a more fundamental restructuring of the foundations of financial supervision as a whole was considered necessary to prevent a recurrence of the crisis, with more European integration in many areas being seen as the long-term solution to problems arising from European monetary union. This second, more fundamental development is another step towards the fulfilment of the ever closer union envisaged by EU Member States in the preamble to the Treaty on the Functioning of the European Union.

In Section IX, we have summarised the developments in relation to the second of these approaches, in particular the implementation of a Single Supervisory Mechanism (SSM) for banking institutions in the eurozone, and common bank recovery and resolution arrangements.

It is important to note that much of the EU legislative activity in the area of banking regulation has traditionally been in the form of directives, which do not normally have legal effect in EU Member States until implemented by provisions of national laws. There have been some EU measures affecting the regulation of banks, however, which have taken the form of EU regulations that apply directly in all Member States. Following recent changes to the European supervisory architecture and the commitment of the European Commission (Commission) to introduce an EU-wide single rule book for financial services (both discussed in this chapter), the introduction of new EU rules relevant to banks is increasingly taking the form of directly applicable EU regulations.

Finally, it would be remiss to introduce this chapter without mention of the United Kingdom's decision to leave the European Union in the referendum of 23 June 2016. While this is addressed more fully in the United Kingdom chapter of this book, its particular impact on EU regulatory law must be noted. Without the UK – a historically influential voice in the

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financial services arena – sitting at the table, the course of EU banking regulation may flow in a different direction. As yet this direction is still far from clear. It can be said with some degree of certainty, however, that the loss of the UK from the conversation will have a significant effect on the shape of future EU banking legislation. Note: further colour should be added to this introductory section when the outcome of the Brexit negotiations is clearer.

II EUROPEAN REGULATORY AND SUPERVISORY FRAMEWORK

i Key EU institutions

The Commission represents the interests of the European Union as a whole and has the sole right to propose new legislation. The Council of the European Union (Council) represents the interests of the individual Member States. The European Parliament (Parliament) represents the interests of EU citizens, and is directly elected by them.

ii Legislative procedure

The Commission, after consultation with interested stakeholders, will put forward a legislative proposal for joint adoption by the Council and the Parliament, which then usually goes through the ordinary legislative procedure (previously known as the co-decision procedure). In addition to its role in adopting legislation proposed by the Commission, the Parliament has limited power to request the Commission to submit appropriate proposals on matters on which it considers an EU legislative measure would be appropriate.

iii Lamfalussy approach to adoption of European financial services legislation

The Lamfalussy approach is a four-level procedure adopted by the EU for the development and application of financial services legislation that involves the following:

a a legislative act (Level 1): the framework legislation is proposed and adopted under the ordinary legislative procedure. Individual articles in that legislation specify where power is delegated to the Commission to adopt Level 2 measures;

b implementing measures drafted and adopted by the Commission, following advice from the specialist committees (Level 2);

c consultation and guidance by the European supervisory authorities (ESAs) (Level 3); and

d supervision and enforcement, principally by the regulators in each Member State (Level 4).

iv Reform of the EU supervisory framework

Until 2011, three Level 3 Committees existed: the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR). These brought together regulators from each Member State to agree on the details of implementing measures and to help to coordinate the supervision of cross-border institutions. The failings in prudential regulation that were highlighted by the financial crisis led to criticism that these advisory committees did not have sufficient powers or influence to address the complex challenges of cross-border regulation.

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Following recommendations contained in the 2009 de Larosière Report,[2] the Commission proposed establishing a new European Systemic Risk Board (ESRB) to be responsible for macroprudential oversight and a European System of Financial Supervision (ESFS) to replace the Level 3 Committees, comprising three new pan-ESAs: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

The ESAs were established to oversee the European financial system at a microprudential level and to achieve convergence between Member States on technical rules and coordination between national supervisors. The ESAs' powers go beyond those of the Level 3 Committees, and their role is no longer merely advisory. Indeed, the operations of the ESAs were subject to public consultation by the Commission in spring 2017 with a view to clarifying their role and to building a clearer overview of areas where their effectiveness and efficiency might be strengthened and improved. This resulted in the Commission publishing legislative proposals for reforming the ESAs, which await agreement from the Parliament and the Council. These supervisory structures, and the recent reforms, are discussed in further detail in Section XVII.

The Commission has committed itself to replacing separately implemented rules within Member States with a single set of harmonised prudential rules within the European Union, termed the single rule book. The ESAs advance this project by developing draft technical standards, which will then be adopted by the Commission as EU law, and by issuing guidance and recommendations with which national supervisors and firms must make every effort to comply. In addition, the Commission's legislative proposals are increasingly taking the form of directly applicable EU regulations, or otherwise employ the maximum harmonisation principle. This principle requires that national legislative implementation should not exceed the terms of the original EU legislation, and therefore prohibits the gold-plating of EU legislation by individual Member States. The Commission's intention is that national options and discretions should be reduced, and that Member States should be permitted to apply stricter requirements only where these are justified by national circumstances, financial stability or a bank's specific risk profile.

The following is a brief description of some of the most important EU legislation affecting the regulation of banks, and several recent legislative initiatives that will affect banking activities in the European Union.

III CAPITAL REQUIREMENTS DIRECTIVE

Between 2006 and 1 January 2014, the principal EU legislation regarding the prudential regulation of banks was the Capital Requirements Directive (CRD I), which comprised two directives, commonly referred to as the Banking Consolidation Directive and the Capital Adequacy Directive. This legislation, which implemented many of the Basel II reforms, was amended in 2009 and 2011 by two further directives, CRD II and CRD III. CRD I was wider in scope than Basel II, as it applied not only to internationally active banks, but also to smaller banks, mutuals and investment firms. Changes to the prudential regime for banks were required as part of the Basel III international programme (discussed in the International

2 Report following the High Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, Brussels, 25 February 2009.

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Initiatives chapter). A new package of legislation, in the form of the CRD IV Directive[3] and the Capital Requirements Regulation (CRR),[4] has now replaced CRD I, and has consolidated the changes introduced by CRD II and CRD III.

The CRD IV package continues to set out prudential rules for banks on a solo and on a consolidated basis, including solo and consolidated capital requirements. Consolidated supervision is, broadly, carried out in respect of groups or subgroups headed by parent undertakings incorporated in the EEA.[5] In addition, banks are required to include participations[6] within the scope of consolidated supervision.

The CRD IV package continues to enshrine passport rights for credit institutions, including banks, which broadly allow a bank authorised in one Member State of the EEA to provide a range of services for which it is so authorised in other Member States, or to establish a branch in other Member States, without having to obtain additional authorisation from the regulators in those Member States. The most important features of the CRD IV package are summarised below.

The Basel III-related reforms include the introduction of:

a new liquidity standards (a 30-day liquidity coverage ratio to promote short-term resilience to the risk that liquidity will cease to be available to a bank, and a net stable funding requirement to promote resilience to liquidity risks over longer periods) and a set of common monitoring metrics and application standards;

b measures to strengthen capital through the redefinition of capital into Common Equity Tier 1, Additional Tier 1 and Tier 2 (eliminating distinctions between different types of Tier 2 capital and abolishing Innovative Tier 1 capital and Tier 3 capital completely). The minimum ratios for Common Equity Tier 1 and total Tier 1 capital are set at 4.5 and 6 per cent, respectively (although the minimum capital ratio, ignoring capital buffers, remains at 8 per cent);

c new capital conservation and countercyclical capital buffers, which apply on top of the increased capital ratios and are intended to address the pro-cyclicality inherent in risk-based capital standards. The capital conservation buffer is set at 2.5 per cent of risk-weighted assets and must consist of common equity, with the bank's ability to make distributions limited if its capital ratio falls into the buffer. The countercyclical capital buffer is intended to supplement the capital conservation buffer, and is set by national regulators and used as a tool to require banks to build up capital during periods of excessive credit growth. This buffer also comprises common equity;

3 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

4 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

5 The legislation provides that a lead regulator, agreed or determined from among the national regulators of members of the group in the EEA, carries out certain coordinating activities. In addition, the scope of consolidated supervision may, in principle, extend worldwide in certain circumstances, but in practice it is usually confined to an EEA-incorporated parent undertaking and its subsidiary undertakings and participations.

6 A participation includes, broadly, a direct or indirect holding of 20 per cent or more of the voting rights or share capital in another undertaking. Participations are consolidated on a proportionate basis.

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d a leverage ratio acting as a cap on the ratio of banks' Tier 1 capital to total non-weighted assets and off-balance sheet exposures, intended to form a backstop to risk-based capital measures; and

e new rules on counterparty credit risk (increasing requirements in respect of exposures arising from derivatives, repurchase transactions (repos) and securities financing activities).

Measures in the CRD IV package not flowing directly from Basel III include:

a strengthened corporate governance arrangements and processes, including risk-management arrangements;

b strengthened sanctioning powers where banks breach CRD IV requirements, including the establishment of minimum administrative sanctions to be applied by national regulators;

c limited measures to reduce banks' reliance on external credit ratings, including requirements for banks to develop internal models to assess risk in portfolios and counterparty exposure;

d a bonus cap: the variable remuneration of certain individuals at banks is limited to 100 per cent of their fixed remuneration. This can be increased, subject to shareholder approval under certain circumstances, to 200 per cent of their fixed remuneration. This cap applies broadly to categories of staff such as senior management, risk-takers, staff engaged in control functions, and employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk-takers, whose professional activities have a material impact on a bank's risk profile; and

e further developments to the requirements in CRD III on remuneration to require the disclosure of the number of individuals within a bank receiving total remuneration of €1 million or more in each financial year (broken down into pay bands of €500,000).

CRD IV is intended to be a key instrument through which the Commission advances the development of a single rule book for financial services. The CRR is, by its nature, a maximum harmonisation measure that includes the majority of CRD IV's prudential requirements. As an EU regulation, the CRR is directly applicable in all Member States, and divergences between national rules will thereby be minimised. On the other hand, provisions addressing, for example, the authorisation of credit institutions, cross-border passporting and the mechanics of prudential supervision (i.e., areas where there is more room for Member State discretion as well as a need to be more responsive to differences in national law) are contained in the CRD IV Directive. As an EU directive, Member States have had some discretion as to how they choose to transpose the CRD IV Directive into their national laws. An important illustration of this is that, while Member States have not generally been able to impose minimum capital requirements in excess of the CRD IV levels (these are provided for in the CRR), Member States do have a degree of flexibility in relation to the calibration of capital buffers (these are addressed in the CRD IV directive).

CRD IV entered into force on 1 January 2014. Full implementation of the capital and liquidity requirements in CRD IV was mandated by 1 January 2019, although national regulators retain limited discretion to use transitional provisions in relation to certain deductions from own funds until 2024. CRD IV is accompanied by a number of regulatory and implementing technical standards, the majority of which have been adopted.

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Building on this foundation, and taking further steps towards completion of the banking union (see Section IX), the Commission published a reform package on 23 November 2016, containing a proposed regulation amending the CRR (CRR II) and a proposed directive amending CRD IV (CRD V). The package also includes amendments to the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRM Regulation) (see Sections IX and X). Through these legislative proposals, the Commission's stated aim was to tackle remaining weaknesses within the financial system and implement some outstanding elements that are essential to ensuring resilience, as recently finalised by global standard setters (i.e., the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB)).[7]

To this end, the reform package proffers a wide-ranging regulatory reform that takes account of international standards set by the BCBS and FSB, while providing for what the Commission terms European specificities. Measures in the reform package that take account of international standards include:

a a 3 per cent binding leverage ratio for all firms within the scope of CRD IV to prevent institutions from excessive leverage, for example to compensate for low profitability;

b a binding net stable funding ratio (NSFR), which will require credit institutions and systemic investment firms to finance their long-term activities (assets and off-balance sheet items) with stable sources of funding (liabilities) to address excessive reliance on short-term wholesale funding and to reduce long-term funding risk; and

c a requirement, known as total loss absorbing capacity (TLAC), for globally systemically important institutions to hold minimum levels of capital and other instruments that bear losses in resolution. TLAC will be integrated into the existing minimum requirement for own funds and eligible liabilities (MREL) system.

Operating in parallel, a keynote of the EU-specific side of the package is increased proportionality, as a simplified approach for smaller and less complex institutions is introduced in respect of some of the current disclosure, reporting and complex book-related requirements. The other significant EU-specific change, which sparked considerable controversy, concerns the proposed requirement for certain non-EU banks headquartered in third countries to set up an intermediate holding company for their EU subsidiaries.

It is envisaged that the final legislative adoption of the package, including the amendments to the BRRD and SRM Regulation, will take place in the first half of 2019; the Parliament and the Council are currently considering the package and are expected to reach political agreement in the first half of 2019, having reached a provisional political agreement in December 2018. Entry into force and implementation vary according to the measure: for example, the NSFR proposal has a two-year implementation period. There are likely to be transitional provisions for implementation once the legislation is adopted.

In addition, the following related legislation was published in the Official Journal of the EU on 27 and 28 December 2017:

a a regulation amending the CRR regarding transitional arrangements for mitigating the impact of the introduction of International Financial Reporting Standard 9 (IFRS 9) on own funds and for the large exposures treatment of certain public sector exposures denominated in the domestic currency of any Member State (CRR IFRS 9 Regulation). This entered into force on 28 December 2017 and applied from 1 January 2018; and

7 COM(2016) 850.

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b a directive amending the BRRD as regards the ranking of unsecured debt instruments in the insolvency hierarchy (BRRD Insolvency Hierarchy Directive). This entered into force on 28 December 2017 and Member States were required to transpose it by 29 December 2018.

IV PAYMENT SERVICES DIRECTIVE

The Payment Services Directive (PSD)[8] is intended to harmonise conduct of business rules for all providers of electronic payment services across the EU, and to create a tiered prudential authorisation regime for non-bank payment service providers, known as payment institutions. It affects banks, building societies, e-money issuers, money remitters, non-bank credit card issuers, non-bank merchant acquirers and their customers. The PSD focuses on electronic means of payment, including direct debits, debit cards, credit cards, standing orders, mobile or fixed phone payments and payments from other digital devices, as well as money remittance services. It does not apply to cash-only transactions or paper cheque-based payments.

The PSD was formally adopted on 13 November 2007. Member States were required to transpose the PSD into their national laws by 1 November 2009.

On 24 July 2013, the Commission adopted a legislative package seeking to amend the EU payments framework. The package proposed a revised and recast Payment Services Directive (PSD2)[9] and a Multilateral Interchange Fees Regulation (MIF Regulation).[10]

PSD2 was formally adopted on 25 November 2015 and had an implementation deadline of 13 January 2018. It updates the existing framework for the regulation of the provision of payment services in the EU, covering payment services providers (PSPs) not previously regulated under the PSD, and introducing enhanced transparency and security requirements.

PSD2 increases the geographical scope of the PSD, applying transparency and information requirements to payment transactions in all currencies and to payment transactions where only one PSP is located in the EU (the PSD only applied where both PSPs were located in the EU). It also brings certain PSPs (such as those providing payment initiation services and account information services) within the scope of PSD2, and limits the exemptions that were available under the PSD. Throughout 2017, the EBA published technical standards and guidelines to accompany PSD2, in advance of its 13 January 2018 implementation date. Some of these technical standards and guidelines do not yet apply, most notably the regulatory technical standards relating to strong customer authentication, which apply from 14 September 2019.

The MIF Regulation was formally adopted on 29 April 2015 and became fully effective on 9 June 2016. The Regulation imposes caps on interchange fees of 0.2 and 0.3 per cent of transaction value for consumer debit card and credit card transactions, respectively. These caps came into effect on 9 December 2015, although for a period of five years from that date, Member States can apply the cap of 0.2 per cent in respect of domestic debit card transactions to the annual weighted average transaction value of all such transactions within the card scheme. After expiry of this period, the cap must be set by reference to transaction value. The

8 Directive 2007/64/EC.

9 Directive (EU) 2015/2366.

10 Regulation (EU) 2015/751.

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Regulation also requires the organisational separation of payment schemes and transaction processing infrastructure, and prohibits territorial restrictions in licensing agreements or payment scheme rules.

V ACQUISITIONS DIRECTIVE

The Acquisitions Directive[11] was formally adopted on 5 September 2007. It was intended to harmonise the criteria that regulators apply in deciding whether to approve changes of control of financial institutions (specifically credit institutions, investment firms, insurers and reinsurers) and to harmonise some important aspects of the process by which they do so. Member States were required to implement the Acquisitions Directive into national law by 21 March 2009.

The Acquisitions Directive is a maximum harmonisation directive in the sense that it prohibits Member States from imposing requirements for the notification to, and approval by, regulators of direct or indirect acquisitions of voting rights or share capital that are more stringent than those set out in the directive. The definition of control (at or above which the person holding control requires regulatory approval) is set at 10 per cent of share capital or voting rights, which follows previously existing EU directives. The Acquisitions Directive also introduced a concept of aggregation of multiple parties' interests for the purpose of determining whether control has been or would be attained where those parties are acting in concert.

Between 8 December 2011 and 10 February 2012, the Commission consulted on the application of the Acquisitions Directive. In February 2013, the Commission published its report, concluding that, overall, the regime created by the Acquisitions Directive was working satisfactorily. The Commission did, however, ask the ESAs to clarify new Level 3 guidance on the Directive in relation to a number of issues, including the definition of acting in concert. These guidelines, which followed a consultation, were published by the ESAs on 20 December 2016, and applied from 1 October 2017.

The provisions which the Acquisitions Directive inserted into sectoral directives have now been repeated in the latest versions of those directives, namely MiFID II,[12] Solvency II[13] and CRD IV.[14]

VI FINANCIAL GROUPS DIRECTIVE

There is a separate EU regime for the consolidated supervision of mixed activity financial groups (financial conglomerates) established by the Financial Groups Directive,[15] also referred to as the Financial Conglomerates Directive or the FGD.

Financial conglomerates, within the meaning of the FGD, are groups that carry on financial services activities as a substantial portion of their business, and that have significant interests in each of the banking or investment services, and insurance sectors.

11 Directive 2007/44/EC.

12 Directive 2014/65/EU, see Section VII.

13 Directive 2009/138/EC.

14 See Section III.

15 Directive 2002/87/EC (as amended).

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The FGD requires that a bank, investment firm or insurer that is authorised by an EEA regulator and that is a member (or parent) of a financial conglomerate group should be subject to supplementary supervision on a group-wide basis in addition to relevant sectoral (i.e., insurance or banking) consolidated supervision. The rules on how this supervision is effected may differ from those that apply to banking-only groups. The criteria for determining whether a group is a financial conglomerate for the purposes of the FGD depend on whether it is headed by a regulated entity. If a group is headed by a regulated entity, this entity must be the parent undertaking of, hold a participation in or be linked by a relationship based on unified management with, an entity in the banking, investment or insurance sector. Where the entity at the head of the group is not regulated, the gross assets attributable to all the financial business activities of the group (that is, all its banking or investment services, and insurance businesses) must account for at least 40 per cent of the group's total gross assets worldwide.

In both cases, groups must also meet the following criteria: at least one member of the group carries on business in each of the banking or investment services, and insurance sectors; and the group's business activities in each of the banking or investment services and insurance sectors are significant.

Significance is measured by reference to the average of two tests: a balance sheet ratio test and a solvency requirements ratio test comparing the significance of each sector with the combined position of all financial sector entities in the group. The average ratio for each of the banking or investment firms and insurance businesses of the group must exceed 10 per cent for the group to be treated as a financial conglomerate. At the initiative of the lead European regulator (to be identified or agreed among the national regulators that supervise members of the group in the EEA), national regulators that supervise members of the group in Member States may agree to substitute or supplement the significance test, or to exclude certain group members from its calculation, if they consider it appropriate to do so.

The significance test can also be satisfied if the gross assets of the smaller of the group's financial sector businesses (banking or investment services as against insurance) exceed €6 billion. If, however, the 10 per cent average ratio test is not satisfied, the relevant national regulators can agree that the group should not be regarded as a financial conglomerate.

Upon becoming a financial conglomerate, the relevant ratios are lowered for three years from that date unless the relevant national regulators agree otherwise. This minimises scenarios in which a group moves in and out of the FGD regime. The FGD also permits relevant regulators to treat a conglomerate as such for three years from the date on which it last satisfied the conglomerate test.[16]

The FGD was amended in December 2011, and those amendments were required to be implemented in full by Member States by 22 July 2013.

The amendments are intended to address certain deficiencies in the way the FGD interacts with CRD IV and equivalent sectoral rules for insurers that mean supplementary supervision cannot currently be carried out for certain groups or on a fully group-wide basis because of their legal structure. The amendments also introduce, inter alia, more discretion for supervisors in applying the significance test and in deciding whether to identify small groups (those with under €6 billion in total assets) as financial conglomerates.

In February 2012, the Commission launched a review of the FGD and published the results on 9 January 2013. The report identified future issues that would be addressed in further

16 Not all national regulators have exercised this discretion.

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revisions to the FGD. These included the criteria for the identification of a conglomerate, the identification of the parent entity responsible for meeting group requirements and the strengthening of enforcement in relation to group entities. Recital (80) to the CRR stated that a review of the FGD was expected in 2015, and in June 2016 the Commission published a consultation paper seeking views on a number of issues, including:

a the scope of the FGD, including asking whether supervisors are able to capture the right groups (and entities within those groups) as well as the right activities under the FGD;

b how the FGD requirements address group risk management, looking at areas such as capital adequacy, corporate governance and intra-group transactions; and

c the FGD's framework for supervisory cooperation.

Following this consultation, the Council published a Commission staff working document, with a summary, in July 2017. While stating that this did not represent a full evaluation of the FGD (owing to a lack of sufficient evidence to support a full evaluation) the Commission concluded that the FGD has, in general, functioned well, and that, overall, it remains a useful supervisory tool.

VII MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE

The Markets in Financial Instruments Directive (MiFID)[17] replaced the Investment Services Directive (ISD),[18] which had constituted one of the foundations upon which the single European market in financial services was developed. The ISD introduced a system of passports under which an investment firm authorised as such in one Member State could carry out certain regulated activities for which it was so authorised in other Member States, or establish a branch in other Member States, without having to obtain additional authorisation from the regulators in those other Member States. MiFID retained and expanded this passporting framework.

MiFID is very important to the very large number of EU banks that provide investment services as well as carrying on deposit-taking and lending activities.

Although the effect in each Member State has varied, MiFID has had some important consequences for the investment services market in the EEA as a whole:

a the scope of regulation of the investment services sector required by EU law has expanded, with the addition of important new regulated investment services and products;

b as a result, the investment services passport now enables firms to provide a wider range of investment services on a cross-border basis, or from branches within the EEA;

c national-level barriers to investment services within the EU single market have been reduced;

d important core business standards for investment services are now prescribed in detail at EU level; and

17 Directive 2004/39/EC (as amended). This directive was supplemented by implementing measures in the form of an EU regulation (1287/2006/EC) and a further directive (2006/73/EC).

18 Directive 93/22/EEC.

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e the rules applying to different securities trading venues have been harmonised to a significant degree, resulting in a wider range of regulated trading venues, such as multilateral trading facilities (MTFs).

The deadline for the implementation of MiFID into the national law of each Member State was 1 November 2007.

In October 2011, the Commission published a legislative proposal to amend MiFID (MiFID II). MiFID II comprises a directive and a regulation (the latter also amended the European Market Infrastructure Regulation, which is discussed below). The provisions of the MiFID II Directive and Markets in Financial Instruments Regulation (MiFIR) came into force on 2 July 2014. A legislative package postponing the application of MiFID II and MiFIR came into force on 1 July 2016, which meant that Member States had until 3 July 2017 to transpose the majority of measures contained in the MiFID II Directive into their national laws, and have had to apply those provisions, and MiFIR, since 3 January 2018. This legislative package delayed the application of MiFID II and MiFIR by one year. The delay reflects the difficulties faced by the ESMA and the Commission both in delivering the necessary technical standards and delegated acts, and in developing the infrastructure required for the collection of financial instrument reference data that trading venues and other entities are required to provide under the new regime.

MiFID II covers a range of issues, some of which are self-evidently matters of regulatory policy playing catch-up with market developments, for example in relation to new trading methods such as high-frequency and algorithmic trading strategies. Other measures, however, demonstrate a prescriptive and rigid response to perceived or suspected potential for investor detriment. In some cases, indeed, the measures seem to cross the line between the regulation of firms' conduct and the imposition of specific conduct requirements, even to the extent of banning certain products or activities. Key elements of MiFID II include the following:

a a new type of trading venue, the organised trading facility (OTF), is within the scope of MiFID II. OTFs are subject to the same core requirements for a trading venue's operation as existing platforms, and are defined broadly to capture all forms of organised trading not matching existing categories;

b all trading of derivatives, which are eligible for clearing and are sufficiently liquid, move to regulated markets, MTFs or the new OTFs;

c improved transparency of trading activities in equity markets, including dark pools, and a new trade transparency regime for non-equity markets;

d new safeguards for algorithmic and high-frequency trading activities;

e in coordination with the ESMA or the EBA and under defined circumstances, supervisors are able to ban specific products, services or practices in the case of threats to investor protection, financial stability or the orderly functioning of markets;

f new powers for regulators to monitor and intervene in commodity derivatives trading, including the imposition of position limits;

g stricter requirements for portfolio management, investment advice and the offer of complex financial products, such as structured deposits; and

h a ban on third-party inducements in the case of portfolio management and for firms providing independent advice.

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MiFID II is accompanied by a number of delegated and implementing acts, which supplement the framework legislation, as well as technical standards, which generally elaborate on its technical aspects.

VIII EUROPEAN MARKET INFRASTRUCTURE REGULATION

At the September 2009 summit in Pittsburgh, G20 leaders agreed that all standardised over-the-counter (OTC) derivative contracts should be cleared through central counterparties (CCPs) by the end of 2012 at the latest, and that OTC derivative contracts should be reported to trade repositories. The EU's response to this commitment is the Regulation on OTC derivatives, central counterparties and trade repositories (commonly referred to as the European Market Infrastructure Regulation or EMIR). The EMIR entered into force on 16 August 2012, apart from certain requirements that needed to be specified further in Level 2 measures. In particular, the first clearing obligations came into effect on 21 June 2016 in respect of certain interest rate derivatives.

The requirements of the EMIR, which extend to all derivative contracts and not just to standardised OTC derivative contracts, include:

a a reporting obligation in respect of derivatives entered into by EU financial and non-financial counterparties, requiring detailed information to be reported to trade repositories and made accessible to supervisory authorities (this obligation came into force on 12 February 2014);

b a clearing obligation for derivatives that meet certain eligibility criteria set by the ESMA;

c measures to reduce counterparty credit risk and operational risk for uncleared OTC derivatives, including risk mitigation standards (such as exchanges of collateral);

d prudential requirements for CCPs and trade repositories, including requirements for authorisation, capital, the provision of margin, the establishment of a default fund, organisational rules and conduct of business standards. These include an obligation on trade repositories to publish aggregate positions by classes of derivatives accessible to all market participants; and

e rules on the interoperability of CCPs.

Regulatory technical standards and implementing technical standards under the EMIR have now been finalised, including those relating to measures to reduce counterparty credit risk for uncleared OTC derivatives.

In November 2016, the Commission published a report under Article 85(1) EMIR to review the EMIR. While noting that certain core requirements provided for under the EMIR were yet to be implemented or completed, the report concluded that no fundamental change should be made to the nature of the core requirements of the EMIR. Nonetheless, a number of areas were highlighted where the EMIR requirements could be adjusted, including:

a introducing a mechanism to suspend the clearing obligation. The Commission has proposed such a mechanism as part of its legislative proposal on CCP recovery and resolution (see Section XVIII);

b facilitating the predictability of margin requirements through better information sharing;

c streamlining trade reporting through an assessment of the current rules, and considering alternative methods for providing access to third-country authorities of trade repositories' data; and

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d reducing disproportionate costs and burdens through a review of the scope of transactions and entities.

The Commission published two proposed regulations in 2017, which seek to amend the EMIR. The first, following the November 2016 consultation and published in May 2017, tackles several areas, including the streamlining of reporting requirements, the asset classes required to be cleared by non-financial counterparties, the introduction of a clearing threshold for small financial counterparties and a new three-year temporary exemption for pension funds from clearing (referred to as the EMIR REFIT proposal).

The second, published in June 2017, concerns the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (which would be subject to a two-tier classification system). In both cases, the Parliament published (in January and February 2018, respectively) a draft report on the proposed regulation, suggesting amendments. Trilogue negotiations between the Commission, the Council and the Parliament resulted in political agreement on the EMIR REFIT proposal in February 2019, with publication in the Official Journal expected to take place in the second quarter of 2019, while the CCP amendment negotiations are still ongoing.

IX THE BANKING UNION, SSM AND SINGLE RESOLUTION MECHANISM

Herman van Rompuy, former President of the European Council, published a report on 26 June 2012 entitled Towards a Genuine Economic and Monetary Union, in which he set out his vision for the future of EU economic and monetary union. This was based on four elements: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework, and democratic legitimacy and accountability.

The proposals for an integrated financial framework (otherwise known as a banking union) comprise:

a a new role for the European Central Bank (ECB), giving it responsibility for the prudential regulation of all credit institutions (meaning all banks, mutuals and other deposit-taking entities) established in the eurozone, resulting in an SSM for banking supervision;

b a single prudential rule book applicable across the European Union, the core elements of which are already contained in CRD IV;

c a harmonised recovery and resolution framework for credit institutions and other systemic firms in the eurozone on the basis of the Commission's current proposals in this area; and

d a common deposit guarantee scheme (DGS) for the European Union.

i The SSM

The legislation establishing the SSM includes two regulations: one conferring supervisory tasks on the ECB (SSM Regulation) and the other modifying the regulation establishing the EBA (EBA Amending Regulation). These are supplemented by the SSM Framework Regulation, which sets out detailed procedures for the SSM. The SSM Regulation entered into force on 3 November 2013 and the EBA Amending Regulation entered into force on

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30 October 2013. In accordance with the SSM Regulation, the ECB assumed its supervisory role on 4 November 2014.

The SSM Regulation is the key piece of legislation establishing the SSM elements of the banking union. The key elements of the SSM Regulation include:

a direct supervisory responsibility for the ECB over significant credit institutions (generally, those with assets of more than €30 billion, representing more than one-fifth of a Member State's national output (where those total assets exceed €5 billion), or with a ratio of cross-border assets or liabilities to total assets or liabilities (respectively) that exceeds 20 per cent). Other banks largely remain under the supervision of the national competent authorities in the participating Member States. However, the ECB does have the supervisory role for licensing and authorising credit institutions, and for assessing the qualifying holdings for all credit institutions;

b the ECB should issue regulations, guidelines or general instructions to national supervisors for the performance of their supervisory responsibilities; and

c investigatory and enforcement powers for the ECB. It may impose fines of up to twice the amount of the profits gained or losses avoided as a result of a breach (where these can be determined), or up to 10 per cent of the total annual turnover of a legal person in the preceding business year. It does not, however, have the power to impose sanctions on individuals.

The EBA Amending Regulation revises the EBA Regulation in relation to voting procedures in respect of the EBA. It includes revised decision-making arrangements in respect of the EBA, which require a majority of non-SSM countries to approve EBA decisions (to prevent the EBA from being dominated by the ECB, representing the SSM Member States).

On 11 October 2017, as required by the SSM Regulation, the Commission published a report that provides an assessment of the setting up and functioning of the SSM, to determine its effectiveness as the first pillar of the banking union. The report covers five themes:

a the governance of the SSM;

b supervisory tools developed by the ECB;

c the performance of supervisory tasks by the ECB;

d the interaction with relevant EU and international bodies; and

e the cost-effectiveness of the SSM.

In its report, the Commission came to an overall positive assessment of the SSM and the first two years of the ECB acting in its supervisory capacity. While stating that there is scope for further improvement, the Commission does not consider it necessary to propose any amendments to the SSM Regulation.

Although non-eurozone Member States do not participate in the SSM, the SSM Regulation allows those countries to enter into close supervisory cooperation with the ECB. To date, none of the nine non-eurozone Member States have opted to do so, although in October 2017, the Commission published a communication stating that Denmark, Sweden and Bulgaria were considering joining the banking union. In November 2018, the ECB announced that it would conduct a comprehensive assessment of six Bulgarian banks in line with the aim of Bulgaria participating in the SSM.

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ii The Single Resolution Mechanism

The SRM Regulation, certain provisions of which have applied since August 2014 and which has been fully effective since 1 January 2016, established the Single Resolution Mechanism (SRM). Its key elements include:

a the establishment of a single resolution board (SRB). The SRB's main role is to assess whether an individual bank needs to be placed under resolution, and to determine the application of the resolution tools and use of the Single Bank Resolution Fund (SBRF);

b the establishment of the SBRF, which is funded through contributions made by all banks established in participating Member States. The level of contributions payable by banks reflects their respective size and business model; and

c the establishment of a resolution mechanism that is intended to reflect the mechanism used by national authorities under the BRRD, discussed below. The framework includes preparatory and preventive measures, early intervention measures and resolution tools, including bail-in.

As discussed in Section III, the Commission published a legislative package in November 2016, which included proposed amendments to the SRM (under the SRM II Regulation). These amendments are intended to mirror those made under BRRD II (see Section X) and relate to the implementation of the TLAC requirements and revisions to MREL. As with the broader legislative package, the Parliament and the Council are considering the proposed amendments, and are expected to reach political agreement in the first half of 2019, having reached a provisional political agreement in December 2018.

X RECOVERY AND RESOLUTION PLANS

Both the G20 and the FSB have advocated the development of recovery and resolution plans – living wills – for financial institutions. The numerous high-profile banking failures in the European Union during the financial crisis (e.g., Fortis and Anglo Irish Bank) revealed shortcomings in the existing arrangements for organising an orderly wind-down of ailing banks and financial institutions, which left Member States with no choice but to bail out their banking sectors.

In response to this, the Commission proposed an EU framework for crisis management in the financial sector with common and effective tools and powers to deal with failing banks at an early stage, and to minimise costs for taxpayers. The overriding objective of the proposal was to ensure that failing banks could be resolved in ways that minimise the risks of contagion and ensure continuity of essential financial services, including continuous access to deposits for insured depositors.

The BRRD is the framework legislation passed as a result of the Commission's proposal to deal with future bank failures. It came into force on 2 July 2014 and establishes new tools and powers for national regulators to deal with crises, including rules requiring banks to prepare recovery plans and requiring resolution authorities to prepare resolution plans based on consultation with the institution concerned; new powers of supervisory intervention at an early stage and during a crisis, such as the ability to require a bank to implement its recovery plan; and powers giving regulators new tools to deal with the failure of a firm, including a sale-of-business tool, a bridge institution tool, an asset-separation tool and a bail-in tool.

The BRRD also establishes new mechanisms for cross-border cooperation for handling banking crises, including a much greater role for the EBA.

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The deadline by which Member States had to transpose the BRRD into national law was 31 December 2014, and all the provisions of the Directive (except for the bail-in tool for use by national regulators) should have come into force by 1 January 2015. The provisions relating to the use of the bail-in tool came into force on 1 January 2016, although some Member States (including the United Kingdom) chose to bring these provisions into force sooner.

As discussed in Section III, the Commission adopted a broad reform package in November 2016 that contained reforms to the BRRD (BRRD II). These reforms, which form part of the Commission's efforts to implement the TLAC standard, included the revision of the existing MREL provisions to align them with the TLAC standard, and targeted amendments to the BRRD related to the insolvency ranking of holders of debt instruments issued by EU banks for the purposes of complying with the BRRD and TLAC requirements concerning loss absorption and recapitalisation capacity of banks.

As with the broader legislative package, it is now for the Parliament and the Council to consider BRRD II. In addition, as flagged in Section III, the BRRD Insolvency Hierarchy Directive entered into force on 28 December 2017, and Member States were required to transpose it by 29 December 2018.

XI SHORT SELLING REGULATION

In distressed markets, short selling can amplify price falls and may lead to disorderly markets giving rise to systemic risk. In 2008, fears of such risks led to various Member States suspending short selling, although there was no coordinated approach across the European Union. To address the perceived risks in a coordinated manner, a regulation on short selling and certain aspects of credit default swaps (Short Selling Regulation (SSR)) was agreed upon and came into force on 1 November 2012. It includes provisions that:

a increase transparency on short positions in certain situations relating to EU shares and EU sovereign debt, and to persons with significant credit default swap positions relating to EU sovereign debt issuers;

b require that those who enter into short sales of European sovereign debt instruments or shares admitted to trading on an EU-regulated market, or an MTF, must have borrowed, entered into an agreement to borrow or made other arrangements that ensure that the relevant instruments are available for borrowing. This effectively bans naked short selling;

c oblige disclosure of a short position in shares of an EU company to the relevant regulator once the short position reaches 0.2 per cent, and to the market once it reaches 0.5 per cent (and each 0.1 per cent above this), of the target's share capital. Only significant short positions in credit default swaps or EU sovereign bonds will need to be disclosed to the regulator (and not the market);

d require trading venues to ensure that there are default arrangements and penalties in place if a short settlement fails;

e require that all short orders should be flagged as such;

f empower national competent authorities to impose restrictions on short selling and related derivative transactions for up to three months where there is a serious threat to financial stability or market confidence in a Member State or the European Union more generally, and very short-term restrictions where there is a significant fall in the price of a financial instrument; and

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g provide that the ESMA will coordinate cross-border measures and intervene in situations where national authorities have not taken sufficient action to address a threat.

On 7 July 2017, the ESMA published a consultation paper seeking the views of market participants on three aspects of its future technical advice to the Commission regarding the SSR: the scope and functioning of the exemption for market making activities; the procedure for imposing a short-term ban on short selling in the event of a significant fall in price of a financial instrument; and the transparency of net short positions, and the related reporting and disclosure requirements.

Following this consultation, the ESMA published its final report containing its technical advice on 21 December 2017, which included a number of proposals centring around the three elements set out in the consultation. These proposals include transforming the current bans on short selling into a ban on entering into or increasing net short positions, and building a centralised notification and publication system across the European Union for transparency purposes. This report is expected to feed into the follow-up actions the Commission announced in its call for evidence as regards the EU regulatory framework for financial services dated 23 November 2016.

XII CONSUMER PROTECTION DIRECTIVES RELEVANT TO THE BANKING SECTOR

A number of other EU directives of importance to banks have been enacted, broadly with the aim of achieving harmonised consumer protection measures in the areas to which they relate. They include those summarised below.

i Deposit Guarantee Schemes Directive

This Directive[19] established minimum levels of protection that Member States are required to provide to depositors of banks that their national regulators supervise. In February 2009, the Council adopted an amending Directive[20] that raised the minimum deposit coverage level to €50,000 as from 30 June 2009 (from €20,000) and set the coverage level at €100,000 as from 31 December 2010; and reduced the maximum payout delay to 25 working days (a period of five working days to establish that a credit institution has failed to repay deposits that are due and payable, followed by a period of 20 working days), subject to extension by 10 working days.

On 2 July 2014, a recast version of the DGSD came into force, and the overwhelming majority of its provisions had to be implemented by 3 July 2015. Among its key provisions are:

a reducing the time permitted for payout to seven working days by 2024 and, to facilitate this more rapid timetable, requiring managers of schemes to inform authorities of likely bank failures, and requiring banks to be able to provide a breakdown of the aggregated deposits of a depositor at any time;

b requiring the provision of standard information to depositors about the scheme that applies to them;

19 Directive 94/19/EC.

20 Directive 2009/14/EC.

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c requiring funds of schemes to reach 0.8 per cent of covered deposits within 10 years of the Directive coming into force. The Commission may permit a Member State to set a lower level (although not less than 0.5 per cent) where that Member State has a concentrated banking sector; and

d introducing a principle of risk-based contributions, whereby riskier banks are required to make greater contributions to the relevant DGS.

The DGSD requires the Commission to submit two reports by 3 July 2019:

a one setting out how deposit guarantee schemes operating in the EU may cooperate through a European scheme to prevent risks arising from cross-border activities and protect deposits from such risks (and, if appropriate, to submit a legislative proposal); and

b one, with the support of the EBA, on the progress towards the implementation of the DGSD, having regard to a number of topics, such as the adequacy of the current coverage level for depositors and the impact on the diversity of banking models.

ii Unfair Terms in Consumer Contracts Directive and Consumer Rights Directive

The Unfair Terms in Consumer Contracts Directive (Unfair Terms Directive)[21] requires Member States, inter alia, to enact provisions in their national laws rendering unenforceable certain unfair terms in consumer contracts. These are defined as contracts between a seller or supplier (meaning any natural or legal person who, in contracts covered by the directive, is 'acting for purposes relating to his trade, business or profession') and a consumer (meaning any natural person who, in contracts covered by the Directive, is 'acting for purposes which are outside his trade, business or profession'). In particular, a term of such a contract that has not been individually negotiated is unfair (and therefore unenforceable) if, 'contrary to the requirement of good faith', it causes a 'significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer'. An annex to the Directive contains an indicative and non-exhaustive list of terms that may be regarded as unfair.

The Directive also introduced a requirement that Member States implement measures ensuring that contracts to which the Directive relates be drafted in plain, intelligible language.

In October 2008, the Commission published a communication proposing the repeal and replacement of this directive with a single EU directive on consumer rights that would also repeal and replace certain other consumer protection directives. The Consumer Rights Directive,[22] which came into force on 12 December 2011, made only minor amendments to the Unfair Terms Directive, rather than repealing it. Among its key provisions are an extension of consumer withdrawal rights on distance purchases to 14 days across the European Union; a cap on fees for use of means of payment equal to the cost borne by the trader for the use of such means; and the provision of mandatory information by the trader to the consumer on distance and off-premises contracts. Member States were required to implement the measures contained in the Consumer Rights Directive by 13 June 2013, and to apply those measures from 13 June 2014.

On 12 May 2016, the Commission launched a consultation as part of its fitness check of EU consumer and marketing law, which included an evaluation of the Unfair Terms

21 Directive 93/13/EEC.

22 Directive 2011/83/EEC.

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Directive. The Consumer Rights Directive underwent a separate evaluation in parallel. The Commission found, overall, the current EU consumer law *acquis* to still be fit for purpose, and not in need of a major overhaul. Nevertheless, the Commission launched a public consultation to seek stakeholder views on some possible targeted legislative changes, which closed on 8 October 2017. The possible legislative changes included consideration of:

a providing more transparency regarding whom consumers conclude contracts with when buying on online platforms, and whether EU consumer rights are applicable to such contracts;

b extension of some consumer rights to contracts for online services where consumers provide data instead of paying with money;

c individual redress or remedies for consumers harmed by unfair commercial practices; for example, misleading green claims;

d more proportionate, effective and deterrent financial penalties to tackle breaches of consumer laws; and

e simplification of some rules and requirements.

As a result of this consultation, on 11 April 2018 the Commission proposed a package of legislative changes (referred to as the New Deal for Consumers), including the amendment of the Unfair Terms Directive and the Consumer Rights Directive to ensure better enforcement and modernise EU consumer protection rules, in particular in light of digital developments. The Commission's proposals will pass to the Parliament and the Council to consider.

iii Anti-money laundering legislation

There are also extensive provisions of EU law setting out anti-money laundering requirements, but these are beyond the scope of this chapter.

XIII THE SFT REGULATION

In its September 2013 Communication on shadow banking, the Commission identified increasing the transparency of securities financing transactions (SFTs) as a priority area. This prompted it to publish a proposal for a regulation on the reporting and transparency of SFTs in January 2014. The final text of the SFT Regulation[23] was formally adopted on 25 November 2015 and came into force on 12 January 2016; the ESMA published a final report on its proposed regulatory and implementing technical standards in March 2017. The Commission adopted these technical standards in December 2018.

The SFT Regulation imposes the following requirements on counterparties to SFTs:

a counterparties must report details of SFTs to a registered or recognised trade repository no later than the working day following the conclusion of the transaction;

b fund managers must provide detailed information on any recourse they have to SFTs and other financing structures in pre-contractual documents and at regular reporting intervals: this measure is aimed at enabling investors to become aware of the risks associated with the use of SFTs and other financing structures; and

23 Regulation (EU) 2015/2365.

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c a counterparty that wishes to rehypothecate clients' financial instruments that it holds as collateral can do so only after receiving the express consent of the providing counterparty, disclosing the potential risks and having the financial instruments transferred to its own account.

The SFT Regulation covers repos, securities and commodities lending and borrowing transactions, buy-sell back and sell-buy back transactions, and margin lending transactions, and applies to all counterparties in SFT transactions that are domiciled in the European Union or acting through an EU branch, certain fund managers and counterparties engaging in rehypothecation.

XIV THE MARKET ABUSE REGULATION

In October 2011, the Commission published legislative proposals for a regulation and directive to replace the Market Abuse Directive (MAD)[24] and to strengthen and update the existing EU market abuse regime. Following consideration by the Council and the Parliament, the final texts of the Market Abuse Regulation (MAR)[25] and the Directive on Criminal Sanctions for Market Abuse (CSMAD)[26] (referred to collectively as MAD II) were published on 12 June 2014 and came into force on 2 July 2014.

The MAR is intended to expand and develop the market abuse regime under the MAD by establishing a common regulatory framework on market abuse. This regulation is intended to complement the MiFID II legislative package, and the two regimes were updated together to ensure that they are coherent and support each other's objectives and principles.

The framework established by the MAR prohibits insider dealing, the unlawful disclosure of inside information and market manipulation. Key changes made to the existing EU market abuse regime by the MAR include:

a an expansion of scope to cover market abuse relating to financial instruments traded on an OTF or MTF, certain OTC activities and, in some cases, spot commodity contracts;

b extraterritorial reach, covering behaviour both within and, where such behaviour relates to instruments traded on an EU trading venue, outside the European Union;

c the introduction of a prohibition on attempted market manipulation;

d the extension of the market manipulation prohibition under the MAD to cover the manipulation of benchmarks; and

e the introduction of a new market soundings safe harbour to the offence of unlawfully disclosing inside information.

The majority of the MAR's provisions applied from 3 July 2016. Under Article 38 of the MAR, the Commission must submit a report to the Parliament on the application of the MAR by 3 July 2019, together with a legislative proposal to amend it if appropriate. This report must assess, inter alia, whether the definition of inside information is sufficient to cover all information relevant for the competent authorities to effectively combat market abuse, and the possibility of establishing an EU framework for cross-market order book surveillance in relation to market abuse.

24 Directive 2003/6/EC.

25 Regulation (EU) No. 596/2014.

26 Directive 2014/57/EU.

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The CSMAD is intended to complement the MAR by requiring Member States to implement minimum rules for criminal sanctions in the most serious instances of market abuse. Under the CSMAD, serious instances of market abuse are broadly those that cause a great impact on the integrity of the market, or under which the profit gained or loss avoided, the level of damage caused to the market or the overall value of the financial instruments concerned is high.

Member States were required to transpose CSMAD provisions into domestic law by 3 July 2016 but, as the CSMAD is a minimum harmonisation directive, are free to impose more stringent requirements. Two Member States, Denmark and the United Kingdom, have opted out of the CSMAD.

XV THE MORTGAGE CREDIT DIRECTIVE

In March 2011, the Commission published a proposal for a directive on credit agreements relating to residential immoveable property for consumers. The Mortgage Credit Directive (MCD) was published in the Official Journal on 28 February 2014 and had to be transposed and implemented by Member States by 21 March 2016.

The MCD introduces requirements in the European Union for residential mortgage lending, and places obligations on credit intermediaries and creditors. The MCD imposes requirements in relation to, inter alia, advertising and marketing, standard pre-contractual information, calculation of the annual percentage rate of charge, creditworthiness and suitability assessments and advice, and introduces a right of the borrower to make early repayment. The Commission was required to carry out a review of the implementation of the MCD by 21 March 2019, which was to consider the effectiveness and appropriateness of the MCD provisions.

XVI BENCHMARKS REGULATION

Following global investigations into the conduct of a number of banks in relation to attempts to manipulate two key financial market benchmarks – the London interbank offered rate (LIBOR) and the Euro interbank offered rate (EURIBOR) – the Commission published a consultation document on the regulation of indices in September 2012.

Further to the consultation, the Commission adopted a proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts (Benchmarks Regulation). Adopted by the European Parliament in April 2016, the majority of the provisions of the Benchmarks Regulation applied from 1 January 2018.

The key elements of the Regulation are as follows:

a the activity of the provision of benchmarks is subject to prior authorisation and continuing supervision at national and EU level. Different governance and control requirements apply to administrators depending on whether they administer critical, significant or non-significant benchmarks. For critical benchmarks (a class which includes LIBOR, EONIA, STIBOR and EURIBOR), colleges of supervisors should be formed to enhance the exchange of information and ensure uniform authorisation and supervision;

b provisions to improve the quality of input data are provided. Input data used to produce a benchmark should be sufficient and accurate to reflect actual market or

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economic reality, the data should be obtained from a reliable and representative panel of submitting institutions, and the benchmark administrator should use robust and reliable methodology for determining the benchmark;

c the benchmark administrator is required to draw up a code of conduct for contributors that clearly specifies their obligations and responsibilities when they provide input data for the determination of the benchmark;

d annexes to the Benchmarks Regulation are provided in relation to commodity benchmarks and interest rate benchmarks to take account of the risks and specificities of these benchmarks in a proportionate manner. Additional requirements are imposed on critical benchmarks, including the power for the relevant competent authority to mandate submission data from contributors and mandate administration; and

e transparency provisions require administrators to provide a statement setting out the relevant benchmark measures and its vulnerabilities, to allow users to choose the most appropriate and suitable benchmark.

XVII SECURITISATION REGULATION

In September 2015, the Commission published a legislative proposal for a regulation establishing a European framework for simple, transparent and standardised (STS) securitisations (Securitisation Regulation), one of the building blocks of the Capital Markets Union action plan adopted by the Commission. In parallel, it published a proposal for a regulation amending the CRR on prudential requirements for credit institutions and investment firms (CRR Amendment Regulation). Political agreement between the Parliament and the Council on these two regulations was achieved in May 2017.

The Securitisation Regulation introduces certain requirements in relation to securitisations, requiring defined institutional investors to conduct due diligence before investing in securitisation instruments and imposing risk retention, reporting and transparency requirements on originators, sponsors and original lenders. The Securitisation Regulation also sets out what constitutes an STS securitisation, and establishes a more risk-sensitive prudential framework in respect of such securitisations. The CRR Amendment Regulation amends the CRR in order to give STS securitisations more favourable capital treatment.

Adopted towards the end of 2017, both regulations are now in force and applied from 1 January 2019.

XVIII FUTURE LEGISLATIVE DEVELOPMENTS

A number of measures of importance to banking activities have recently been proposed by the Commission, including those briefly summarised below.

i The European deposit insurance scheme

In November 2015, the Commission adopted a legislative proposal for a regulation establishing a European deposit insurance scheme (EDIS). The proposal reflects the Commission's concern that national DGSs established under the Deposit Guarantee Schemes Directive (DGSD)[27] (see Section XII) may be vulnerable to large local events and form one of the key

27 Directive 2014/49/EU.

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components of the proposals for a European banking union. The Commission's proposals would only apply in Member States that are participants in the SSM. The Parliament and the Council are currently considering the legislative proposal.

Under the legislative proposals, EDIS would provide insurance to participating DGSs from 2024, funding a participating DGS where it is required to contribute to a resolution or make a payout under the DGSD. This would be funded by risk-based contributions paid by banks to a deposit insurance fund, which the Commission envisages would be equivalent to 0.8 per cent of the covered deposits of all banks within the banking union by 2024.

On 11 October 2017, the Commission – noting that it had been two years since the presentation of the EDIS proposal, which remains on the table unchanged – proposed revisions to the operation of the EDIS regulation, with a view to ensuring agreement by the end of 2018. These revisions included introducing the EDIS in a more gradual manner, starting with a more limited reinsurance phase and moving gradually to co-insurance. The Parliament and the Council are still considering the legislative proposal for the EDIS regulation.

ii CCP resolution framework

In October 2012, the Commission published a consultation paper on the establishment of a recovery and resolution framework for CCPs. Following this consultation paper, the Commission published its legislative proposal for a proposed regulation establishing the CCP recovery and resolution framework on 28 November 2016. The proposed rules aim to ensure that the critical functions of CCPs are preserved, while maintaining financial stability and helping to avoid the costs associated with the restructuring and resolution of failing CCPs from falling on taxpayers. Setting out provisions comparable to those in the BBRD (see Section X), while using CCP-specific tools, key elements of the proposed rules are as follows:

a a requirement for CCPs to draw up recovery plans, which would include measures to overcome any form of financial distress that would exceed their default management resources and other requirements under the EMIR;

b a requirement for resolution authorities to prepare resolution plans for how CCPs would be restructured, and their critical functions maintained, in the event of their failure;

c specific powers that are to be granted to CCP supervisors to intervene in the operations of CCPs where their viability is at risk, but before they reach the point of failure or where their actions may be detrimental to overall financial stability;

d a requirement to place a CCP in resolution when it is failing or likely to fail, when no private sector alternative can avert failure and when its failure would jeopardise the public interest; and

e the establishment of resolution colleges for each CCP containing all the relevant authorities, including the ESMA and the EBA.

The draft regulation has been submitted to the Parliament and the Council for their approval and adoption.

iii Non-performing loans

Following the establishment of the Council's action plan to reduce stocks of non-performing loans (NPLs) in July 2017, thereby making progress on completing the banking union

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by accelerating risk reduction in the EU banking sector, in March 2018 the Commission proposed a package of actions to address the high stock of NPLs and prevent their possible future accumulation. These actions target four key areas:

a ensuring that banks set aside funds to cover the risks associated with loans issued in the future that may become non-performing. This is to be achieved via a proposal for a regulation amending the CRR that introduces common minimum coverage levels for newly originated loans that become non-performing. In case a bank does not meet the applicable minimum, deductions from banks' own funds would apply;

b encouraging the development of secondary markets where banks can sell their NPLs to credit servicers and investors by harmonising requirements and creating a single market for credit servicing and the transfer of bank loans to third parties across the EU;

c facilitating debt recovery, where banks and borrowers can agree in advance on an accelerated mechanism to recover the value from loans guaranteed with collateral (subject to specified safeguards); and

d assisting Member States that so wish in the restructuring of banks, by providing non-binding guidance – a blueprint – for establishing asset management companies or other measures dealing with NPLs.

In addition to this package, the Commission presented a proposal in November 2016 for a directive on restructuring, second chance and efficiency of insolvency. The key features of this proposal – in particular the availability of restructuring procedures enabling viable companies in financial difficulties to avoid insolvency, and measures to enhance the effectiveness of restructuring and insolvency proceedings – would contribute to reducing NPLs and preventing their accumulation in the future. In its November 2018 progress report, the Commission called on the Parliament and the Council to progress swiftly on this proposal as well as those from March 2018.

XIX EU REGULATORY BODIES

In response to the de Larosière Report, the Commission announced in May 2009 a new financial services supervisory framework for the European Union. In November 2010, the Council and the Parliament adopted legislation creating, from 1 January 2011, two structures around which new European financial supervisory arrangements were established: the ESRB, which is concerned with macroprudential supervision, and the ESFS, which is focused on microprudential supervision.

This change in European regulatory architecture was made in the context of widespread dissatisfaction among politicians and regulators with the way in which the previous EU regulatory system, with its network of national regulators and the division of responsibilities for cross-border institutions between home and host authorities, failed to cope during the financial crisis.

Targeted powers, including powers to overrule national regulators and, in limited cases, to intervene directly in the supervision of individual firms, have been allocated to the new EU authorities.

In the case of macroprudential supervision, the changes were not so much a matter of making the previous arrangements work better as addressing the significant gap in those

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arrangements that arose from the fact that systemic supervision at an EU level was not within the remit of national regulators.

i The ESFS

Three ESAs were established, which are independent EU bodies with full legal personality: the EBA, the ESMA and the EIOPA. The former committees (CEBS, CESR and CEIOPS) were replaced, and effectively merged into the ESAs. The ESA of most importance to the banking sector is the EBA.

The regulations that created the ESAs[28] are supported by the Omnibus I Directive,[29] which amended financial services legislation (other than Solvency II).[30] Together, these pieces of legislation give the ESAs significant powers, including the power to make decisions that bind national regulators and, in certain circumstances (particularly in an emergency), even circumvent national regulators in the supervision of significant financial institutions. The ESMA also has direct responsibility for the regulation of credit rating agencies.

The powers of the ESAs may be summarised as follows:

a to develop binding technical standards in connection with specific areas of existing directives;

b to ensure the consistent application of EU rules by national regulators, including requesting the Commission to make decisions binding on national regulators;

c in cases designated by the Council as emergency situations, to make decisions that bind national regulators, or to intervene directly in the supervision of financial institutions in limited cases. In these circumstances, the ESAs also have the power to require competent national regulators to take necessary action in accordance with EU law where developments threaten the orderly functioning and integrity of financial markets or the stability of the whole, or part, of the financial system of the European Union;

d to arbitrate disagreements between national regulators, including making decisions that bind regulators to end disagreements, and to address decisions to financial institutions if a national regulator does not comply with a decision made by the ESMA in respect of requirements directly applicable to the institutions (i.e., under EU regulations); and

e the EBA may temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole, or part, of the financial system in cases specified, and under the conditions laid down, in EU legislation or, if so required, in emergency situations as provided for in the regulations.

The last two powers are subject to the important proviso that no decision adopted in their exercise should 'impinge in any way on the fiscal responsibilities of Member States'.

28 The EBA was created by Regulation No. 1093/2010, the ESMA by Regulation No. 1095/2010 and the EIOPA by Regulation No. 1094/2010.

29 Directive 2010/78/EU.

30 Solvency II has been amended by the Omnibus II Directive, which came into force on 23 May 2014. The Solvency II regime came into force on 1 January 2016.

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Technical standards

The ESAs' powers to set technical standards are intentionally limited. Only those issues identified in the relevant EU legislation may be subject to technical standards. Selection of the issues to which technical standards may relate is based on the following high-level principles:

a the issues must be genuinely technical, where the development of standards is best left to supervisory experts. They are not areas that involve strategic or policy decisions, although distinguishing between technical and policy matters may be difficult;

b issues where a common approach or predictability would be of benefit to all concerned are candidates for technical standards; and

c the areas selected should be ones where detailed technical rules promote financial stability, consumer protection, and market efficiency and integrity.

The ESAs do not themselves have the power to set binding technical standards; the Commission must enact the standards, usually in the form of a decision or a directly applicable EU regulation, for them to be binding. It is open to the Commission not to endorse technical standards submitted by an ESA, or to endorse them only in part. In addition, both the Council and the Parliament have the right to object to technical standards, in which case those standards will not enter into force or will only enter into force with amendments.

Before proposing technical standards to the Commission, an EBA is generally required to hold a public consultation and to obtain the opinion of the Banking Stakeholder Group. This is a group of 30 members, representing credit and investment institutions operating in the European Union, their employees' representatives, as well as consumers, users of banking services, top-ranking academics, and representatives of small and medium-sized enterprises.

Consistent application of rules

This power enables an ESA to investigate breaches or non-application of EU law and, in certain limited circumstances, to direct decisions to financial institutions. Use of this power, and in particular the ability to make binding decisions, is triggered if:

> *[A] competent authority has not applied the [provisions of the relevant EU legislation], or has applied them in a way which appears to be a breach of Union law, including the regulatory technical standards and implementing technical standards [...], in particular by failing to ensure that a [financial institution or financial market participant] satisfies the requirements laid down in those acts.*[31]

This is clearly aimed at a national regulator's failures in the prudential supervision of a financial institution.

The power would be exercised as follows:

a an ESA may investigate the alleged incorrect application of EU law. This investigation may be undertaken at the ESA's own initiative or at the request of the Commission, the Council, the relevant stakeholder group (which in the case of the EBA is the Banking Stakeholder Group), or one or more national regulators;

31 Regulation No. 1093/2010, Regulation No. 1094/2010 and Regulation No. 1095/2010.

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b within two months of commencing an investigation, the ESA may give the national regulator a formal recommendation as to how it should comply with EU law. The national regulator then has only 10 working days to respond with assurances as to the steps that it has taken or intends to take;

c if the national regulator has not complied with EU law within one month of the recommendation, the ESA will inform the Commission of this fact. The Commission may then issue a formal opinion, requiring it to take the necessary action to comply with EU law; and

d the national regulator then has 10 working days to inform the Commission and the relevant ESA of the steps it has taken or intends to take to comply with that opinion.

As is the case with the development of new technical standards, the Commission has the final say. The Commission must issue its opinion no later than three months after the adoption of an ESA's recommendation, with an option for the Commission to extend this period by one month. The Commission's power to issue an opinion may be exercised on its own initiative or at the request of an ESA.

There are circumstances in which an ESA may take its own action without the involvement of the Commission. If the relevant requirement of EU legislation that is the subject of a Commission formal opinion is directly applicable to financial institutions (i.e., it is contained in an EU regulation), then the ESA may adopt an individual decision addressed to a particular financial institution requiring it to take the necessary action to comply with EU law, but only where the national regulator has not complied with the formal opinion within the time specified. This power is exercisable where, in the ESA's opinion, it is necessary to remedy non-compliance in a timely manner to maintain or restore neutral conditions of competition in the market or to ensure the orderly functioning and integrity of the financial system.

Action in emergency situations

The ESAs' powers here are triggered by the Council adopting a decision determining the existence of an emergency situation. The Council is required to consult the Commission and the ESRB and, where appropriate, the ESAs. An emergency situation is defined as one where there are 'adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union'.

Where the Council has adopted such a decision, the ESA may, where coordinated action is necessary, adopt individual decisions requiring competent authorities to take action in accordance with EU law that are needed to address adverse developments in the markets or the stability of the wider financial system by ensuring that financial institutions and competent authorities satisfy the requirements laid down in that legislation. The ESA can enforce a decision if the competent authority does not comply where urgent action is required.

In these circumstances, an ESA may temporarily prohibit or restrict certain financial activities if those financial activities threaten the orderly functioning and integrity of financial markets, or the financial stability of the whole or part of the financial system in the European Union. An ESA must review these decisions at least every three months, and the decision automatically expires after three months if it is not renewed. The ESA must also reconsider its decision if requested to do so by a Member State. Where the ESA considers that a permanent

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restriction or prohibition on a particular financial activity is required, it can inform the Commission, which will consider facilitating the action. An ESA is not permitted to take such actions where it would impinge in any way on the fiscal responsibilities of Member States (e.g., by requiring the financial rescue of an institution).

Settlement of disagreements

These powers arise where a national regulator is in disagreement with another regulator concerning the application of EU legislation. Following a request by one or more of the national regulators concerned, an ESA may attempt to assist the national regulators to reach an agreement. In addition, where disagreement between the national regulators can be determined on the basis of objective criteria the ESA may, on its own initiative, assist national regulators to reach agreement.

In that case:

a where, despite such assistance, no agreement is reached, the ESA may make a binding decision requiring one or more of the national regulators to take action to comply with EU law; and

b where a national regulator fails to comply with an ESA's decision and thereby fails to ensure that a financial institution complies with directly applicable requirements of EU law, the ESA may make a further decision addressed to the financial institution concerned requiring it to take any necessary action to comply.

These powers are also subject to the safeguard that no decision may impinge on the fiscal responsibilities of any Member State.

ii The ESRB

The establishment of the ESRB addressed an obvious gap exposed by the financial crisis that, at an EU level, responsibility for macroprudential analysis was fragmented, and conducted by various authorities at different levels with no mechanism to ensure that macroprudential risks were adequately identified, and that warnings and recommendations were issued clearly, followed up and translated into action.

Unlike the ESAs, the ESRB is a pan-sectoral body, covering not just the banking or investment services sector but also the insurance sector.

The responsibility of the ESRB is to provide macroprudential oversight of the financial system within the European Union to prevent or mitigate systemic risks within the financial system. The ESRB's main functions are the collection and exchange of information, the identification and prioritisation of systemic risks, and the issuance of warnings and recommendations.

Information

The information function is directed primarily at the provision by the ESRB of information on systemic risks to the relevant ESAs. In return, the ESAs, with the national central banks and Member States themselves, are required to cooperate with the ESRB and provide it with information necessary for the fulfilment of its systemic monitoring objective.

Where deemed systemically relevant, the ESRB may address a reasoned request to an ESA to provide data about particular institutions.

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Warnings and recommendations

If the ESRB identifies significant systemic risks, it must issue a warning and, if appropriate, recommendations. Warnings or recommendations may be either general or specific, and may be addressed to the Union as a whole, one or more Member States, one or more of the ESAs, one or more national regulators, or (in respect of relevant EU legislation) the Commission. Different levels of risk are differentiated by a colour-coded system to enable correct prioritisation. A Member State, an ESA or a national regulator in receipt of a recommendation from the ESRB must respond by setting out either the actions undertaken to implement the recommendation or the reasons for not following the recommendation.

The only tool available to the ESRB to deal with a refusal by the recipient of a recommendation to act on it is to inform the Council or, where relevant, the ESA or ESAs concerned. Those bodies may then take action. It will be at the discretion of the ESRB whether to make a warning or recommendation public. If it decides to do so, it must inform the Council and the addressee in advance.

iii Reform

On 20 September 2017, the Commission published a communication and adopted a package of measures to strengthen the European system of financial supervision, comprising the ERSB and the ESAs. These proposals followed a consultation on the future of the ESAs inaugurated in March 2017, as well as reflecting the Commission's August 2014 review of the ESFS. The Commission is proposing:

a stronger coordination of supervision across the European Union, whereby the ESAs will set EU-wide supervisory priorities. They will also monitor authorities' practices in allowing banks, fund managers and investment firms to delegate and outsource business functions to non-EU countries. The EIOPA will have a stronger role in promoting convergence in the validation of the internal models that some large insurance companies use to calculate solvency capital requirements. The functioning of the ESRB will also be made more efficient;

b the extension of direct supervision by the ESMA to selected capital market sectors. The Commission is proposing that the ESMA would have direct supervisory powers over critical benchmarks and data reporting services, and a greater coordinating role over market abuse regulation. It would also supervise certain prospectuses and be responsible for direct supervision of European venture capital funds, European social entrepreneurship funds and European long-term investment funds. The proposals would also extend its product intervention powers to fund managers. The Commission is not proposing to change the responsibilities of national authorities to supervise other areas, such as central depositories, money market funds, trading venues, undertakings for collective investment in transferable securities and alternative investment funds;

c improved governance and funding of the ESAs. New executive boards will prepare the ESAs' work programmes and have decision-making powers. There will also be a new funding system to ensure that the resources of the ESAs are commensurate with their tasks, with a greater contribution by industry and market participants; and

d the promotion of sustainable finance and fintech by ESAs.

On 12 September 2018, the Commission published a revised proposal that seeks to concentrate anti-money laundering powers in relation to the financial sector within the EBA, and to strengthen its mandate to ensure that risks of money-laundering are effectively and

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consistently supervised by all relevant authorities, and that the relevant authorities cooperate and share information. Among other changes, it is proposed that the EBA will be able to request national anti-money laundering supervisors to investigate potential material breaches, and to request them to consider targeted actions such as sanctions. The Parliament and the Council are currently considering these legislative proposals, and the Commission has invited the Parliament and the Council to discuss and agree these proposals as a matter of priority to ensure their entry into force before the end of the current legislative term in 2019.

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Chapter 12

FINLAND

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I INTRODUCTION

The Finnish banking sector is characterised by a strong presence of pan-Nordic banking groups in Finland coupled with robust local financial and banking groups, and specialised institutions. Finland suffered a severe banking crisis between 1991 and 1994 that thoroughly reshaped the banking sector. Partly because of this experience and ensuing structural changes, Finnish banks were able to weather the global financial crises that began in 2008 more resiliently than some of their European peers.

During 2018, Finland's total economic output increased in a broad range of sectors, but at a slower rate than in 2017, and according to the Finnish Ministry of Finance, Finnish GDP growth is expected to slow down from 2.5 per cent in 2018 to 1.5 per cent in 2019.[2] Despite a slowdown in economic growth, moderate growth in real earnings is expected to maintain demand for the labour force in Finland. In 2018, Finnish non-financial corporations (excluding housing corporations) drew down €18.6 billion worth of loans from credit institutions operating in Finland, the largest amount in three years.[3] Households' new drawdowns of housing loans in December 2018 amounted to €1.2 billion, remaining roughly at the same level as in the corresponding period in the previous year. As interest rates fell in 2018, housing loan amortisations reached an all-time high, and Finns made nearly €17 billion's worth of home loan repayments during 2018.[4] The faster amortisation of housing loans decreased Finnish consumers' loan portfolio and their overall indebtedness ratio.

The largest credit institutions in Finland measured by total assets as at 31 December 2018 were Nordea Group with €551 billion, OP Financial Group (previously OP Pohjola Group, including 157 cooperative banks) with €140.4 billion, Municipality Finance Plc with €35.7 billion, Aktia Group with €9.3 billion and the Savings Bank Group with €11.7 billion.

A significant structural change took place on 1 October 2018 when Nordea Group transferred the domicile of its parent company from Sweden to Finland. The re-domiciliation was carried out through a cross-border reversed merger, whereby the Swedish parent company, Nordea Bank AB (publ), merged into its newly established Finnish subsidiary, Nordea Bank Plc. The decision to change the parent company's domicile was based on the

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2 Source: 'Economic Survey', Winter 2018 by the Finnish Ministry of Finance, published on 19 December 2018.

3 Souce: Bank of Finland, 31 January 2019.

4 Source: Finance Finland, 11 February 2019.

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Nordea Group's unique pan-Nordic international structure, which means that the Swedish regulatory frameworks did not fully accommodate the group's operating model and recent strategic developments. Nordea Group expects that domiciling the parent company within the EU Banking Union will subject Nordea Group to the same regulatory framework as its European competitors, with greater consistency in the application of its laws and regulations.

The most significant trends in the financial markets in 2018 included the influence of digitalisation and the emergence of new technologies, driven by changing customer expectations, competition and increasing regulatory requirements. In addition, the growing awareness of the role of financial institutions in promoting sustainable growth and a positive impact on society has placed increased expectations on financial institutions to consider their corporate social responsibility. Consequently, Finnish banks have taken steps to adapt to the changing environment, and new forms of competition in the financial sector by revising their strategies and developing new services and service channels as well as cooperating with fintech companies. Furthermore, the revised Markets in Financial Instruments Directive (MiFID II)[5] and the second Payment Services Directive (PSD2)[6] became applicable in early 2018, and leading Finnish banks have accommodated new regulations by investing in the development of digital services and service channels such as mobile bank platforms, mobile payment platforms and online advisory meetings.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The primary law governing credit institutions in Finland is the Act on Credit Institutions (ACI).[7] The ACI entered into force in August 2014, replacing the previous act of the same name. One of the main objectives of the reform was to implement, via the ACI, the CRD IV Directive[8] and the Capital Requirements Regulation (CRR)[9] into Finnish legislation.

The ACI is generally applicable to all credit institutions. In addition, there are other laws on specific matters that are applicable to banks of particular forms. Deposit banks are categorised as commercial banks (banks in the form of a limited company), cooperative banks or savings banks, each of which are subject to their own specific regulation. As such, the regulatory framework in Finland consists of various laws governing specific forms of banking activities. The most important laws and regulations are the following:

a the ACI, which governs, inter alia, the establishment and management of credit institutions. The definition of a credit institution includes deposit banks and credit societies. As a general law applicable to all credit institutions, the ACI lays down the authorisation requirements, defines the permitted business activities and sets out the conduct of business rules. The ACI also contains provisions on capital adequacy and liquidity requirements;

b the Act on Commercial Banks and Other Credit Institutions in the Form of a Limited Company,[10] which regulates the operations of commercial banks. This Act lays down provisions regarding, inter alia, the division, merger, liquidation and bankruptcy of

5 Directive 2014/65/EU.

6 Regulation EU/2015/2366.

7 Act on Credit Institutions 8.8.2014/610.

8 Directive 2013/36/EU.

9 Regulation (EU) No. 575/2013.

10 28.12.2001/1501.

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commercial banks. The Companies Act,[11] as a generally applicable law, governs the corporate aspects of commercial banks except as otherwise provided for in the Act on Commercial Banks and Other Credit Institutions in the Form of a Limited Company or in the ACI;

c the Act on Cooperative Banks and Other Credit Institutions in the Form of a Cooperative,[12] which regulates the operations of cooperative banks. The Act lays down provisions regarding, inter alia, the division, merger, liquidation and bankruptcy of cooperative banks. The Cooperatives Act,[13] as a generally applicable law, governs the corporate aspects of cooperative banks except as otherwise provided for in the Act on Cooperative Banks and Other Credit Institutions in the Form of a Cooperative or in the ACI. There are two cooperative bank groups operating in Finland: OP Financial Group and POP Bank Group. At the end of 2018, OP Financial Group was made up of 157 independent cooperative banks, while POP Bank Group consisted of 26 independent cooperative banks;

d the Act on Mortgage Banks[14] and the Act on Mortgage Societies[15] regulate the operations of mortgage banks and mortgage societies, respectively. Mortgage banks and mortgage societies are credit institutions that specialise in the financing of residential and commercial real estate. However, their role is not significant in the Finnish financing sector owing to the strong position of deposit banks as providers of financing;

e the Savings Bank Act[16] governs the operations of savings banks, which have the special purpose of promoting saving. At the end of 2018, there were 23 regional savings banks operating in Finland;

f the Deposit Banks Amalgamation Act (Amalgamations Act).[17] An amalgamation of deposit banks comprises a cooperative central institution, the companies belonging to the central institution's consolidation group, the member credit institutions and the companies belonging to the member credit institutions' consolidation groups, and the credit institutions, financial institutions and service companies in which the aforementioned institutions jointly hold more than half of the voting rights. Under the Amalgamations Act, a central institution is liable for the debts of its member credit institutions. Furthermore, the member credit institutions are jointly liable for each other's debts. Pursuant to the Amalgamations Act, the aggregate amount and liquidity of the amalgamation's own funds are monitored at the amalgamation level on a consolidated basis; and

g regulations and guidelines issued by the Finnish Financial Supervisory Authority (FIN-FSA).

As regards banking services provided by non-Finnish banks, the ACI sets out conditions under which non-Finnish credit institutions may provide their services in Finland. Credit institutions from countries belonging to the European Economic Area (EEA) may provide

11 624/2006.
12 423/2013.
13 421/2013.
14 688/2010.
15 8.12.1978/936.
16 1502/2001.
17 599/2010.

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banking services in Finland either by establishing a branch or by providing cross-border services, provided that a notification is submitted to the FIN-FSA in accordance with the passporting regime available to EEA credit institutions. Credit institutions from non-EEA countries are not able to take advantage of the passporting regime available to EEA credit institutions; consequently, if a credit institution from a non-EEA country intends to provide its services in Finland, this must happen through a branch with prior authorisation from the FIN-FSA. The authorisation procedure for non-EEA credit institutions is comparable to the authorisation procedure applicable to Finnish credit institutions. At present, there are no authorisations for non-EEA credit institutions in force in Finland.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The FIN-FSA is responsible for the supervision of Finland's financial sector. The objectives of the FIN-FSA's activities are to enable balanced operations of credit institutions and other supervised entities as well as to foster public confidence in financial market operations. The FIN-FSA is further responsible for, inter alia, promoting compliance with good practice in the financial markets and disseminating general knowledge about the markets. These objectives and the duties of the FIN-FSA have been included in the Act on the Financial Supervisory Authority,[18] which sets forth a comprehensive list of the FIN-FSA's duties and delineates its supervisory powers. While the FIN-FSA operates in connection with the Bank of Finland, it makes independent decisions in its supervisory work. In addition to that work, the FIN-FSA is the authority that grants authorisations needed by many financial market participants, such as credit institutions, investment firms, fund management companies and insurance companies.

When carrying out its supervisory duties, the FIN-FSA has considerable authority to obtain information from the entities under its supervision, regardless of any rules on confidentiality. Furthermore, the entities supervised by the FIN-FSA are required to regularly file various reports to the FIN-FSA, which uses the reported data to monitor the supervised entities' economic standing and risks, and to analyse their profitability, capital adequacy, risks and business volumes.

The FIN-FSA may exercise various supervisory powers, such as imposing a temporary prohibition on a person holding a managerial position in a supervised entity or, in extreme circumstances, cancelling an authorisation granted to a supervised entity. Moreover, the FIN-FSA may impose administrative sanctions, including administrative fines, public warnings and penalty payments. By the entry into force of the new ACI, the sanctioning powers of the FIN-FSA were extended notably. In particular, the maximum amounts of penalty payments were increased significantly, bringing the maximum amounts of the penalty payments the FIN-FSA may impose for failures to comply with certain requirements of the ACI in line with the maximum penalties provided for in the CRD IV Directive.

A significant change took place in the supervisory regime when the new single supervisory mechanism (SSM) commenced its operations in Europe in November 2014. The SSM is a system of financial supervision comprising the European Central Bank (ECB) and the competent national authorities of the participating EU Member States. The legal

18 878/2008.

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basis for the SSM is Council Regulation (EU) No. 1024/2013. Within the SSM, the ECB will directly supervise significant credit institutions, and will have an indirect role in the supervision of less significant credit institutions, which continue to be supervised by their national supervisors in close cooperation with the ECB. At the time of writing, three Finnish credit institutions and groups (Nordea Group, OP Financial Group and Municipal Finance Plc) have been classified as significant institutions, and they have been transferred to the direct supervision of the ECB.

Under the SSM, the FIN-FSA will not use its powers directly where the ECB has jurisdiction. Therefore, in respect of institutions subject to ECB's direct supervision, the powers of the FIN-FSA described herein should be read also to refer to the ECB under the SSM.

The Act on the Financial Supervisory Authority contains specific provisions for the supervision of foreign supervised entities and their branches in Finland, and on cooperation with foreign supervisory authorities.

ii Management of banks

The board of directors of a bank shall create a framework for the bank's internal governance. To fulfil this and other tasks, the board may opt to create committees or other working groups that are charged with assisting the board in fulfilling its duties. The day-to-day operations of the bank are the responsibility of its senior management, consisting of, for example, the managing director and members of the management group. It should be noted that while there is no legal requirement to have a management group, it is recommended to create such a body to provide assistance to the bank's managing director in the fulfilment of his or her duties.

In addition to the organisational requirements discussed above, a bank's managers must fulfil certain obligations (as set forth in the ACI and in the FIN-FSA's regulations and guidelines) to manage the bank professionally and in a way that complies with sound business principles. All banks must maintain an effective risk-management system that seeks to manage and reduce risks to the bank's liquidity and capital adequacy. The FIN-FSA's supervision of banks' corporate governance procedures takes particular note of certain items including, inter alia:

a the planning and management of a bank's activities;
b the establishment of an internal audit function;
c the organisation of a bank's activities in general (identification of conflicts of interest, storage of information, effective customer complaint procedures, etc.); and
d whether the bank maintains sufficient personnel for its operations, has created and follows a strategic business plan, and ensures that its operations are governed according to sound professional and ethical standards.

Each credit institution is required to follow certain rules, pursuant to the ACI, which include a requirement to have a remuneration policy that is in line with the business strategy, objectives, values and long-term interests of the institution. Additionally, remuneration policies must be consistent with, and promote, sound and effective risk management, and must not encourage risk-taking that exceeds the level of tolerated risk of the institution. The rules of the ACI governing remuneration policies are in line with those of CRD IV.

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iii Regulatory capital and liquidity

Authorisation for a credit institution will be granted if the preconditions set out in the ACI are met. These include, inter alia, that the share capital, cooperative capital or basic capital must be at least €5 million and fully paid at the time of granting a licence, and that the credit institution must meet the capital requirements set out in the ACI.

The implementation of the CRD IV package introduced significant changes to the prudential regulatory regime applicable to Finnish credit institutions, including increased capital requirements, and changes in the elements of own funds and in the calculation of own fund requirements. The directly applicable CRR entered into force in Finland on 1 January 2014, whereas the requirements of CRD IV were implemented in Finland through the ACI.

In light of the implementation of the CRD IV package, Finnish regulatory capital and liquidity requirements are determined in accordance with both the CRR and the ACI. Pursuant to the ACI, a Finnish credit institution must continuously hold the required minimum amount of own funds and consolidated own funds, calculated in accordance with both the CRR[19] and Chapter 10 of the ACI. Under the ACI, the definition of own funds corresponds to the definition of own funds as set forth in the CRR.[20]

Pursuant to the CRR, credit institutions must have a Common Equity Tier 1 capital ratio of at least 4.5 per cent, a Tier 1 capital ratio of 6 per cent and a total capital ratio of 8 per cent (each ratio expressed as a percentage of the total risk exposure amount). Furthermore, pursuant to the ACI, an additional capital conservation buffer of 2.5 per cent has been applicable from 1 January 2015 to all credit institutions. The FIN-FSA is also authorised to set a countercyclical buffer of zero to 2.5 per cent based on macroprudential analysis. Both the additional capital conservation buffer and the countercyclical buffer must be satisfied with Common Equity Tier 1 capital. At the time of writing, the FIN-FSA has not imposed the countercyclical buffer. As of 1 January 2018, the FIN-FSA has been authorised to set a systemic risk buffer of between 1 and 5 per cent on credit institutions to be applicable from 1 January 2019 at the earliest. The FIN-FSA made a decision on the level of systemic risk buffer requirements for Finnish credit institutions on 29 June 2018. Finally, there is an additional capital buffer requirement for other systemically important institutions (O-SIIs) whose failure or other malfunction would be expected to jeopardise the stability of the national financial system. The O-SII buffer for credit institutions operating in Finland may be set at zero to 2 per cent of the total risk exposure amount and must be satisfied with Common Equity Tier 1 capital. At the time of writing, the FIN-FSA has imposed additional capital requirements (O-SII buffers) on three Finnish credit institutions.[21]

The ACI also contains specific provisions on the consolidated supervision of banking groups, including provisions on the calculation of own funds on a consolidated basis, consistent with the CRR and CRD IV.

The FIN-FSA has issued further national regulations and guidelines on the calculation of capital requirements and large exposures. These instructions are related to the national application of the CRR and contain, inter alia, the FIN-FSA's guidelines on the categorisation

19 Article 92(3) of the CRR.

20 Article 4(1)(118) of the CRR.

21 These credit institutions are Nordea Group, OP Financial Group and Municipal Finance Plc.

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of various Finnish capital instruments into Common Equity Tier 1, additional Tier 1 or Tier 2 instruments for the purposes of satisfying the own funds requirements imposed by the CRR and the ACI.

As regards liquidity requirements, Finnish credit institutions must comply with the liquidity requirements set forth in the CRR and as further specified by the Commission Delegated Regulation.[22]

iv Recovery and resolution

Directive 2014/59/EU, providing for the establishment of a European-wide framework for the recovery and resolution of credit institutions and investment firms (BRRD), entered into force on 2 July 2014. EU Member States were required to adopt and publish the implementing regulations to comply with the BRRD by 31 December 2014. In addition, the European Union has adopted a directly applicable regulation governing the resolution of the most significant financial institutions in the eurozone (i.e., a regulation establishing a Single Resolution Mechanism Regulation (SRM Regulation)).[23]

In Finland, the BRRD was implemented mainly through two new acts: the Act on Resolution of Credit Institutions and Investment Firms (Resolution Act)[24] and the Act on the Financial Stability Authority.[25] The latter regulates the Finnish Financial Stability Authority (Stability Authority), which is the national resolution authority and is responsible for the resolution of credit institutions and investment firms in Finland. Among its key tasks, the Stability Authority draws up resolution plans for institutions, decides whether a failing institution is to be placed under resolution and applies the necessary resolution tools to an institution under resolution. The implementation of the BRRD also involved amendments to dozens of existing acts, most notably to the ACI, and the repeal of the Act on the Temporary Bank Levy and of the Act on the Government Guarantee Fund.

Under the new regime, credit institutions are generally required to draw up recovery plans to secure the continuation of their business in the event of financial distress. These plans must include options for measures to restore the financial viability of the institution and must be updated annually. The plans must be submitted to the scrutiny of the FIN-FSA.

In the context of the new legislation, the FIN-FSA has been empowered to apply early intervention tools to banks and investment firms. These tools may be used if the FIN-FSA has solid reasons to believe that an institution will fail in regard to its licensing conditions, liabilities or obligations under the capital adequacy regulations within the next 12 months. The early intervention tools include, inter alia, the right of the FIN-FSA to:

a require the bank's management to implement measures included in the recovery plan;
b convene a general meeting of shareholders for the purpose of taking necessary decisions for recovery;
c require the removal of members of the bank's management; and
d require changes to the legal and financial structure of the institution.

22 Commission Delegated Regulation (EU) 2015/61.
23 Regulation (EU) No. 806/2014.
24 1194/2014.
25 1195/2014.

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Pursuant to the Resolution Act, the Stability Authority shall set up and maintain a resolution plan for each institution. The resolution plan must be ready for execution in the event that the institution needs to be placed in a resolution process.

The Resolution Act vests the Stability Authority with resolution powers and tools as provided in the BRRD. If the Stability Authority considers that an institution is failing or likely to fail, and that there is no reasonable prospect that any private or early intervention measures or write-down of capital instruments would prevent the failure, and further that resolution is necessary in the public interest, the Stability Authority is empowered to declare and initiate a resolution process in respect of the institution.

During such a process, the institution could be subject to the exercise of a number of resolution tools: mandatory write-down of debts or conversion of debts into equity (bail-in), sale of business, bridge institution and asset separation. To continue the operations of the institution, the Stability Authority has the power to decide upon covering the losses of the institution by reducing the value of the institution's share capital or cancelling its shares.

The BRRD (and consequently the Resolution Act) provide a requirement for credit institutions to meet the minimum requirement for own funds and eligible liabilities (MREL) designed to ensure sufficient loss-absorbing capacity to enable the continuity of critical functions without recourse to public funds. All institutions must meet an individual MREL requirement calculated as a percentage of total liabilities and own funds and set by the relevant resolution authorities. The Stability Authority has started gathering information from credit institutions in its direct jurisdiction. Based on the gathered information, the Stability Authority has been preparing individual resolution plans and decisions on eligible liabilities under MREL for Finnish credit institutions. The process and schedule of the planning and decision process varies between institutions.

The SRM Regulation has established a pan-European resolution authority, the Single Resolution Board (SRB). The SRB has been fully operational, with a complete set of resolution powers, since January 2016. These powers have replaced the resolution powers of the Stability Authority in respect of the Finnish institutions that are subject to the SRM Regulation.[26]

As part of the single resolution mechanism, a new Single Resolution Fund (SRF) managed by the SRB commenced operations in January 2016. Finnish credit institutions must pay annual contributions to the SRF. The amount of the contributions shall be determined in accordance with the SRM Regulation.

IV CONDUCT OF BUSINESS

The ACI sets out the conduct of business rules for banks, and lays down provisions on civil and criminal liability for breaching those rules.

As regards the activities banks may engage in, all credit institutions may provide various financing services (such as lending, leasing and factoring) as well as other services covered by their licence, but only deposit banks are entitled to accept deposits from the public. The regulation concerning payment accounts with basic features was amended through the adoption of the Payment Accounts Directive[27] (PAD) via the ACI on 1 January 2017. Pursuant to the ACI, customers are always entitled to certain basic banking services, as a result of which deposit banks may only refuse to open a payment account with basic features

26 Namely, OP Cooperative and Municipal Finance Plc.

27 Directive 2014/92/EU.

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and to offer payment services relating to that payment account for weighty reasons, such as non-compliance by the customer with anti-money laundering obligations. Following the implementation of the PAD, online banking credentials are also considered a part of basic banking services, and banks may no longer refuse to offer online banking credentials to, for example, customers with a bad credit history.

With the entry into force of the ACI in 2014, certain new conduct of business obligations were introduced in the legislation; these include the obligation for banks to comply with good banking practice, the content of which is likely to evolve in the future. Furthermore, a binding maximum loan-to-value (LTV) ratio for housing loans was introduced in the legislation. The binding maximum LTV ratio, and the FIN-FSA's power to tighten this ratio, entered into force on 1 July 2016. In November 2015, the FIN-FSA issued specific guidelines on the calculation of the LTV ratio to harmonise the LTV concept in the market of housing loans for personal customers. Foreign (non-Finnish) credit institutions providing services in Finland must also comply with these guidelines.

The ACI also provides banks' clients with extensive protection as regards banking secrecy. In practice, banking secrecy rules are generally strictly applied in Finland, although there are certain notable statutory exemptions to the banking secrecy obligations, including the ability to provide information within the same group of companies for certain purposes, and the right of certain authorities to obtain information.

Since the enactment of the ACI, the legislation now contains express provisions requiring non-Finnish credit institutions to comply with the conduct of business obligations set forth in the ACI when offering banking services in Finland, irrespective of whether these services are offered through a Finnish branch or on a cross-border basis.

The ACI contains provisions on both civil and criminal liability, although breaches of certain provisions of the ACI are governed by the Finnish Penal Code. Under the ACI, civil liability for damage caused due to wilful misconduct or negligence when performing their duties extends to the founder of a credit institution, the members of its supervisory board and board of directors, as well as the credit institution's managing director.

V FUNDING

The main source of funding for banks operating in Finland is deposits. The banks fill the funding gap between lending to customers and accepting deposits by issuing bonds mainly to international wholesale capital markets. The market demand for the bond issuances of Finnish banks has remained satisfactory. The market has seen the introduction of CRR-compliant additional Tier 1 and Tier 2 instruments. As part of the new CRR regime, banks need to consider the capital adequacy treatment of each of the instruments. Being cautious about any possible strings attached, Finnish banks have not resorted to ECB special funding facilities to any significant extent.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Prior notification to the FIN-FSA is required when acquiring shares or interests, either directly or indirectly, in a credit institution and thereby establishing a qualifying holding

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(i.e., at least 10 per cent of the shares or comparable other capital of the credit institution, or at least 10 per cent of the voting rights or other holding entitling the holder to exercise similarly significant influence in the credit institution).

The FIN-FSA must also be similarly notified if the holding in a credit institution is increased so that the proportion of the share or comparable other capital or voting rights held reaches or falls below any of the thresholds of 20, 30 or 50 per cent of the same, or results in the credit institution becoming or ceasing to be a subsidiary of the acquirer. The same notification requirements apply where an acquirer is party to an agreement or other arrangement that, if or when effected, will result in the acquirer's holding reaching, exceeding or falling below one of the aforementioned thresholds.

The names of the owners of holdings referred to above, as well as the sizes of those holdings, must be notified by the credit institution or its financial holding company to the FIN-FSA at least once a year, and any changes in the ownership of any holdings that have come to its notice must immediately be notified by the credit institution or its financial holding company.

The FIN-FSA may, within 60 business days of receipt of the notification, object to the acquisition of the holding if the holding would endanger the business operations of the credit institutions being carried out in accordance with prudent and sound business principles, and the endangerment is grounded on a breach of additional approval criteria.

The FIN-FSA may prohibit the exercise of voting rights in the credit institution by the acquirer for periods of one year at a time where an acquisition violated the acceptance criteria of the FIN-FSA's opposition or is not duly notified to the FIN-FSA, resulting in, inter alia, the suspension of all the rights related to shares or participations in a credit institution other than the right to profit.

ii Transfers of banking business

The Act on Commercial Banks and Other Credit Institutions in the Form of a Limited Company contains provisions on mergers, demergers and transfers of business of a credit institution operating in the form of a limited liability company. Corresponding transfers of business provisions are also included in the Savings Bank Act and in the Act on Cooperative Banks and Other Credit Institutions in the Form of a Cooperative, which means that savings banks and cooperative banks are also able to transfer business to another credit institution in accordance with the special regime. The provisions require, inter alia, a merger, demerger or transfer plan to be prepared, and public summons to be given to the creditors of the bank, except for its depositors.

Creditors, excluding depositors, are entitled to object to the arrangement, usually within a period of three to four months of the date of the public summons. If the prompt completion of the arrangement is considered necessary by the FIN-FSA to safeguard the stable operation of a credit institution, the arrangement can be executed, despite any objections by creditors whose position will not be jeopardised by the arrangement, in the FIN-FSA's opinion.

Creditors who have objected to the arrangement under any other circumstance must give their consent and receive payment or be granted a security for their claims before the completion of the arrangement. Even though they are not considered creditors, banks' depositors must be informed of the arrangement. Depositors whose deposit would be excluded from the deposit guarantee in full or in part are entitled to terminate their deposits.

The FIN-FSA must be informed of the arrangement before the public summons is applied for, and informed in due course of creditors' potential objections. The FIN-FSA has

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an individual right to object to the arrangement in the event that the receiving party will not need to apply for a new authorisation and the FIN-FSA considers that the arrangement endangers the fulfilment of the conditions for the bank's authorisation.

VII THE YEAR IN REVIEW

With regard to the regulation of the Finnish banking sector, as of 1 January 2018, the FIN-FSA has been authorised to set a systemic risk buffer of 1 to 5 per cent on credit institutions to be applicable from 1 January 2019 at the earliest. The FIN-FSA made a decision on the level of systemic risk buffer requirements for Finnish credit institutions on 29 June 2018. In addition, the Insolvency Hierarchy Directive[28] regarding the ranking of unsecured debt instruments in insolvency hierarchy was implemented into national legislation through the ACI. The implementation of the Insolvency Hierarchy Directive creates a new category of senior non-preferred debt, and entitles credit institutions to agree on the ranking of non-preferred financial instruments in accordance with the EU legislation.

Further amendments to the ACI, the Act on Commercial Banks and Other Credit Institutions in the Form of a Limited Company and the Resolution Act relating to the implementation of the CRD IV package and certain requirements arising from the General Data Protection Regulation[29] are currently pending.

As regards structural changes in the banking industry, the most significant event of the year was the previously mentioned re-domiciliation of the Nordea Group's parent company from Sweden to Finland on 1 October 2018. The re-domiciliation was carried out through a cross-border reversed merger by way of absorption, through which the Swedish parent company Nordea Bank AB (publ) was merged into its wholly owned subsidiary Nordea Bank Plc, a newly established public limited liability company registered under the laws of Finland. Through the re-domiciliation, Nordea Group comes under the direct supervision of the ECB, but a majority of the supervisory work will be undertaken by the FIN-FSA. Consequently, the FIN-FSA was required to strengthen its resources and recruit approximately 30 people for the supervision of Nordea Group.[30]

VIII OUTLOOK AND CONCLUSIONS

Digitalisation, the emergence of new technologies and increasing regulatory requirements are reforming the financial sector and increasing competition. While technological development provides opportunities for new service concepts, rising customer expectations and competition beyond the traditional banking sector is putting pressure on banks to revise their strategies and operating models rapidly. The implementation of PSD2 into national legislation in 2018 has also attracted, and is expected to further attract, new entities to enter into the financial market. Digitalisation has also increased threats arising from cyber-related crimes, which challenges banks to establish new approaches to cybersecurity. As a result, Finnish banks have taken steps to prepare for the changing environment by investing in developing IT systems and new services and service channels, as well as cooperating with

28 Directive (EU) 2017/2399.

29 Regulation (EU) 2016/679.

30 Interview with Anneli Tuominen, Member of the Supervisory Board of the ECB, ECB Supervision Newsletter, 16 May 2018.

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fintech companies. However, digitalisation has not introduced major changes in lending, and although the Finnish regulatory framework for crowdfunding[31] has facilitated entry into the lending market, markets for peer-to-peer lending and crowdfunding have remained relatively small.

Despite the continued low interest environment, the profitability of the Finnish banking sector has remained relatively good. The capital adequacy of the Finnish banking sector is also strong, clearly exceeding the requirements imposed by the CRD IV regime. However, the low level of interest rates is placing a strain on Finnish banks; consequently, they have continued to reinvent their business models and strived to strengthen their ability to compete by undertaking structural reorganisations. These structural changes are likely to continue.

31 The Finnish Act on Crowdfunding (734/2016) entered into force in 2016.

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Chapter 13

FRANCE

Didier Martin, Samuel Pariente, Jessica Chartier, Béna Mara and Gaël Rivière[1]

I INTRODUCTION

The banking sector in France is characterised by its highly integrated nature – the six leading French banking groups in terms of net banking income for 2017 were BNP Paribas, BPCE, Groupe Crédit Agricole, Société Générale, La Banque Postale and Groupe Crédit Mutuel.

Pursuant to Regulation 1024/2013, 12 French banking groups are significant, representing 33 per cent of the total banking assets held by significant credit institutions supervised by the European Central Bank (ECB).

Another key feature of the French banking sector is the presence of cooperative and mutual benefit banking groups. Three of the five largest banking groups in France are mutual benefit banking groups. The main characteristic of these groups is their inverted pyramid structure. The groups are held by cooperative banks, which are in turn owned by their cooperative member-shareholders. The banking industry is one of the main private employers in France (employing more than 366,200 people in 2017).

Since 2014, the most significant event with respect to the French banking system has been the implementation of a harmonised European regulatory framework. This includes:

a a Single Supervisory Mechanism (SSM);
b a Single Resolution Mechanism (SRM);
c the Bank Recovery and Resolution Directive (Directive 2014/59/EU) (BRRD); and
d the adaptation of the national regulation framework thereto.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Five significant steps towards European harmonisation have been taken since 2011:

a on 1 January 2011, the European Banking Authority (EBA) was created;
b on 26 June 2013, the EU adopted a legislative package to implement the Basel III Accords into the EU prudential framework, and to strengthen the regulation and supervision of the banking sector in Europe by introducing harmonised rules (the CRD IV Package);
c on 29 October 2013, the EU adopted the creation of the SSM to confer specific supervision tasks on the ECB;
d on 30 July 2014, the EU enacted the creation of a bank SRM, elements of which entered into force on 19 August 2014; and

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e on 15 May 2014, the European Union enacted the BRRD, which was amended as regards the ranking of unsecured debt instruments in an insolvency hierarchy by a directive dated 12 December 2017.

Other than EU regulations of direct application, the statutory framework applicable to the regulation of banking activities is provided by the French Monetary and Financial Code, and by specific decrees and orders. The power to regulate the banking and financial sector is now shared between European legislature and the French Minister of Economy and Finance, assisted by a consultative authority, the Advisory Committee on Financial Legislation and Regulation.

In addition, the EBA issues regulatory guidelines and recommendations. In principle, the French Prudential Control and Resolution Authority (ACPR) must inform the EBA within two months whether it complies or intends to comply with those guidelines and recommendations.

In accordance with Regulation (EU) No. 1024/2013,[2] since 4 November 2014, the authority to supervise and control banks is shared between the ACPR and the ECB. The ECB supervises all credit institutions with respect to certain domains, such as granting or withdrawing banking licences, or assessing acquisitions of qualifying holdings in such institutions. In addition, the ECB is the sole competent prudential regulator for credit institutions that are categorised as significant entities, as recently reaffirmed by the European Court of Justice.[3] The ECB has also issued a letter stating that it is directly competent to exercise, in certain situations, supervisory powers granted under national law.[4]

The ACPR remains directly in charge, subject to the oversight of the ECB, of credit institutions that are classified as less significant. These authorities cooperate, and the terms of such cooperation are defined, inter alia, in Regulation (EU) No. 468/2014 of 16 April 2014.

The ACPR is a public authority without legal personality. The French Central Bank (Central Bank) plays a key role in the functioning of the ACPR. It is chaired by the governor of the Central Bank, and the administrative staff are seconded from the Central Bank.

In accordance with EU Regulation No. 806/2014,[5] since 1 January 2016, the authority to implement a bank resolution in France is shared between the national resolution authority, which is the resolution college within the ACPR, and the Single Resolution Board.

Banks and investment service providers also fall within the remit of the French Market Authority (AMF), which supervises compliance with professional rules relating to the provision of investment services and asset management activities.

The provision of banking services in France requires a licence that is, since 4 November 2014, granted by the ECB, while the provision of investment services requires a licence obtained from the ACPR. Portfolio management companies (i.e., investment companies providing portfolio management services on behalf of third parties or collective portfolio management as their main activities) must be authorised by the AMF.

2 EU Regulation No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

3 CJEU, ECLI:EU:T:2017:337, 16 May 2017, *Landeskreditbank Baden-Württemberg v. ECB*.

4 Letter from the ECB, additional clarification regarding the ECB's competence to exercise supervisory powers granted under national law, SSM/2017/0140 of 31 March 2017.

5 EU Regulation No. 806/2014 of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a single resolution mechanism and a single resolution fund.

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Banks and investment firms licensed in a Member State of the European Economic Area (EEA) benefit from a mutual recognition procedure, and are authorised to provide banking or investment services in France through a branch or by virtue of the free provision of services subject to the procedures required in their home state and to the competent authority being informed of the provision of those services. A non-EEA bank may either apply for a licence or establish a representative office in France, but only to provide information, liaison or representation services to French customers (i.e., such an office is not permitted to carry out any banking operations in France). The competent authority must be notified of the opening of a representative office.

Under French law, only authorised credit institutions or financing companies may, on a regular basis, enter into credit transactions and only credit institutions may, on a regular basis, receive repayable funds from the public. These restrictions are commonly referred to as the French banking monopoly. Rules applicable to finance companies were outlined in a decree published on 13 November 2014. New exceptions from the banking monopoly have been included:

a by Ordinance No. 2014-559, dated 30 May 2014, to allow crowdfunding companies to carry out their business in France;

b by Law No. 2015-990, published on 6 August 2015 (known as the Macron Law), allowing certain companies to grant credit for a maximum term of two years to small and medium-sized businesses with whom they maintain a business relationship;

c by Law No. 2015-992, published on 17 August 2015, allowing third-party financing companies to grant credit to builder–owners in the field of energy-efficient construction;

d by Law No. 2016-1691, published on 9 December 2016, regarding transparency, anticorruption and economic modernisation, certain funds are entitled to carry out credit transactions; and

e by Ordinance No. 2017-1432, published on 4 October 2017, on the modernisation of the legal framework of asset management and debt financing.

For banks authorised to carry out investment services, it should be noted that at the beginning of January 2019, the European Commission published a draft delegated regulation on how investment firms should take into account the environmental, social and governance preferences of clients.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Since 4 November 2014, the prudential supervision of a credit institution is handled by the ECB or the ACPR, depending on whether the institution is qualified as a significant entity or a less significant entity. In addition, the AMF has investigative and jurisdictional powers with regard to financial activities.

Supervision by the ACPR

The ACPR carries out supervision of banks mainly in two ways: off-site monitoring and on-site inspections.

Off-site monitoring is based on an in-depth examination by the ACPR of accounting and prudential filings, which are usually submitted quarterly, along with internal audit reports filed once a year, and on regular contact with the senior managers of credit institutions. The

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ACPR adopts a different approach when dealing with large credit institution groups, based on a structured programme of enhanced supervision meetings, in addition to dealing with specific issues, overseeing the implementation of recommendations made following on-site inspections and periodic meetings with financial departments and the departments in charge of measuring and monitoring risks, particularly when quarterly earnings figures are published. Moreover, the ACPR may request at any time that a credit institution provide it with any supplemental information. Banks are also required by law to advise the ACPR promptly of any fact or decision that may constitute a breach of existing regulations, and which is likely to have a significant effect on the financial situation, profits or assets of the bank.

ACPR on-site inspections are designed to ensure that the information disclosed by banks accurately reflects their situation. The ACPR usually carries out a general inspection every one or two years. In addition to these routine inspections, if deemed necessary on the basis of a review, the ACPR also carries out more specific inspections on targeted risks or business segments. For more transparency, the ACPR has compiled in a charter rules governing the inspection process and the rights and obligations of the persons checked as well as of the controllers.

Following its off-site monitoring and on-site inspections, the ACPR sends a follow-up letter to the relevant institution. If the ACPR finds that the credit institution's liquidity or solvency is at risk or that the interests of clients are threatened, it may:

a send a cautionary notice to the management of the credit institution concerned, allowing it to provide the ACPR with explanations;

b issue a recommendation to the credit institution describing the measures designed to improve the credit institution's financial condition or management methods;

c issue an injunction to the credit institution requiring it to take certain specific measures within a set period; or

d order the following interim protective measures in the most serious cases:

- special surveillance;
- appointment of one or more ACPR officers;
- suspension, temporary restriction or prohibition of the free disposal of all or part of the assets of the credit institution;
- cessation of the credit institution's activities;
- limitation on the number of branches or agencies of the credit institution;
- the transfer of some or all of the credit institution's credit or deposit portfolios;
- limitation of or prohibition on the distribution of dividends;
- cessation of interest distribution for certain holders of additional Tier 1 funds;
- suspension of one or more senior managers of the credit institution;
- appointment of a temporary director;
- transfer of one or several activities;
- transfer of all or part of the credit institution's assets, rights and obligations to a bridge credit institution with a view to continuing or selling its business;
- implementation of bail-out measures (including capital reductions, cancellation of shares or liabilities);
- issuance of new equity instruments; or
- a prohibition on paying prior debts.

Since 20 February 2014, the ACPR may also require credit institutions to submit a recovery programme.

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Through its enforcement powers, the ACPR may impose a wide range of sanctions, either in respect of a breach of regulations or for failure to comply with obligations resulting from a cautionary notice, a recommendation or an injunction issued by the ACPR. These sanctions include (in ascending order of severity):

a a warning;
b a reprimand;
c a prohibition on engaging in certain operations or limits on the conduct of certain credit institution activities;
d a temporary suspension of one or more senior managers of the credit institution (with or without the appointment of a provisional administrator);
e requiring the resignation of one or more managers or directors, or both (with or without the appointment of a provisional administrator);
f a partial withdrawal of the credit institution's licence (with respect to specific banking activities); and
g striking the bank off the list of credit institutions authorised to conduct banking activities in France (with or without the appointment of a liquidator).

In addition to these measures, the ACPR may also:

a impose a fine of up to €100 million or 10 per cent of the annual turnover;
b prohibit or limit the payment of dividends to shareholders;
c order any of the above-mentioned sanctions to be made public at the expense of the bank; or
d order a penalty payment to compel execution of its sanctions.

Supervision by the AMF

Banks authorised to offer investment services are also supervised by the AMF, to the extent that they provide those services.

The AMF may impose a warning, reprimand, or temporary or permanent ban on providing some or all of the investment services provided by an authorised bank. In lieu of, or in addition to, these sanctions, the AMF may impose fines of up to €100 million or 10 times any profit earned in violation of applicable rules. For certain offences, the sanction may amount to 15 per cent of the annual turnover.

Individuals acting under the authority of or on behalf of credit institutions may be liable to receive a warning, reprimand, a temporary suspension or withdrawal of their professional licence, and a temporary or permanent ban on conducting some or all business activities. In lieu of, or in addition to, these sanctions, the AMF may impose a fine of up to €15 million or 10 times any profit earned, or €300,000 or five times any profit earned, for violations of the applicable rules, depending on the seriousness of the violation.

ii Management of banks

For significant credit institutions under the supervision of the ECB, the French regulations referred to below are to be read in conjunction with the governance requirements set out in EU Regulation No. 1024/2013.

On 26 September 2017, the EBA and the European Securities and Markets Authority (ESMA) published joint guidelines on the assessment of the suitability of members of management bodies and key function holders, which entered into force on 30 June 2018; on the same day, the EBA published revised Guidelines on Internal Governance. The ACPR

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published on 5 June 2018 a notice declaring its compliance with the second guidelines and its partial compliance with the first guidelines. As regards the guidelines on the assessment of the suitability of members of the management body and key function holders, the ACPR declared its intention to comply with the document with the exception of those paragraphs relating to the supervisory authority's assessment of the suitability of key functions holders, and in relation to the paragraphs relating to the presence and the definition of independent members, subject to two reserves of interpretation.

Management

French banks are managed by at least two senior managers. In practice, before the implementation of the CRD IV Package, banks usually took the form of a public limited company with a board of directors, an executive chair and a deputy chief executive officer (CEO). However, since the implementation of the CRD IV Package by way of a 20 February 2014 ordinance, and guidance dated 29 January 2014 from the ACPR, the latter expressly requires the separation of the functions of the chair and the CEO, which has led to a reorganisation of the management of major banks in France. That requirement has recently been confirmed by the General Court, which has declared, regarding regional branches of a major French mutual banking group, that the same person may not occupy at the same time the post of chair of the board of directors and that of the effective director of a credit institution subject to prudential supervision.

Senior managers are appointed by the board of directors, subject to the approval of the ACPR, which ensures that they are fit and proper. Managers are collectively responsible for the effective implementation and the general direction of the bank's business, internal control, accounting and financial information, and capital requirements.

The 20 February 2014 ordinance also modified the rules on the number of corporate offices held by senior managers of a credit institution, which is now restricted to no more than one executive mandate and two non-executive mandates for the same person at the same time; and no more than four mandates as a member of the board of directors, supervisory board or any other body performing equivalent functions at the same time.

The ACPR also pays particular attention to the availability of managers, and makes sure in particular that, notwithstanding the aforementioned restriction, managers of a credit institution devote sufficient time to fulfilling their duties.

Decision-making body

Banks are usually incorporated as public limited companies in which the decision-making body is the board of directors. Managers report to the board of directors, which must comprise at least three members. Banks and investment companies are required, as with respect to the senior managers, to notify the ACPR of the appointment or renewal of their directors. The ACPR is entitled, based on similar criteria as those applicable to senior managers, to oppose any appointment or renewal. Similarly, the ACPR may demand the resignation of a director as a sanction for breach of an applicable regulation or failure to comply with any of the ACPR's recommendations or injunctions.

The board is in particular responsible for supervising the management and the global situation of the bank as well as the implementation of its strategy. At least once a year, the board must review the activities and results of the internal control.

An audit committee is required to assist the board of directors in the exercise of its functions.

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Control functions

Banks must appoint two control officers who are responsible for ensuring permanent and periodic control respectively, and who report to the managers and, as the case may be, the board of directors or the audit committee.

Banks are also required to appoint a compliance officer to ensure compliance with all relevant applicable rules. Depending on the bank's size, the functions of the compliance officer may be exercised by the permanent officer.

It is also compulsory to appoint a risk management officer, who is responsible for a bank's risk analysis and risk measurement systems. The risk manager does not have any operational role unless he or she is a senior manager.

Smaller banks may elect to entrust these functions to a manager, who is usually a member of the board.

Risk, nomination and compensation committees

Banks are required to create a separate risk committee to supervise the implementation of risk management procedures and policies (except for non-significant banks, which may merge their risk committee with their audit committee). This committee acts under the exclusive and collective liability of the members of the board of directors or supervisory board, as the case may be.

The CRD IV Package provides for the creation of a risk committee within a bank's board of directors or supervisory board, as the case may be, composed exclusively of members not exercising any management powers, and a risk division in each bank. These rules have been transposed into French law.

Following the transposition of the CRD IV Package into the Monetary and Financial Code, institutions with a balance sheet exceeding €5 billion must now create a nomination committee and a compensation committee.

In the case of credit institution groups that are subject to supervision on a consolidated basis, these specific committees may, in principle, be implemented at the level of parent companies of the consolidated group only.

Compensation

Rules governing compensation are contained in Article L511-71 et seq. of the Monetary and Financial Code. In particular, these rules provide that:

a the board of directors, or supervisory board, adopts and regularly reviews the compensation policy with the support and advice of the compensation committee;

b the compensation policy must be adequate for the economic strategy, aims, values and long-term interests of the bank; must incorporate measures that aim to avoid conflicts of interest; and must not encourage risk taking above the threshold fixed by the bank;

c the shareholders must be consulted every year about the global amount of remuneration given to directors and employees exercising activities that have a significant influence on the bank or group's risk profile (i.e., a say-on-pay procedure for risk takers);

d at least once a year, implementation of the compensation policy must be subject to an internal and independent evaluation to ensure its compliance with the compensation policy and the process governing compensation adopted by the board of directors or supervisory board of the bank. The compensation committee must assess the compensation policy and the remuneration granted to the bank's directors every year;

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e the variable remuneration of employees exercising control functions must not be based on the controlled activities;

f the compensation policy must clearly distinguish between fixed remuneration (experience-based) and variable remuneration (performance-based);

g the variable remuneration must take into account the overall performance of the employee and of its unit, must be based on long-term objectives and cannot be guaranteed; and

h credit institutions must ensure that the variable remuneration of senior employees, management or risk takers cannot exceed their fixed remuneration, except if otherwise decided by the shareholders by a two-thirds majority.

In addition, the EBA published on 21 December 2015 guidelines on sound remuneration policies, and the ACPR declared it would require compliance with the major part of these guidelines.

The ACPR can impose a revision of a bank's compensation policy if it considers that such a policy is not compatible with sound risk management and the long-term objective of growth. Institutions must also be able to justify the amount and terms of payment of variable remuneration.

In addition, the ECB supervises the remuneration of the management bodies of significant entities, and at the start of 2019 published recommendations for a dividend policy.

iii Regulatory capital and liquidity

The current French requirements regarding capital and prudential ratios are those resulting from the implementation of the CRD IV Package.

If a French credit institution is categorised as a significant entity, compliance with the prudential requirements described below is supervised by the ECB.

Minimum capital requirements

Banks with headquarters in France are required to have a minimum share capital of €5 million.

The ACPR carries out a periodic assessment of banks' compliance with the capital adequacy guidelines, and may adopt a variety of measures to ensure that a shortfall in capitalisation is remedied: it may order a bank to increase its share capital; it may appoint a provisional administrator vested with the full powers of administration, management and representation of the credit institution; or, when appropriate, the governor of the Central Bank is entitled to invite (not require) the shareholders of the bank to provide the necessary support.

Prudential ratio requirements and composition of regulatory capital

Solvency ratio

The Capital Requirements Regulation imposes harmonised rules relating to prudential ratio requirements in the EU, which are directly applicable to French banking institutions, whereas the CRD provides for additional requirements that have not yet been fully implemented in France (i.e., additional own funds buffers).

The solvency ratio, according to the CRD IV Package, now includes the following categories: Common Equity Tier 1 (CET1), Tier 1 and Tier 2. Tier 3, provided for under CRD III, was abolished by the CRD IV Package.

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In addition to the 8 per cent ratio, the CRD IV Package introduces three additional capital buffers (a capital conservation buffer equal to 2.5 per cent of CET1, a countercyclical capital buffer, currently equal to zero per cent (being increased to 0.25 per cent as of 1 July 2019), and the systemic buffer). These have been applied since 1 January 2016. In addition, local banking regulators can apply an additional buffer for other systemically important institutions, as well as institutions important to the EU.

Finally, each Member State may introduce a systemic risk buffer for the financial sector. Since 2015, this buffer has been capped at 5 per cent, but in France it is currently at zero per cent due to the lack of a decision by the French stability board (HCSF).

Liquidity ratio

The CRD IV Package introduced two mandatory liquidity ratios: the liquidity coverage ratio (LCR) and the net stable funding ratio. Until a mandatory level is required for this second ratio, banks with headquarters in France will be required to comply only with the LCR, which since 2018 has required them to maintain, at all times, an LCR of at least 100 per cent.

Exposure requirements

Banks with headquarters in France are required to maintain their overall exposure resulting from operations per beneficiary below the higher of €150 million or 25 per cent of their own funds.[6]

Supervision of banking groups

French banking groups that do not fall within the scope of the general EU-wide ECB supervision are subject to supervision on a consolidated and individual basis. All institutions that belong to a French banking group are subject to an assessment, the scope of which depends on their position within their group.

For the parent institution, the evaluation process is primarily implemented on a consolidated basis.

For an institution that is a parent of a sub-consolidation, the ACPR primarily conducts its evaluation on a sub-consolidated basis, based on a scope of application similar to that for group parents. The position of the sub-consolidation parent institution within its group, and the influence of its shareholding, is also taken into account.

For a bank that belongs to a group but that does not have any subsidiaries that are supervised by the ACPR, the supervision is conducted on a stand-alone basis, while taking into account the influence of the group to which it belongs and the businesses and risks of any non-banking subsidiaries. Financial holding companies and mixed financial holding companies are also subject to consolidated supervision.

In parallel with this consolidated basis approach, a stand-alone analysis is also conducted whenever the assessment of the specific risk profile and the risk assessment and management systems are of particular interest.

6 CRBF Regulation No. 93-05.

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iv Recovery and resolution

As a general principle, banks are subject to the same insolvency procedures that are applicable to all companies in financial difficulties in France, with certain specificities (Article L613-24 et seq. of the Monetary and Financial Code).

The ACPR plays a central role both before and after a crisis. As soon as the information available indicates that the financial balance of a credit institution is at risk or that its management methods are not satisfactory, the ACPR may require the credit institution to comply with higher capital requirements or require the adoption of specific methods of booking of provisions for certain assets. The ACPR may also employ administrative measures when certain practices of a given credit institution may harm its clients' interests: it may issue a warning against those practices or require that the bank concerned submit a recovery plan or upgrade its management methods. When the ACPR deems that the solvency or liquidity of a credit institution or the interests of its clients are at risk, it may take certain measures (see above).

When necessary, the governor of the Central Bank may invite the bank's shareholders to provide financial support. There is, however, no obligation on the part of the shareholders to accept such an invitation.

When a credit institution is in a crisis situation, the ACPR may nominate a temporary administrator, who will have all the powers to manage and represent the bank, or a liquidator, in particular in the event that the entity's banking licence is withdrawn (Article L613-24). In both cases, the ACPR may petition the local court for the forced sale of the shares owned by the management (Article L613-25). Moreover, the ACPR may request the involvement of the Deposit Guarantee Fund, for instance when a credit institution is unable to repay deposits received from the public.

This recovery and resolution framework changed in 2015 through the passing of EU Regulation No. 806/2014, dated 30 July 2014, which implemented an SRM, and the transposition by an ordinance dated 20 August 2015 of EU Directive No. 2014/59/EU, dated 15 May 2014, on bank recovery and resolution (BRRD). The recovery and resolution framework was amended in August 2015, January 2016 and December 2017. These amendments introduced in particular the requirements relating to total loss-absorbing capacity (TLAC), which relate to global systemically important banks. Further, in 2017, in accordance with Article 45 of the BRRD, the Single Resolution Board (SRB) introduced binding requirements and started to address both the quantity and quality of the minimum requirement for own funds and eligible liabilities (MREL). The law on banking resolutions is now *lex specialis* to general insolvency procedures to prevent systemic effects on the banking sector.

For significant banks and other cross-border groups within the Banking Union, the resolution authority is the SRB, and national resolution authorities are responsible for all other banks, except when resolution requires the use of the Single Resolution Fund or if the SRB decides to exercise directly all its powers.

Preventive recovery plans

The following entities are obliged to draw up preventive recovery plans:

a significant credit institutions that fall under the sole supervision of the ECB;

b credit institutions within a group that are not supervised on a consolidated basis;

c the parent company of credit institutions within a group that are supervised on a consolidated basis within the EU; and

d credit institutions where required by virtue of a decision of the resolution college (Article L613-35 et seq. of the Monetary and Financial Code).

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The plans have to be adjusted regularly, and are subsequently examined by the supervisory college within the ACPR (Article L613-36 of the Monetary and Financial Code). Preventive group recovery plans are communicated to other authorities, in addition to the resolution college (Article L613-37 et seq. of the Monetary and Financial Code). Significant banks' recovery plans are reviewed by the ECB.

Preventive resolution plans

For entities that are obliged to produce recovery plans, the resolution college has the competence to also establish preventive resolution plans on an individual or consolidated basis (Article L613-38 et seq. of the Monetary and Financial Code). The resolution college designs potential resolution measures and cooperates with other authorities, particularly the respective supervisory authorities. At the initial elaboration of each plan, and at the point of any subsequent revision, the resolution college evaluates whether and to what extent an entity is resolvable without putting at risk its critical functions or the financial system as a whole (Article L613-41 et seq. of the Monetary and Financial Code). To guarantee the resolvability of an entity, the resolution college can take certain preventive measures (Article L.613-42 of the Monetary and Financial Code).

The resolution college also ensures that credit institutions and investment firms fulfil the minimal capital requirements determined by the law or by the residual discretion of the resolution college (Article L613-44 et seq. of the Monetary and Financial Code).

Intragroup guarantees, by which one group entity guarantees the obligations of another group entity to a third party, can be granted to stabilise the financial situation of the whole group. Such a contract is only effective when approved in advance by the resolution college and the supervisory college, as well as any other concerned supervisory institution within the ACPR (Article L613-46 et seq. of the Monetary and Financial Code).

Note that, as the competent resolution authority for significant banks and cross-border groups within the Banking Union, the SRB is responsible for drawing up the resolution plans and adopting all decisions relating to banking resolution in relation to these entities.

Minimum requirement for own funds and eligible liabilities

The MREL corresponds to the minimum amount of loss-absorbing capacity that is also covered by the international standard TLAC developed by the Financial Stability Board. The SRB is committed to implementing and enforcing the applicable legal framework, including by setting MREL targets for the banking groups under its remit. For other entities, the national resolution authorities (in France, the ACPR) are responsible for setting MREL targets. Since 2017, several banking groups have been notified about their MREL level, and have started to issue eligible debts (such as non-preferred senior debt) to reach these targets.

Resolution proceedings

Before taking concrete resolution measures in respect of a bank, including the write-down and conversion of capital instruments, an entity's value must be estimated by an independent expert (Article L613-47 of the Monetary and Financial Code). The resolution college can only write down and convert capital instruments if the entity's insolvency is otherwise unavoidable (Article L613-48 et seq. of the Monetary and Financial Code). The resolution procedure is initiated by the Governor of the French Central Bank, the Head of the French Treasury or the ECB (Article L613-49 of the Monetary and Financial Code).

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The resolution college has the power to assume the effective management of an entity, designate a special administrator and replace members of the board (Article L.613-51 et seq. of the Monetary and Financial Code). All or part of a bank's activities can be transferred to a voluntary purchaser (Article L.613-52 et seq. of the Monetary and Financial Code). The bank's assets can also be transferred to a bridge bank (Article L.613-53 et seq. of the Monetary and Financial Code) or to an asset manager (Article L613-54 et seq. of the Monetary and Financial Code) with a view to a subsequent sale. A bail-in of eligible liabilities may be implemented in accordance with Article 27 of Regulation No.806/2014 (Article L613-55 et seq. of the Monetary and Financial Code). Additionally, the resolution authority is allowed to order the issue of new shares or Tier 1 capital instruments (Article L613-56 et seq. of the Monetary and Financial Code).

For entities subject to the direct supervision of the ECB, it determines, after consulting the SRB, whether a bank is failing or likely to fail. If so, the SRB places the bank under resolution and adopts a resolution scheme determining which resolution measures will be applied.

IV CONDUCT OF BUSINESS

i Rules governing the business conduct of banks

The primary laws and regulations governing the business conduct of banks are:

a the Monetary and Financial Code (in particular Article L533-1 et seq.);

b the French Civil Code (general contractual rules and rules relating to loans) and the French Commercial Code (rules relating to commercial paper);

c regulations issued by regulatory authorities, such as orders of the Minister of Economy and by the AMF and, in particular, the rules of good conduct set out in Articles 314-1 to 314-105 of the General Rules of the AMF;

d European banking and market abuse rules, in particular the Market Abuse Directive[7] and the Market Abuse Regulation;[8]

e regulatory guidelines and recommendations issued by the EBA, in particular the guideline on internal governance under Directive 2013/36/EU; and

f all international banking rules, such as those issued by the Office of Foreign Assets Control or resulting from the Financial Action Task Force (anti-money laundering) and the Basel Committee on Banking Supervision.

ii Potential sources of civil, criminal and regulatory liability

Banks have many potential sources of civil, criminal and regulatory liability.

The main sources of civil and regulatory liability include non-compliance with one or several of the following obligations:

a obligations relating to investment services:

- the general principle of good conduct (honesty, loyalty, professionalism and compliance with the principle of prioritising clients' interests and the integrity of the market);

7 Directive 2014/57/EU on criminal sanctions for market abuse.

8 Regulation (EU) No. 596/2014 of 16 April 2014 on market abuse.

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- obligation to classify clients as professional clients, eligible counterparties and retail clients;
- obligation relating to the provision of information (accurate, clear and sufficient information must be provided to clients);
- obligation to evaluate clients (evaluation of clients and potential clients to determine the services and financial instruments best suited to their needs);
- obligation of best execution (in the execution of orders, reasonable measures to be taken to provide the client with the best possible result);
- obligation to call margins for orders with deferred settlement;
- written and up-to-date policies for preventing and managing potential conflicts of interest; and
- internal compliance obligations (internal administrative procedures, compliance rules, efficient techniques to evaluate risks and the back-up of electronic data);

b obligations and liabilities relating to credit services:

- obligation to inform and advise clients and potential clients in connection with all services provided;
- obligation to confirm in advance that a loan is adapted to the financial resources of the client (liability resulting from excessive, inappropriate or abusive loans);
- no liability resulting from unreasonable financial support except in the case of fraud, clear interference with the debtor's management or if the guarantees taken in consideration of the credit granted are disproportionate to the latter;[9]
- liability for claims of insufficient assets (liability for mismanagement if there is an insolvency proceeding brought with respect to a company, the assets are insufficient to cover the company's liabilities, the bank can be considered as a *de facto* or *de lego* manager of the company, and the bank has mismanaged the insolvent company.[10] Banks are very rarely considered liable as *de facto* managers);
- liability resulting from abusive termination of credit, in the event that reasonable notice has not been provided when terminating credit facilities (unless there is a stated maturity);
- liability for non-compliance with the rules relating to the structure of and access to the banking profession (violations of the rules governing the approval of credit institutions); and
- liability for mismanagement of portfolios (banks may be held liable if they do not comply with the limits of the mandate given by their clients); and

c main sources of criminal and regulatory liability:

- money laundering:[11] punishable by a maximum of five years' imprisonment, a fine of €375,000 for individuals or €1.875 million for legal entities such as banks; these fines may be raised to half the value of the property or funds in respect of which the laundering operations were carried out. The ACPR may also

9 Article L650-1 of the French Commercial Code.

10 Article L651-2 of the French Commercial Code.

11 Banks may be found criminally liable for facilitating, by any means, the concealment of the true origins of goods or resources of a person who commits a crime or a misdemeanour that provides that person with a direct or indirect profit. Banks may also be considered guilty of money laundering if they knowingly facilitate a transaction involving the investment, concealment or conversion of the direct or indirect product of a crime or a misdemeanour (Article 324-1 of the French Penal Code).

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impose important sanctions on banks for failing to comply with their anti-money laundering and counter-terrorist financing obligations (a credit institution was recently subject to a €50 million fine on that basis);

- market abuse: regulatory and criminal liability for insider trading, disclosing false and misleading information and share price manipulation. Criminal offences are punishable by a maximum of five years' imprisonment, and a fine of €100 million for individuals or €500 million for legal entities such as banks, or 10 times the amount of the profits gained or losses avoided, or 15 per cent of the total annual turnover. Regulatory violations are punishable by a fine of a maximum of €100 million, or 10 times the profit made through insider trading. Note that the French Constitutional Council ruled on 18 March 2015 that no one can be prosecuted twice for a market abuse (once before a criminal court and once before the regulator);
- usurious loans: punishable by a maximum of two years' imprisonment, a fine of €45,000 for individuals or €225,000 for legal entities such as banks;
- illicit solicitation: banks that do not have a European passport, or that have not been authorised by the ACPR to conduct business in France, may be held criminally liable for any unsolicited contact made with an individual or legal entity to obtain an agreement for a banking, investment or financial transaction or service;[12] and
- complicity in tax fraud: punishable by seven years' imprisonment, a fine of €20,000 for individuals or up to €10 million for legal entities such as banks.

iii Banking confidentiality

All managers, officers and employees of banks are bound by the principle of banking confidentiality.[13] Any person who does not comply with this obligation can face tortious or criminal liability.[14] The disclosure of information subject to banking confidentiality is punishable by up to one year's imprisonment, a fine of €15,000 for an individual or €55,000 for a bank.

Banking confidentiality protects the interests of the client, and can only be waived by the client.

There are several exceptions to this prohibition relating to information provided in connection with disclosure obligations made to, or investigations conducted by, the following authorities:

a tax and customs authorities;
b the French Central Bank;
c the AMF and the ACPR; and
d reports of suspected money laundering or terrorism activity made to the French anti-money laundering authority (TRACFIN).

Moreover, several banks may benefit from shared banking confidentiality for the implementation of specific transactions, such as syndicated loans, banking pools or hedging transactions.

12 Article L341-1 et seq. of the Monetary and Financial Code.
13 Article L511-33 of the Monetary and Financial Code.
14 Article 226-16 of the French Penal Code.

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Recent case law also suggests that banks are not bound by banking confidentiality with respect to guarantors.

V FUNDING

French banks fund their activities from a capital base comprising equity and deeply subordinated debt, accounted for as equity, subordinated debt, medium and long-term senior debt, customer deposits and shorter-term debt. This section focuses on the non-equity sources of financing available to French banks to fund their activities.

The following table shows the principal non-equity funding sources of some of the largest banking groups in France as indicated in their latest available reports:

Bank	Amount due to credit institutions (€ billion)	Customer deposits (€ billion)	Debt securities (€ billion)	Subordinated debt (€ billion)
Société Générale	96.8	411.4	114.1	13.1
BNPP	103.3	792.7	156.3	16.6
BFCM	65.2	189.7	114.4	8.9
La Banque Postale	15.2	186.7	12.5	3.9
Crédit Agricole	99.3	772.9	189.3	23.4
BPCE	91.8	526.8	225.6	17.2

i Amounts due to credit institutions

Interbank debt will usually comprise unsecured loans, short-term deposits and repurchase agreements.

Repurchase agreements, known as pensions, are governed by Article L211-27 et seq. of the Monetary and Financial Code and are defined as transactions pursuant to which an entity transfers the ownership of financial instruments to another entity, in consideration for an agreed price, and under which the transferee agrees to transfer the ownership of the financial instruments (which the transferor must accept) back to the transferor, for a price and on a date agreed by the parties. The financial instruments subject to the repurchase agreement remain at all times on the balance sheet of the transferor despite the initial transfer of ownership.

ii Customer deposits

As illustrated by the table above, customer deposits generally represent the largest source of funding for the main French banks, as has been the case for the past few years. According to the Central Bank (which is responsible for compiling regional statistics on the bank deposits of the non-financial sector), between 31 October 2017 and 30 November 2018, customer deposits increased from €1.914 trillion to €2.035 trillion.

In addition, in its report on the performance of French banking groups in 2017, dated May 2018, the ACPR stressed that 'the French banks' average loan-to-deposit ratio increased slightly by 1.1 pt' between the end of 2016 and the end of 2017, 'consistent with the median of European banks'. This consistency can also be acknowledged by the supervisory statistics for Q3 2018 published by the ECB on 25 January 2019, according to which the loan-to-deposit ratio at the European level increased from 117.58 per cent at Q3 2017 to 118.42 per cent at Q3 2018.

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iii Debt securities

Debt securities issued by banks (other than subordinated debt) include short to medium-term instruments issued in the money markets and longer-term securities issued in the capital markets.

Short to medium-term instruments issued in the money market

The French money market is divided into three components: the interbank market, the interest rate swap market and the market in negotiable debt securities (TNs).

The TN market is the component of the money market open to all participants (financial and non-financial, resident and non-resident, subject to certain conditions), in which the TN category of instruments governed by Articles L213-1 to 213-4-1 and D213-1 et seq. of the Monetary and Financial Code (as well as treasury bonds) are traded. The minimum value of a TN is €150,000.

The rules governing the TN market in France were reformed in 2016 through Decree 2016-707 of 30 May 2016 and the Ministerial Order of 30 May 2016 (TN Reform), which entered into effect on 1 June 2016 with a view to opening the market to foreign investors by, in particular, simplifying the applicable rules and existing TN categories.

Since the TN Reform, the main features of TNs are as follows:

a no requirement to provide a summary of the financial documentation in French when the documentation is drafted in a customarily accepted language in the financial sphere, subject to the obligation to include in the financial documentation a warning in French inviting investors to use a French translation of the documentation;

b the minimum value of a new TN is increased to €200,000 (or the equivalent amount in another currency) when the financial documentation is drafted in a customarily accepted language in the financial sphere; and

c extension of the list of rating agencies allowed to rate the issuer to any rating agency registered with the ESMA (to the extent that the rating agency has the technical capacity to proceed with the rating of the instrument).[15]

As at the end of December 2018, the outstanding amount of negotiable European commercial paper was €267.2 billion and the outstanding amount of medium-term notes was €56.5 billion.

The advantage of these instruments is the flexibility offered with respect to their maturity, allowing the issuer to adjust the instrument's characteristics to meet its specific funding needs.

Longer-term debt securities issued on the capital markets

French banks issue a variety of bond instruments, including covered bonds.

As in other European countries, covered bonds issued in France are dual-recourse bonds, with a claim against the issuer and a priority claim on a pool of collateral (referred to as the cover assets). These are issued in most instances pursuant to a specific legal framework. As such, covered bonds constitute one of the safest instruments available, and have proven

15 Further details in Article 11 of Ministerial Order of 30 May 2016.

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relatively more resilient than other funding instruments in the face of recent financial turmoil. French covered bonds are issued pursuant to four different legal regimes, which are described below.

Bonds issued by the Caisse de Refinancement de l'Habitat

The Caisse de Refinancement de L'Habitat (CRH) is a credit institution owned by French banks, created by the government in 1985 to fund or refinance residential home loans granted by certain French banks. The CRH issues bonds and lends the bond proceeds to the borrowing banks, which then issue promissory notes (of a nominal value equal to or higher than €100,000) in favour of the CRH evidencing the loan from the CRH. The CRH's operations are governed by a specific legal regime set out in Article 13 of Law 85-695 of 11 July 1985, and Articles L313-42 to L313-49-1 and R313-20 to R313-25-1 of the Monetary and Financial Code. Since 4 November 2014, the CRH has operated under the supervision of the ECB owing to the size of its balance sheet.

As at 30 June 2018, CRH shareholders' equity is exclusively constituted of Core Equity Tier 1 (CET1) in a total amount of €556.5 billion, and is allocated as follows:[16]

a Crédit Mutuel: 35.4 per cent;
b Crédit Agricole SA – Crédit Lyonnais: 33.6 per cent;
c Société Générale: 17.9 per cent;
d BNPP: 7.6 per cent; and
e BPCE: 5.5 per cent.

The refinanced loans remain on the borrowing banks' balance sheet, but are pledged as collateral in guarantee of the banks' obligations under the promissory notes. In turn, the bondholders have a legal privilege over the promissory notes in guarantee of the CRH's obligations under the bonds, so that the allocation of amounts generated by the promissory notes are given priority over the payment of interest and principal on the CRH bonds.

The only eligible loans (i.e., the cover assets) are residential loans with a first-ranking mortgage, or a guarantee issued by a credit institution or an insurance company (such guaranteed loans not exceeding 35 per cent of the cover assets).

Real estate bonds

Real estate bonds may only be issued by special-purpose mortgage credit companies (SCFs), which are usually set up by a credit institution and governed by a stringent legal framework set out in Article L513-2 et seq. and Article R513-1 et seq. of the Monetary and Financial Code. SCFs are supervised by the ACPR.

The cover assets are narrowly defined by law, and include loans secured by a first-ranking mortgage, and loans granted to finance real estate and guaranteed by a credit institution or an insurance company (guaranteed loans of this type shall not exceed 35 per cent of the assets of the SCF).

As an exception to the general rules of French bankruptcy law, holders of real estate bonds and other privileged debts benefit from a legal privilege allowing them to be paid prior to all other creditors.

16 Total: 100 per cent.

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Structured covered bonds

In view of the restrictions imposed by the existing legal framework with respect to the collateral that can be used as cover assets for covered bonds, and in particular the 35 per cent cap on guaranteed housing loans with respect to the real estate bonds described above, certain banks have structured instruments as covered bonds outside of a specific legal regime. These structures rely on Article L211-36 et seq. of the Monetary and Financial Code, which implements the Collateral Directive[17] (as amended by Directive 2009/44/EC) and allow the enforcement of collateral with respect to certain financial obligations even when the collateral provider is the subject of an insolvency proceeding.

Residential bonds

To remedy the disadvantages inherent in real estate bonds, in particular the 35 per cent cap on guaranteed housing loans and the uncertainty as to the structure of the structured covered bonds, the government created a new category of covered bonds called residential bonds.

Residential bonds may only be issued by special-purpose housing finance companies (SFHs), which are usually set up by a credit institution and governed by a stringent legal framework set out in Article L513-28 et seq. and Article R513-19 et seq. of the Monetary and Financial Code. SFHs are supervised by the ACPR.

The major difference between the two legal frameworks is that, in the SFH framework, no cap has been set with regard to guaranteed loans, which is clearly an advantage given that more than 75 per cent of real estate loans are guaranteed loans.

iv Subordinated debt

The subordinated debt issued by banks usually takes the form of subordinated redeemable bonds, perpetual subordinated bonds or deeply subordinated bonds.

The subordinated nature of these instruments is based on Article L228-97 of the Commercial Code, which provides that debt securities may be structured so as to be subordinated to all other indebtedness of the issuer or to all other indebtedness other than participating loans (which is another category of subordinated debt provided by law).

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Ownership restrictions and control

Since 4 November 2014, the ECB is in charge of the control of banking licence approvals and acquisitions of qualified holdings in credit institutions. To support applicants and all entities involved in the process of authorisation, the EBC published on 9 January 2019 a non-binding consolidated guide to assessments of licence applications, which applies to all licence applications to become a credit institution (including applications for credit institutions, fintech companies and qualifying holding approvals).

Requests for a banking licence are filed at the ACPR, which first assesses whether all conditions for the granting of a banking licence are fulfilled, then submits a proposed decision to the ECB.

17 Directive 2002/47/EC.

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The conditions for granting a banking licence under French law include a review of the credit institution's shareholders.

A shareholder may be invited by the ACPR to provide support to a bank. In practice, however, a shareholder is invited to do so only when it owns at least 10 per cent and less than 50 per cent of the voting rights of the bank. The ACPR would normally consider that majority shareholders or shareholders exercising an effective control over a bank should provide all or substantially all of the necessary financial support.

In practice, the ACPR regularly rules in accordance with the following principles:

a one or several shareholders may only own a controlling interest in a bank if they have sufficient financial means and prior experience in the activities to be authorised. Otherwise, the ACPR would require an EU-authorised bank (usually with a blocking minority vote) to act as sponsor;

b if the effective control of a bank will not be held by a single shareholder, the ACPR would seek to ensure that the allocation of the share capital is sufficiently stable, and that certain undertakings from the main shareholders are provided, and would usually recommend entering into a shareholders' agreement;

c the ACPR would not grant its authorisation to banks that are owned by a single individual; and

d the ACPR would prefer interests to be held directly in the bank rather than through holding companies.

With regard to point (a), above, the ACPR would generally consider that when a controlling ownership is owned by entities that are not subject to the supervision of banking authorities, the authorisation should be granted (and maintained) only if the entities' investment in the bank is reasonable, given their assets and available capital. In addition, the non-banking activities of these entities must generate annual financial results sufficient to satisfy any future requirement to reinforce the capital of the bank. The ACPR would require non-banking controlling shareholders to be sponsored by an EU-authorised bank. It is likely that a comfort letter from the entities would also be required (providing for long-term ownership of the bank, permanent supervision of the bank's business and a commitment to provide financial support to the bank if necessary).

If the majority shareholders of a bank are foreign banks that do not belong to the EEA and are small or average-sized participants in the world banking market, it is likely that an EU-authorised bank should act as a sponsor for the foreign shareholders. This sponsor is usually required to own a blocking minority vote and to be represented on the bank's board of directors.

Although in theory there is no obligation for a shareholder to provide additional capital to the bank in the event that it becomes undercapitalised, it appears that shareholders of a bank may be required to give support to a bank at the ACPR's request, in particular given the fact that committing such support was often considered by the regulatory authority to be an underlying condition for the granting of the authorisation for the operation of banking activities in the first place.

In the context of an acquisition of control, regulators also need to evaluate the impact of a proposed transaction on the prudential ratios of the acquiring entity, the target and the combined group. Similarly, the ability to implement risk-monitoring systems (i.e., both permanent and periodic controls) is a key factor for securing ECB non-opposition. The ACPR also considers the proposed post-transaction management team to be a critical

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element. In addition, the ACPR will ensure that a change of control does not adversely affect the funding of the bank, the risks incurred by the bank, the internal control procedures or the IT infrastructure.

In practice, when projects for establishment in France are submitted by banks with confirmed international experience and a first-rate financial situation, and a country of incorporation that guarantees French credit institutions sufficiently free access to its market, the French authorities will generally allow the applicants considerable latitude with regard to their form of establishment: they may choose to either open a branch or create a subsidiary.

In contrast, when foreign banks from countries that are not members of the EEA or the G10 wish to open an establishment for the first time, the French regulator is likely to impose a requirement that they create subsidiaries to involve, as a shareholder, a local partner bank that could facilitate their initial contact with French customers and act as their sponsor.

Changes in the qualifying holding

Since 4 November 2014, assessing changes in the qualifying holding of any European credit institution falls within the scope of the ECB's competence. Such changes are, however, first examined by the competent national authorities.

A qualifying holding is defined as 'a direct or indirect holding in an undertaking which represents 10 per cent or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of that undertaking'.

Changes in the qualifying holding are filed at the ACPR, which first assesses whether the filing is compliant with the French provisions transposing the CRD IV Package. The rules governing changes in the qualifying holding of credit institutions are laid down in a ministerial order dated 4 December 2017. The ACPR then submits a proposed decision to the ECB, which renders a final decision following its assessment.

ii Transfers of banking business

French law does not provide for any specific regime allowing banks to transfer all or part of their business to another entity without requiring the relevant third-party consents, including the customers' consent with respect to loans and deposits (with the exception of the above-mentioned power of the ACPR to permit a transfer).

If a transaction is structured as a sale of a going concern, then relevant third-party consent would need to be obtained. However, in practice, approval is generally sought only for material contracts. For contracts that are not considered material, the bank will usually simply notify their transfer to the counterparty.

Third-party consent should, however, not be required if the sale of a business is structured as a sale of the shares of the entity that is party to the deposit and loan agreements, or as the contribution of an autonomous business activity to another entity in exchange for shares in such an entity (since deposit and loan agreements would not typically contain change of control provisions).

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VII THE YEAR IN REVIEW

i Blockchain

A legal framework has been set for blockchain under Ordinance No. 2016-520 of 28 April 2016. According to this text, blockchain technology is defined as a 'shared electronic recording system allowing for authentication'.

Moreover, the issuance of mini-bonds can now be recorded on a blockchain. In this case, the bonds can be sold under appropriate modalities: the recording of the sale operation in an electronic shared recording system proceeds to the transfer of the ownership title.

Pursuant to an ordinance dated 8 December 2017, the registration in a blockchain of an issuance or assignment of securities that are not admitted to the operations of a central securities depository are given the same effects as securities recorded in a securities account. A decree dated 24 December 2018 details the conditions for the application of this new registration process.

ii Brexit

Further to the decision of the United Kingdom to leave the EU, the ACPR and the AMF are getting ready to welcome British-based institutions that wish to relocate their business to France. For existing activities that are already supervised by the competent authority in their home country, the aim is to simplify and speed up the licensing procedure. This will be done by using documents already available in English, such as forms that have been submitted to the supervisory authorities in home countries and papers concerning a branch whose business will be taken over by a subsidiary firm. An English-speaking contact point has been appointed to guide applicant firms through the procedure, starting with the pre-authorisation period, and provides all necessary information to ensure the smooth processing of applications.

In addition, as a preventive measure, by Law 2019-30 of 19 January 2019, the French Parliament has given the government the ability to take specific measures in the event that the UK and the EU fail to reach a withdrawal agreement.

iii Payment services

PSD2[18] entered into force on 12 January 2016, and has been applicable since 13 January 2018. In France, Ordinance No. 2017-1252, dated 9 August 2017, and several decrees and orders, have transposed PSD2, the main measures of which include the regulation and supervision of new actors in the payment services sector (payment initiation service providers and account information service providers), changes to the scope of the entities that are excluded from the Directive, reinforced consumer protection rights, rules relating to the security of payment services with a view to preventing fraud, and the extension of the scope of the rules to include non-EEA currency payments between EEA-domiciled payment service providers, as well as payment transactions where one of the payment service providers is located outside the EEA in all currencies.

18 Directive (EU) 2015/2366 of 25 November 2015 on payment services.

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iv Endorsement of the final changes to the Basel III framework

The Basel Committee on Banking Supervision announced on 7 December 2017 that the outstanding Basel III post-crisis regulatory reforms had been endorsed, including:

a a revised standardised approach for credit risk;
b revisions to the internal ratings-based approach for credit risk;
c revisions to the credit valuation adjustment framework;
d a revised standardised approach for operational risk;
e revisions to the measurement of the leverage ratio and a leverage ratio buffer for global systemically important banks; and
f an aggregate output floor.

The revised standards will take effect from 1 January 2022, and are to be phased in over five years.

v Prevention of money laundering and terrorist financing

France has just finalised the transposition of Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, adopted on 20 May 2015.

The main text adopted for this purpose is Ordinance No. 2016-1635, dated 1 December 2016, transposing the requirements set out in the Directive and specifying the scope of the changes made to the French regulatory framework, including, inter alia, reinforcement of the risk-based approach, a widening of the scope of the declaration of suspicions and enhanced measures for politically exposed persons. The Ordinance has been supplemented by Decree No. 2017-1094 on the centralised beneficial owner register, as well as by Decree No. 2018-284 of 18 April 2018 detailing the definition of beneficial owners and the provisions relating to the duties of obliged entities. The ACPR also issued specific guidelines on the identification, identity verification and knowledge of customers in December 2018.

At the European level, a new directive amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (Fifth AML Directive) was published on 30 May 2018. Member States must comply with the Directive by 10 January 2020. The Fifth AMLD Directive, inter alia, extends its scope to new technologies such as virtual currencies and electronic wallets, makes national beneficial ownership registers accessible to the general public under certain conditions and obliges Member States to create a list of offices and functions that qualify as being politically exposed.

vi Recovery and resolution

A new rank in insolvency for non-preferred senior debt that can be bailed-in in the case of resolution, ranking as senior to regulatory capital instruments but as junior to other senior liabilities, was introduced by Directive (EU) 2017/2399 of 12 December 2017 amending the BRRD as regards the ranking of unsecured debt instruments in the insolvency hierarchy.

Its aim is to provide a consistent legal framework with respect to bank creditors' hierarchy on a EU-wide basis, meeting the requirements described in the TLAC standard and the MREL.

In accordance with Article 2 of this Directive, EU Member States must bring into force the laws necessary to comply with the Directive by 29 December 2018.

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France had already enacted a similar rank under Article L613-30-3 of the Monetary and Financial Code, pursuant to Law No. 2016-1691 dated 9 December 2016.

vii Data protection

Regulation (EU) 2016/679 of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data is due to enter into force in May 2018.

Under this Regulation, companies, including credit institutions, have to, inter alia, ensure the compliance of their processing activities and keep records of those activities, meaning that they will have to set up an *ad hoc* internal control and reporting procedure on these matters. Credit institutions also have to comply with several other obligations, including the appointment of an independent data protection officer, the introduction of a new standard of consent given to the processing of data, as well as data portability requirements and the right to be forgotten.

Breach of these obligations may result in fines of up to €20 million or up to 4 per cent of the annual worldwide turnover of the company concerned.

On 21 June 2018, Law No. 2018-493 on the protection of personal data was enacted to adapt the existing national law to comply with the provisions set out in the GDPR.

viii New banking package

On 4 December 2018, the European Parliament and the Council of the European Union reached a provisional political agreement on a package amending the Capital Requirements Regulation, the Capital Requirements Directive, the Bank Recovery and Resolution Directive and the SRM Regulation. The European Parliament's Plenary plans to officially adopt the agreement by a vote that should take place early in 2019. This package addresses various matters such as:

a a binding 3 per cent leverage ratio for all institutions subject to the CRD and an additional 50 per cent buffer for global systemically important institutions;
b revised net stable funding ratio and weighing risks;
c changes to the large exposure treatment;
d the reduction of capital requirements for certain loan exposures made to small and medium-sized companies;
e integration of TLAC and MREL; and
f reduced requirements for small and non-complex institutions in certain areas.

This Ministerial Order takes into account the fields of competence of the ECB since the entry into force of the SSM.

VIII OUTLOOK AND CONCLUSIONS

While the French banking sector had been steadily recovering from the 2008 financial crisis, the eurozone crisis, combined with the heavy exposure of French banks to such sovereign risks, has resulted in the need for French banks to continue to strive to meet the regulatory capital requirements and remain profitable.

It appears that these efforts are starting to pay off. French banks have reduced their balance sheets by selling certain non-core activities and loan portfolios, reinforced their

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regulatory capital and accumulated significant liquidity reserves. The French Banking Law and the new European regulatory framework did not significantly alter the French universal banking model, which has shown resilience during the crisis.

French banks are therefore looking to the future with greater confidence and optimism, and are again focusing on their growth plans. The profitability of the French banking sector is set at a good level, since return on equity of the banking sector was at 6.2 per cent in 2017, well above the eurozone average of 5.7 per cent The soundness of the French banking sector is confirmed by the weighted average CET1 solvency ratio for the banking sector, which was 14.2 per cent in 2017, in excess of minimal regulatory requirements and slightly below the EU average of 15 per cent.

Additional challenges are faced by the sector in the context of a changing regulatory environment – this involves, for the four biggest French banking groups (BNP, Société Générale, Crédit Agricole and BPCE), a focus on their upcoming compliance with the TLAC rules, and, more generally, for banking groups to work on their compliance with the upcoming MREL requirements.

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Chapter 14

GERMANY

Sven H Schneider and Jan L Steffen[1]

I INTRODUCTION

Germany is one of the biggest and most important markets for banking business in the world. Its banking system is based on three pillars: commercial banks, public law banks (including savings and loan associations and state banks) and cooperative banks. Commercial banks are private companies governed by private law; usually they are listed or unlisted stock corporations, or unlisted limited liability companies. Savings and loan associations are public law entities owned by municipalities or counties. They usually focus on local or regional business. Cooperative banks are customer-owned entities; their members democratically control, govern and own these banks (following the one person, one vote principle).

The number of banks in Germany as at the end of October 2018 was as follows: 263 commercial banks with assets of around €3.62 trillion; 878 cooperative banks with assets of around €925 billion; and 393 public law banks with assets worth around €2.16 trillion.[2] The five largest banks in terms of assets are Deutsche Bank, DZ Bank, KfW, Commerzbank and Unicredit Bank (HypoVereinsbank).

II THE REGULATORY REGIME APPLICABLE TO BANKS

i The basic structure of banking regulation

Banking regulation in Germany comprises two basic elements: a licence system to prevent untrustworthy institutions from doing business, and provisions regulating the way licensed institutions should operate, including a bank's minimum capital and liquidity, risk management and general conduct of business.

Germany participates in the single supervisory mechanism (SSM) established within the eurozone. The SSM covers the main aspects of prudential regulation of institutions that conduct at least deposit and lending business (CRR credit institutions). Within the SSM, responsibilities are shared between the European Central Bank (ECB) and national competent authorities (NCAs): the ECB is generally responsible for the direct supervision of significant CRR credit institutions, with NCAs having only an assisting role. With regard to less significant CRR credit institutions, the NCAs are in charge of their direct supervision,

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2 Deutsche Bundesbank, Statistisches Beiheft 1 zum Monatsbericht Januar 2019, p. 106.

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with the ECB being generally limited to indirect oversight, but nevertheless having the final word on the granting and withdrawal of authorisations and the assessment of qualifying holdings in CRR credit institutions (common procedures).

The role of NCAs is carried out by the Federal Financial Services Supervisory Authority (BaFin). BaFin is also responsible for all tasks of prudential supervision that have not been conferred on the ECB, and the supervision of financial services institutions, insurance undertakings and asset management companies. The Bundesbank, the German central bank, is responsible for assisting BaFin and the ECB in the supervision of CRR institutions. The tasks of the Bundesbank include the gathering of prudential and statistical information reported by German banks, and the analysis of their compliance with capital adequacy and risk management requirements. The Bundesbank may not issue administrative instructions to individual institutions.

ii Regulatory regime: selected licensing requirements

As a Member State of the European Union, Germany has fully implemented the Capital Requirements Directive (CRD IV)[3] and the Markets in Financial Instruments Directive II (MiFID II).[4] Therefore, the regulatory regime is quite similar to those of other EU Member States.

Anyone wishing to conduct a banking business (credit institutions) or to provide financial services (financial services institutions) commercially in Germany, or on a scale that requires a commercially organised business undertaking, generally requires a licence or an EU passport.

Banking businesses include, inter alia, the acceptance of deposits or other repayable funds from the public (deposit business), the granting of loans (lending business), safe custody services, and the purchase and sale of financial instruments in one's own name for the accounts of clients (principal broking service). Financial services include, inter alia, the purchase and sale of financial instruments for one's own account as a service for clients, high-frequency trading, portfolio management and investment advice.

Regulated activities are performed in Germany if they are offered to customers in Germany repeatedly and in a commercial manner. This includes services offered from other countries to customers in Germany by mail, telephone, fax or email. Concerning internet activities, an institution is assumed to offer regulated services in Germany if it advertises its products actively through the internet to customers in Germany. Further indications are the adaptation of offers to German law and to the expectations of German customers, as well as a German internet address or cooperation with German institutions.

Institutions are only eligible for a licence if they have a head office in Germany. Foreign entities must therefore set up a German subsidiary or branch. Generally, no particular legal form is required. However, entities carrying out banking businesses must not be operated as a sole proprietorship. Furthermore, to obtain a licence, sufficient initial capital is needed and must be available in Germany. The exact amount of the required initial capital depends on the business conducted.

An institution must employ at least one qualified manager. Credit institutions and financial services institutions that are authorised to own or possess funds or securities of customers must have at least two managers. All managers must be fit and proper, that is to

3 Directive 2013/36/EU.

4 Directive 2014/65/EU.

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say, sufficiently qualified and trustworthy. Concerning professional qualifications, designated managers must have sufficient theoretical and practical knowledge (i.e., experience) in the business concerned. A person with three years' experience at a bank of similar size and type of business in a leading position is normally deemed to be sufficiently experienced. Trustworthiness could be excluded where the designated manager has committed certain crimes (such as fraud or breach of trust), violated regulatory provisions, or shown bad personal or business behaviour. Supervisory board members must also be trustworthy and sufficiently qualified.

The number of mandates per person is limited for both managers and supervisory board members. Managers and supervisory board members of CRR credit institutions that are of significant importance (this includes, inter alia, all CRR credit institutions under direct ECB supervision) are subject to the following restrictions: one manager position and two supervisory board memberships, or four supervisory board memberships. Directorships held within the same group (which applies to groups of institutions, financial holding groups, mixed financial holding groups and mixed holding groups) are counted as one directorship. With regard to other institutions, supervisory board members are not permitted to hold more than five supervisory board mandates within undertakings supervised by BaFin.

In individual cases, BaFin may exempt entities other than CRR credit institutions from specific regulatory duties (including the licensing requirement) if supervision is not deemed to be necessary. This exemption can also be used, inter alia, by non-EU institutions wishing to provide cross-border services into Germany (see below).

If a banking business is conducted or financial services are provided without the required licence, BaFin may order the immediate cessation of that business. Managers may be subject to criminal liability in these cases.

iii Regulation of branches of foreign banks, representative offices and the cross-border activities of foreign banks

Like German banks, subsidiaries of foreign banks established to conduct regulated business in Germany are subject to licensing procedures and monitoring. Likewise, dependent branches of foreign banks conducting banking business or providing financial services in Germany generally require a licence.

Foreign banks domiciled in another EEA Member State may conduct certain regulated business either through a branch or on a cross-border basis without a German licence if they hold an EU passport. An EU passport requires that the entity is licensed and supervised by the competent authorities of its home state, and that the business the entity intends to conduct in Germany is covered by the home state licence.

No licence is required for a representative office of a foreign bank in Germany. The representative office must not conduct any regulated business. Prior notice of the establishment of such a representative office must be given to BaFin.

No licence is required if foreign banks perform requested services (also known as reverse solicitation). German residents and companies domiciled in Germany may request the services of foreign institutions at their own initiative. An institution offering these services following such a request does not need a licence in Germany, provided it does not conduct any business on German territory or on a cross-border basis (including by means of telecommunication) directed towards potential customers residing in Germany. BaFin

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specifies, in a guidance note, the differences between requested services that are not subject to the licensing requirement, and cross-border banking businesses or financial services requiring a licence or an EU passport.

An exemption of non-EU institutions from the licensing requirement may be granted by BaFin at its discretion, provided that the bank in question is effectively supervised in its home country by the competent authorities in accordance with internationally recognised standards, and that the competent home country authorities cooperate satisfactorily with BaFin. Additionally, the applicant company must submit a certificate from the competent authorities of its home country confirming to BaFin that it holds a banking or financial services licence, and that the provision of the intended cross-border services in Germany raises no supervisory concerns. As a general rule, an exemption for the conduct of banking businesses and the provision of financial services to private clients will only be granted if a foreign bank uses a German credit institution or an EEA credit institution with an EU passport as an introducing agent.

As a consequence of a bilateral agreement between BaFin and the Swiss Financial Market Authority, Swiss banks have the option of applying for a simplified exemption procedure under which they can directly solicit private German clients without a credit institution acting as an introducing agent; however, in such a case they would be subject to compliance with strict MiFID and other requirements.

iv Regulation of payment services and e-money business

Germany has implemented the second Payment Services Directive[5] and the second E-Money Directive.[6] Payment services institutions and e-money institutions (other than CRR credit institutions) are required to hold a payment services or e-money licence and are supervised by BaFin. It is possible for licensed payment services and e-money institutions registered in other EEA Member States to conduct their business in Germany through a branch or on a cross-border basis without a German licence if they hold an EU passport.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The ECB and BaFin may examine institutions routinely or in the event of a special cause. The regulators may enter and inspect an institution's offices for this purpose during normal business hours. This right generally also applies to an institution's subsidiaries. Furthermore, BaFin representatives may attend a bank's general meeting and meetings of the supervisory board. An institution and its managers must provide the ECB, BaFin and the Bundesbank upon request with all relevant information and documentation.

Institutions are subject to numerous *ad hoc* and regular reporting and notification obligations. Generally, notifications must be sent both to BaFin and the Bundesbank, whereas regular reporting (such as COREP and FINREP) is received by the Bundesbank only. Institutions have to notify BaFin and the Bundesbank annually of their participating interests in other enterprises, any qualified participating interests they hold in the reporting institution and the number of domestic branches.

5 Directive (EU) 2015/2366.

6 Directive 2009/110/EC.

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Within the SSM, a slightly different reporting regime applies to CRR credit institutions that qualify as significant and are thus directly supervised by the ECB. Generally, these institutions must submit their notifications to the ECB, with copies going to BaFin and the Bundesbank. An exception applies to those notifications by which significant CRR credit institutions notify their intention to appoint a manager, the appointment of a supervisory board member or the end of term of any of these individuals. In relation to these notifications, the NCAs (i.e., BaFin and the Bundesbank) act as the single point of entry.

ii Management of banks

Typical management structures and the influence of holding companies

Stock corporations

Commercial banks in the legal form of a German stock corporation have a management board consisting of the managers and a supervisory board. This two-tiered structure can be seen as an important element of self-regulation and internal governance of banks. The management board is responsible for both the day-to-day affairs of the bank and the business strategy. It represents the bank when dealing with third parties. In performing their duties, managers must act solely in the bank's best interests, without being subject to instructions from any third party, including the supervisory board. The supervisory board is responsible for supervising and advising the management board, and it appoints managers and can dismiss them with reason (a loss of confidence is sufficient to satisfy that requirement). To the extent set out in the bank's articles of association or the management board's by-laws, the management board must obtain the prior approval of the supervisory board for certain transactions and other actions of the bank, which may, for example, include the establishment and closure of branches and the purchase and sale of companies. Supervisory board members are elected by the shareholders; therefore, large shareholders are regularly represented on the supervisory board. Legal persons cannot be members of the boards.

Shareholders may communicate recommendations to the management board and the supervisory board, as long as those recommendations are legally and factually non-binding (unless a domination agreement is concluded).

Limited liability companies

Limited liability companies only require a supervisory board if they have more than 500 employees. The shareholders of limited liability companies may generally render binding instructions to the management board, even regarding the day-to-day business. Nevertheless, the managers in limited liability companies are also solely responsible for compliance with all applicable laws and regulations.

Domination agreements

German corporate law allows parent companies to establish the authority to give binding instructions (relating to day-to-day business and business strategy) to the management boards of their subsidiaries by concluding a domination agreement with them. In the case of banks, however, this possibility is not unlimited, because domination agreements conflict with the independence of bank managers required by regulatory law. Therefore, a domination agreement with a bank must provide that the controlled bank's managers must be independent from instructions to the extent necessary to comply with mandatory regulatory requirements.

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Regulatory duties of management of banks

A manager of an institution is required to carry out several regulatory duties. For example, he or she must report to BaFin and the Bundesbank (as well as to the ECB if the bank is directly supervised by the ECB) the commencement and termination of activities as a manager or member of the supervisory board or administrative board of another enterprise, as well as the acquisition and disposal of a direct participating interest in an enterprise, and any changes in the scale of such a participating interest.

Restrictions on payments to the management of banks

Company law

The compensation of managers of a stock corporation must be appropriate in terms of personal performance and the common level of compensation. For example, to reduce the incentives for managers to focus on short-term profits, stock options are not exercisable in the first four years after they have been granted. These rules do not apply to managers of limited liability companies.

Regulatory law

As required under the CRD IV, the variable component of the total remuneration paid to a manager or an employee generally must not exceed 100 per cent of the fixed component. The institution's shareholders may approve a higher variable component, but not exceeding 200 per cent of the fixed component for each individual. In addition, restrictions on payments are part of the Regulation on the Remuneration Systems of Institutions. Pursuant to these requirements, remuneration systems should be orientated around the objectives of the bank's strategy. Incentives to take disproportional risks should be avoided. The remuneration of bank managers should adequately reflect their functions and performance, and should not exceed the common remuneration without particular reason. Remuneration agreements between banks and their managers must be in written form. Banks are obliged to disclose information annually about their remuneration systems, and the total amounts of all fixed and variable compensations.

iii Regulatory capital and liquidity

Regulatory capital requirements

Regulatory capital requirements have been harmonised within the European Union and are part of the Capital Requirements Regulation (CRR).[7] The CRR covers regulatory capital requirements in particular with respect to counterparty risk, market risk, operational risk and settlement risk. In addition to the capital requirements laid down in the CRR, banks are required to hold a minimum capital of €5 million in the form of Common Equity Tier 1 (CET1) capital.

Capital buffers

Germany has also implemented the new CRD IV regime on capital buffers. For 2019, banks must thus maintain a capital conservation buffer of 2.5 per cent of their total risk exposure as well as an institution-specific countercyclical capital buffer equivalent to the weighted average

7 Regulation (EU) No. 575/2013.

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of the national countercyclical buffer rates of those EU Member States in which relevant credit exposures are located. The current countercyclical buffer rate for Germany has been set at zero per cent. Additional buffer requirements apply to global and other systemically important institutions.

Consolidated supervision

Concerning groups of institutions, (mixed) financial holding groups and financial conglomerates, consolidated supervision is exercised. A group comprises a parent company and subordinated companies. A parent company is an institution or a (mixed) financial holding company that is domiciled in Germany and is not subordinated to other institutions in Germany. Group member institutions taken together must fulfil the capital requirements laid down in the CRR. To determine whether a group has adequate capital, the capital of the group members, on the one hand, and the risk exposure amounts of the group members, on the other, are aggregated. As a general rule, intragroup positions will be eliminated to calculate capital requirements on a group level. If a parent company prepares consolidated accounts under IFRS,[8] such consolidated accounts will be the basis of consolidated supervision.

iv Recovery and resolution

As of 1 January 2015, Germany implemented the Bank Recovery and Resolution Directive (BRRD).[9] In addition, on 1 January 2016, the SRM Regulation[10] came fully into effect, establishing a uniform procedure for the resolution of CRR credit institutions established within the eurozone (single resolution mechanism (SRM)). The European and German recovery and resolution framework distinguishes mainly between the following areas of regulation: recovery planning by the banks themselves; resolution planning by the competent resolution authority; and resolution (i.e., the application by a resolution authority of one or more resolution tools to an institution that is in a crisis situation).

CRR credit institutions and their holding companies are required to prepare, and update annually, recovery plans describing how their financial stability could be restored in the event of a financial crisis. The recovery plans are to be assessed by the competent prudential supervisory authorities (i.e., the ECB for significant CRR credit institutions, and BaFin for less significant CRR credit institutions), which have also been granted extensive powers when recovery plans are regarded as insufficient.

On the other hand, resolution planning and the application of resolution tools fall within the scope of application of the SRM. Within the SRM, competencies and tasks are shared between the Single Resolution Board (SRB), a special agency of the European Union, and the national resolution authorities of the participating EU Member States. The national resolution authority for Germany was, until 31 December 2017, the Federal Agency for Financial Market Stabilisation; its role has since then been taken over by BaFin. While the SRB is competent and responsible for preparing resolution plans and adopting all decisions relating to the resolution of those CRR credit institutions and their parent undertakings that

8 International financial reporting standards are issued by the IFRS Foundation to provide a common global language for business affairs.

9 Directive 2014/59/EU.

10 Regulation (EU) No. 806/2014.

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are subject to direct supervision within the SSM by the ECB or are part of a cross-border group, BaFin as the national resolution authority is responsible for resolution planning and the resolution of all other German CRR credit institutions.

When establishing resolution plans, the resolution authority (i.e., the SRB or BaFin) must identify and, where necessary and proportionate, address and remove any material impediments to resolvability. Similar to the powers of the competent prudential regulator when assessing a bank's recovery plan, resolution authorities have the power to require a bank to limit its risk exposures or to divest specific assets to restrict or prevent the development of new or existing business lines, or to require changes to legal or operational structures of the institution and the group, respectively.

Resolution tools and powers may be applied by the SRB or BaFin when an institution is failing or likely to fail, there is no reasonable prospect that any alternative private sector or prudential measure would prevent the failure of the institution, and the resolution action to be applied is necessary and proportionate to ensure the continuity of critical functions of the institution, provided this is necessary to protect depositors, client funds or client assets, to avoid a significant adverse effect on the financial system or to protect public funds from being used in a bail-out scenario. The resolution tools are:

a a sale of business, by which assets, rights or liabilities as well as shares in an institution can be transferred to an acquirer;

b a bridge institution, by which assets, rights or liabilities and shares can be transferred to a bridge bank owned and controlled by the resolution authority;

c an asset separation, by which assets, rights or liabilities can be transferred to a special purpose vehicle with the purpose of maximising the value of these assets through a sale or orderly wind-down; and

d a bail-in, by which shareholders and specific creditors may now be required to participate in losses and the recapitalisation of a credit institution or its group entities in a resolution scenario. With the bail-in tool, the SRB and BaFin have the power to write down equity and liabilities in whole or in part, and to convert liabilities into shares or other CET1 instruments of the respective institution or group entity or of a bridge institution. The requirements for the application of the bail-in tool, as well as the regime of liabilities that are either statutorily excluded from bail-in or may be excluded by the SRB or BaFin, are laid down in the SRM Regulation.

To ensure that sufficient own funds and liabilities are available for the application of the bail-in tool, credit institutions and respective groups must maintain a minimum amount of own funds and 'bail-inable' liabilities as required by the SRB or BaFin (minimum requirement of own funds and eligible liabilities).

IV CONDUCT OF BUSINESS

i German rules concerning banks' organisation and conduct of business

Proper business organisation, including risk management

An institution must have in place a proper business organisation and suitable arrangements to ensure compliance with legal and regulatory duties. BaFin has specified these requirements in detail in its MaRisk (minimum requirements for risk management) circular. Risk management comprises the formulation of an appropriate strategy and the establishment of appropriate internal surveillance procedures. These procedures include appropriate risk management and

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controlling procedures, stress tests, an independent risk controlling function, a compliance function, and an efficient and independent internal audit function. In addition, BaFin has provided for detailed minimum requirements regarding a bank's internal organisation and procedures when granting loans (e.g., a relatively strict four eye principle) or trading in financial instruments.

Investment services

According to MiFID II, anyone who provides investment services or performs investment activities (such as reception and transmission of orders in relation to financial instruments, dealing on own account, portfolio management or investment advice) must comply with certain rules of conduct with regard to customers. Investment services enterprises must provide investment services with the requisite degree of expertise, care and prudence in the interests of their customers. These institutions are obligated to enquire about their customers' experience and knowledge of financial transactions, and to provide certain information to their customers. The specific scope of the obligations depends on whether the customer is a private client, a professional client or an eligible counterparty. Professional clients include authorised or regulated enterprises, large undertakings, national or regional governments, central banks and other institutional investors whose main activity is to invest in financial instruments.

In addition to the rules implementing MiFID II, banks are required to ensure that their investment advisers, sales representatives (i.e., persons competent for the definition of sales objectives) and compliance officers have the relevant expertise and necessary trustworthiness for their respective activities. Banks must notify these persons to BaFin prior to the commencement of their activity.

ii Sources of liability in German law

Criminal and administrative liability

Operating without a required licence and doing banking business that is prohibited, as well as violations of the duty to report insolvency or over-indebtedness to BaFin, are causes of criminal liability for bank managers. In addition, non-compliance with certain other regulatory duties is subject to administrative fines. Under German law, a bank itself can be held liable for administrative fines, but not criminal violations.

Civil law liability

Concerning civil law, three sources of liability have to be considered: management's liability to the bank, a bank's liability to its customers and management's liability to customers. Managers must apply the diligence of orderly executives in performing their duties, and may be liable to the company for damages if they fail to do so. A business decision taken by the management board is not considered to be a breach of duties if the management acted on the basis of adequate information, and if the management could reasonably assume that the transaction was in the best interests of the company (business judgement rule). A bank's liability to its customers is, in most cases, a result of the violation of contractual duties. In very exceptional cases, the management may be directly liable to customers.

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iii Applicable law on banking secrecy

Except for the statutory confidentiality requirements imposed on officers of the supervisory authorities, there is no special law on banking secrecy in Germany. Banking secrecy in Germany is a result of contractual duties between a bank and its customers. More specifically, banking secrecy is provided for in the bank's general terms and conditions, which are standardised general terms and conditions used by most German banks. Pursuant to these standardised contractual clauses:

> *the bank has the duty to maintain secrecy about any customer-related facts and evaluations of which it may have knowledge (banking secrecy). The bank may only disclose information concerning the customer if it is legally required to do so, if the customer has consented thereto, or if the bank is authorised to disclose banking affairs.*

German data protection law also protects information relating to private individuals. Concerning banking business, data protection concerns can arise, for example, in loan portfolio transactions. The assignor is, on the one hand, obliged to provide the assignee with all the relevant information under German civil law; on the other hand, however, this may be a violation of data protection law.

V FUNDING

The funding of banks in Germany is typically based on several pillars: deposits from customers, unsecured and secured capital market products (including, for example, covered bonds), deposits from other banks and ECB funding.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Regulation of persons controlling banks and the approval process for a change of control

Based on the German rules that implemented the European Acquisition Directive,[11] persons intending to acquire a qualifying holding in an institution have to comply with several requirements.

The term qualifying holding is defined in the CRR, and means a direct or indirect holding in an undertaking that represents 10 per cent or more of the capital or the voting rights, or that makes it possible to exercise significant influence over the management, of that undertaking. According to BaFin, the question of whether an indirect holding representing at least 10 per cent of the capital in a target undertaking exists has to be assessed on a calculation basis (look-through or multiplication approach: for example, a 40 per cent holding in a 30 per cent shareholder of a bank leads to an indirect holding of 12 per cent of the capital in that bank and would therefore be sufficient).

11 Directive 2007/44/EC.

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This approach has also been taken by the European Supervisory Authorities (ESAs) in their joint Guidelines,[12] published in this respect in December 2016. The ESAs are further of the view that any person who directly or indirectly controls another person that has been identified as an acquirer of an indirect qualifying holding pursuant to the application of the multiplication approach also qualifies as an acquirer of an indirect qualifying holding even if the controlling person does not indirectly hold at least 10 per cent of the target bank's capital. BaFin and the ECB have in the meantime changed their administrative practice and also follow this approach.

A notification must be made once a purchaser has formed the intention to acquire a qualifying holding. Therefore, BaFin may, for example, already have to be notified if and when a letter of intent or an exclusivity agreement is signed. In the notification, the prospective purchaser must state the facts relevant to the amount of the qualifying holding and to the acquisition of the significant influence as well as to assessing its trustworthiness, and must name the seller or sellers of the respective shares. A detailed business plan is required that contains, inter alia, a business strategy for the acquired institution and target figures for the three full business years following the year of acquisition. The intended acquisition may be prohibited within 60 business days if, inter alia, the proposed acquirer or a designated manager is not reliable or financially stable, the institution is at risk of not meeting its regulatory requirements as a consequence of the acquisition, or the transaction is connected to money laundering or the financing of terrorism. In view of the detailed content and form of the notification, it is very important to consider the disclosure requirement in a timely manner in merger and acquisition transactions in which banks are involved. If a holder of a qualifying holding intends to increase the amount of the holding to 20, 30 or 50 per cent, or more, BaFin must be notified again. Conversely, if a shareholder of a bank intends to dispose of its qualifying holding or to reduce the shareholding below these thresholds, it must notify the competent authorities accordingly.

Within the SSM, the ECB is responsible for all shareholder control procedures pertaining to CRR credit institutions, including less significant CRR credit institutions. BaFin retains exclusive responsibility only for those institutions that do not qualify as CRR credit institutions (e.g., financial services institutions). The notifications for all institutions (including CRR credit institutions) must be submitted to BaFin and the Bundesbank. In the case of CRR credit institutions, BaFin will assess the proposed acquisition and submit a proposal for a decision to oppose or not oppose the acquisition to the ECB. The ECB will then issue a resolution and communicate it to BaFin and the interested acquirer.

The Foreign Economy Act and a change of control

The Federal Ministry of Economic Affairs and Energy can prohibit or restrict acquisitions of German enterprises by non-EU residents if the purchase leads to a total takeover or to a stake of at least 25 per cent, and a serious threat to public policy or public safety results from the purchase. The signing of a purchase agreement in relation to enterprises that qualify, inter alia, as operators of critical infrastructures must be notified in writing to the Ministry, and in any event the Ministry may enter into a formal assessment up to three months after

12 See the Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector (JC/GL/2016/01) dated 20 December 2016. The Guidelines apply as of 1 October 2017.

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having knowledge of the signing of a purchase agreement. Therefore, in cases where no notification is due, it may also be advisable to announce an acquisition voluntarily to obtain transaction security.

ii Transfers of banking business

Concerning the general possibilities of transferring businesses in Germany, there are no special rules for banks. German civil and corporate law provide for the general framework for such transfers.

Under German civil law, it is generally possible to transfer payment claims arising from banking transactions to another bank without the consent of the banking customers concerned. However, the transfer of contractual duties or contracts as a whole generally requires customers' consent. Under certain circumstances, consent can be obtained in the form of deemed consent.

A transfer of banking business to another entity is also possible by means of a split-off or hive-down, which are special schemes under German statutory corporate law. As a consequence of the split-off or hive-down becoming effective, legal title to the assets passes to another company by operation of law. Therefore, it is not necessary to transfer each asset individually. A banking licence cannot be transferred by way of split-off or hive-down. A split-off or hive-down under foreign law may also be used in this context: for example, to transfer the assets of a German branch of a foreign credit institution to a newly established German credit institution, it is possible, and has been tested in practice, to hive-down the assets of the German branch to a new subsidiary of that foreign credit institution registered in the same jurisdiction (becoming the German branch of that subsidiary) and, in a second step, to merge the subsidiary cross-border into the newly established German credit institution.

A further possibility for transforming banking business is to transfer assets by way of an accrual. First, the seller transfers assets to a new partnership by way of a hive-down. The transferee then becomes a partner of the limited partnership, after which the transferor leaves the partnership, which results in the complete transfer of all assets of the partnership to the transferee by operation of law. This model can also be used in cross-border transactions if it is also recognised in the other jurisdiction.

VII THE YEAR IN REVIEW

2018 saw a flurry of new rules and regulations for financial institutions in Germany. In particular, the new rules of MiFID II entered into force in Germany on 3 January 2018, and the respective German transposition act, the German Securities Trading Act, was completely overhauled. Furthermore, the second Payment Services Directive was transposed into national German law with effect from 13 January 2018 and, in particular, introduced new authorisation requirements for account information service providers and payment initiation service providers having a right to receive certain information on current accounts from the classical banks in order to provide their services. In addition, BaFin announced that it does not intend to treat fintechs on more favourable terms than other, more traditional institutions.

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Furthermore, the new General Data Protection Regulation,[13] which has applied since 25 May 2018, brought new challenges for the financial industry, especially for retail banks and fintechs that rely heavily on the digitalisation of their products and services. Despite the two-year implementation period, many German financial institutions are apparently still not yet fully compliant.[14] This appears to be a problem not confined to the financial industry, but other industries as well.

The dominant topic of the year, however, was the preparation for Brexit. Once Brexit becomes effective, the United Kingdom will become a third country for the purposes of access to the single market established within the European Union. As a consequence, UK financial institutions will lose the EU passports under which they established branches or provided cross-border services in the remaining Member States. Likewise, financial institutions in Germany and other Member States will lose their respective passports for doing business in the United Kingdom. To answer the practical questions of institutions in this respect, BaFin has published a list of frequently asked questions, and has established a special contact point for institutions wishing to move their registered offices or operations to Germany. Brexit has also triggered a discussion about the booking model practices used by international banks. In this respect, the ECB as the main regulator within the SSM recently published the SSM's expectations regarding booking models, in particular in relation to certain back-to-back models that have come up in the context of relocating UK institutions to the eurozone. The ECB and national supervisors have made it very clear that they expect banks to have adequate local resources, continuous access to financial market infrastructures without being fully dependent on their parent undertakings in third countries, and not to rely on intragroup back-to-back hedging strategies or remote booking with group entities in third countries. As it became increasingly likely that the United Kingdom would leave the EU without a withdrawal agreement, many UK financial institutions decided to establish a licensed entity in the EU from which they would be able to service their European clients after Brexit. Frankfurt was apparently one of the main benefactors of this development.

VIII OUTLOOK AND CONCLUSIONS

The regulatory agenda for 2019 will continue to be dominated by the SSM, and by the ECB as the trendsetter for banking supervisory matters within Germany and the whole of the eurozone. The ECB has set three focus areas (priorities) for banking supervision within the SSM in 2019 for which specific supervisory action is planned:

a credit risk (e.g., an examination of banks' non-performing loan strategies, an investigation of real estate exposures, and an analysis of collateral management and valuation practices is planned by the ECB for 2019);

b risk management (supervisory action includes a continued targeted review of internal models, a finalisation of the ECB's guidance on the Internal Capital Adequacy Assessment Process and the Internal Liquidity Adequacy Assessment Process, as well as further scrutiny of banks' preparedness for supervisory changes); and

13 Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

14 Cf Handelsblatt, Finanzbranche hat DSGVO noch nicht vollständig umgesetzt, 2 November 2018.

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c activities comprising multiple risk dimensions (e.g., banks' preparations for Brexit or the EU-wide stress test that is planned for 2019).

All these priorities are continuing on from 2018, when the ECB had identified banks' business models and profitability drivers as further priorities.

For the first time, BaFin has also published supervisory priorities. For 2019, these are:

a digitalisation (e.g., dealing with changes in financial practices triggered by digitalisation, data security and the improvement of BaFin's own digital infrastructure);

b Brexit (dealing with the loss of passporting rights, continuing cooperation with the UK supervisory authorities, ensuring consumer protection, and continuing and intensifying public communications on the topic of Brexit);

c specifically for the banking supervision, the execution of stress tests for less significant institutions and an examination of IT systems and processes; and

d specifically for securities supervision, in particular the implementation of MiFID II/ MiFIR, the PRIIPS Regulation and the Prospectus Regulation, and dealing with new developments on the capital markets (e.g., initial coin offerings).

In March 2019, the German parliament passed a law concerning tax-related and further accompanying regulations for use following the exit of the United Kingdom from the European Union. This law contains, among other things, a transition period of 21 months in which EU passports from UK financial institutions would continue to be recognised under certain conditions should there not be a withdrawal agreement in place at the date of Brexit. An additional transitional regime relates to UK companies that deal on own account in financial instruments in Germany as a member of, or under direct electronic access to, a German trading venue; these companies may continue to do so if they apply for an exemption within the first three months of Brexit.

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Chapter 15

HONG KONG

Peter Lake[1]

I INTRODUCTION

Hong Kong has a three-tier system of banking institutions covering licensed banks, restricted licence banks and deposit-taking companies. There are separate licensing regimes, laws and regulations governing money lenders and money brokers. As of 28 February 2019 there were 152 licensed banks, 18 restricted licence banks, 16 deposit-taking companies and 48 local representative offices of overseas banks in Hong Kong. The five largest licensed banks in Hong Kong measured by total assets are HSBC, Bank of China (Hong Kong), Hang Seng Bank, Standard Chartered Bank (Hong Kong) and the Industrial and Commercial Bank of China (Asia) Limited. The Hong Kong Monetary Authority (HKMA) is the government authority responsible for maintaining monetary and banking stability in Hong Kong.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Companies wishing to carry on banking business or the business of taking deposits in Hong Kong are required under the Banking Ordinance[2] to be authorised by the HKMA. These institutions are referred to in the Banking Ordinance as authorised institutions (AIs).

i The HKMA

The HKMA's functions and policy objectives are:

a maintaining currency stability;
b promoting the stability and integrity of the financial system;
c helping to maintain Hong Kong's status as an international financial centre; and
d managing the Exchange Fund (Hong Kong's official reserves).

The HKMA fulfils some of the functions of a central bank, such as formulating and implementing monetary policy, supervising banks and managing the Exchange Fund. Other functions, notably the issuance of bank notes, are carried out by three banks within Hong Kong's commercial banking sector: Bank of China, HSBC and Standard Chartered.

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1 Peter Lake is a partner at Slaughter and May. The author would like to thank his colleagues Sarah Peterson and Nicholas Dinan for their assistance in preparing this chapter.

2 Chapter 155 of the Laws of Hong Kong.

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ii Banking regulation

The Banking Ordinance provides the legal framework for banking regulation, which is supplemented by two publications by the HKMA: the Supervisory Policy Manual and the Guide to Authorization. The Supervisory Policy Manual contains the HKMA's latest supervisory policies and practices. The Guide to Authorization sets out the HKMA's interpretation of the authorisation criteria, the procedures for processing applications for authorisation and the grounds for revocation of licences.

iii Local representative offices

Instead of seeking authorisation to be AIs, overseas banks may, with the approval of the HKMA, establish local representative offices in Hong Kong. Local representative offices are not allowed to engage in any banking or deposit-taking business in Hong Kong. Their role is therefore largely confined to liaison work between the overseas bank and its customers in Hong Kong.

iv AI eligibility criteria

Certain basic criteria must be satisfied to be eligible to become an AI and obtain a banking licence. The HKMA has general discretion to grant or refuse an application for authorisation and, if one or more of the criteria is not fulfilled, the HKMA must refuse the relevant application for authorisation. An AI must be a body corporate. Where the applicant for AI branch authorisation is a bank incorporated outside Hong Kong, the HKMA will confirm with the relevant overseas banking supervisory authority that it has given consent for the applicant to establish a branch in Hong Kong. The authorisation criteria for AIs, which are set out in the Seventh Schedule to the Banking Ordinance, ensure that only fit and proper institutions are entrusted with public deposits.

v Securities activities

The banking industry is regulated jointly by the HKMA and the Securities and Futures Commission of Hong Kong (SFC) to the extent that AIs carry on business in one or more regulated activities as defined in the Securities and Futures Ordinance (SFO).[3] Regulated activities include dealing in securities, advising on securities, advising on corporate finance and asset management.

The foundation of the regulatory framework for the securities and futures industry is that carrying on a business in a regulated activity without a licence, and without reasonable excuse, is a criminal offence. AIs that carry on business in one or more regulated activities are defined as registered institutions in the SFO. To become a registered institution, the institution in question must satisfy the SFC that it is a fit and proper person.

The SFO sets out a limited number of regulated activities (such as leveraged foreign exchange trading and certain types of securities margin financing) that AIs may carry out without a licence. The SFO includes provisions that have not yet commenced whose effect is to extend regulated activities to advising or dealing in derivatives (or other structured products). AIs will largely be exempted from the derivatives-regulated activities but are required under other provisions – and in line with international standards – to comply with mandatory reporting, clearing and margining rules in respect of their derivatives activities.

3 Chapter 571 of the Laws of Hong Kong.

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vi Cross-border marketing

The Banking Ordinance prohibits marketing that invites members of Hong Kong's public to make deposits. The prohibition catches persons outside Hong Kong who market to persons in Hong Kong. The prohibition is subject to a number of exceptions, including invitations to make deposits with AIs and invitations to make deposits outside Hong Kong, which contain prescribed disclosures.

Hong Kong's securities legislation, under the SFO, similarly prohibits the active marketing of regulated activities to Hong Kong's public if the relevant service provider of the regulated activities has not been granted a licence by the SFC.

vii HKMA's approach to banks regulated by overseas regulators

The HKMA recognises that the primary authority for supervising overseas banks lies with the supervisory authority of the jurisdiction where the relevant bank is incorporated. Accordingly, not all of the provisions in the Banking Ordinance and the Supervisory Policy Manual are applicable to AIs incorporated outside Hong Kong. Corporate governance and capital adequacy are two areas where the Banking Ordinance and the Supervisory Policy Manual are not applicable to banks incorporated outside Hong Kong, although the Banking Ordinance does set out certain capital thresholds to be met by an institution to become and remain authorised.

However, the HKMA does retain supervising power over most matters of day-to-day conduct of banking affairs for overseas banks authorised in Hong Kong. Rules and guidelines under the Banking Ordinance covering areas such as the appointment of directors responsible for the Hong Kong operations of overseas banks, the code of conduct of their Hong Kong operation, internal risk controls and risk management, liquidity management, trading activities and money laundering are applicable to overseas banks authorised in Hong Kong.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The primary responsibility for the prudent management of an AI rests with the board of directors and management itself. The HKMA issues guidance to AIs through its Supervisory Policy Manual. While the Supervisory Policy Manual does not itself have the force of law, any failure to adhere to any of the guidelines set out in it may call into question whether an AI continues to satisfy the minimum criteria for authorisation under the Banking Ordinance.

Continuous supervision

The HKMA adopts a continuous supervision policy so as to detect and address problems at an early stage. Various techniques are used by the HKMA to gather information and to monitor the business of each AI, including:

a on-site and off-site examinations;
b prudential meetings with the senior management;
c meetings with the board of directors;
d cooperation with external auditors; and
e sharing information with other supervisors.

Furthermore, regular statutory returns are required to be submitted to the HKMA.

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Risk-based approach

The HKMA adopts a risk-based approach to evaluate the safety and soundness of an AI, its risk-management systems and its internal controls. This enables the HKMA to pre-empt any serious threat to the stability of the banking system.

The major types of inherent risks identified by the HKMA are credit, interest rate, market, liquidity, operational, legal, reputational and strategic risks. A risk-management rating is assigned and factored into the management and other relevant components of the CAMEL rating system, which is an internationally recognised framework for assessing capital adequacy, asset quality, management, earnings and liquidity. The output of the CAMEL system is a supervisory rating to reflect the HKMA's view of the overall safety and soundness of the relevant AI.

For a Hong Kong-incorporated AI, the HKMA normally conducts a regular supervisory review once a year. The supervisory review process is a comprehensive assessment of the level of capital that a Hong Kong-incorporated AI should set aside for the major types of inherent risks identified for the purpose of risk-based supervision.

The HKMA has issued rules under the Banking (Capital) Rules[4] that prescribe in detail how the capital adequacy of locally incorporated AIs should be calculated. These rules incorporate Basel III technical guidance. In addition, the HKMA's revised Supervisory Policy Manual module CA-G-5 (supervisory review process) sets out details of the changes to the supervisory review process that were necessitated by the implementation of the Basel III capital standards. The Banking (Capital) Rules have been amended in previous years to introduce several capital buffers such as the capital conservation buffer, the countercyclical capital buffer and the higher loss absorbency (HLA) requirement. The capital conservation buffer is an additional layer of Common Equity Tier 1 (CET1) capital above the hard minimum capital requirements that has been phased in in equal annual increments to 2.5 per cent of banks' total risk-weighted assets with effect from January 2019. The countercyclical capital buffer is a further requirement for CET1 capital ranging from zero to 2.5 per cent of risk-weighted assets for banks' private sector credit exposures in Hong Kong when the HKMA determines there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. The HLA ratio will apply to domestic banks considered by the HKMA to be systemically important (there are currently no global systemically important banks (G-SIBs) headquartered and incorporated in Hong Kong). They will be obliged to comply with this requirement by maintaining an additional layer of CET1 capital increasing to a range (as from 2019) from 1 to 3.5 per cent of their total risk-weighted assets.

The latest amendments to the Banking (Capital) Rules were introduced by the Banking (Capital) (Amendment) Rules 2018, will come into operation in stages: 11 January 2019, 1 April 2019 and 1 July 2019. These rules cover:

a loss-absorbing capacity;

b an expanded scope of instruments to be subject to deductions (or risk-weightings) when calculating capital, including the holding of loss-absorbing capacity instruments;

c amendments to the criteria to recognise instruments as regulatory capital;

d new provisions relating to sovereign concentration risk and risk-weightings; and

e new provisions relating to unrated securitisation exposures to asset-backed commercial paper.

4 Chapter 155L of the Laws of Hong Kong.

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Rules relating to loss-absorbing capacity are discussed further below.

While there are separate regulators for the prudential supervision of securities, insurance, Mandatory Provident Fund schemes and money lending businesses in Hong Kong, the HKMA supervisory review process assesses all the major risks of a banking group, whether arising from banking or non-banking activities.

Consolidated supervision

The capital adequacy, concentration of exposures and liquidity of a Hong Kong-incorporated AI are supervised on a consolidated basis to enable the HKMA to assess any weaknesses within a banking or financial group that may have an impact on the AI itself, and to take any necessary defensive or remedial actions. When supervising banking groups, the HKMA takes a flexible approach to determining the scope of consolidated supervision. As a general rule, a banking group's local and overseas offices and financial subsidiaries are covered. Non-bank companies are included in the consolidation if they undertake financial business such as hire purchase, credit cards or leasing. Where non-bank companies (e.g., securities firms or insurance companies) are adequately supervised by other supervisors, the HKMA will rely heavily on their cooperation to ensure the effective overall supervision of the banking group. The HKMA will also consider contagion risk in relation to an AI's holding and sister companies.

ii Management of banks

One of the authorisation criteria under the Banking Ordinance is that the HKMA must be satisfied that the chief executive and directors of the applicant company are fit and proper persons to hold their respective positions. The HKMA will have regard to the person's experience, knowledge and skills, as well as his or her reputation and character, competence, soundness of judgement and diligence, whether he or she has a record of non-compliance with non-statutory codes or disciplinary records, his or her involvement as a director in any companies wound up by the court, and his or her business record and financial soundness and strength.

The legal and regulatory duties of the management of AIs are detailed in the HKMA's Supervisory Policy Manual modules on corporate governance (CG-1 to CG-7). In particular, the revised Supervisory Policy Manual module CG-1 (corporate governance of locally incorporated authorised institutions) sets out principles adopted by the HKMA in line with the Basel Committee on Banking Supervision's principles for enhancing corporate governance, and the revised Supervisory Policy Manual module CG-6 (competence and ethical behaviour) sets out the latest developments in enhancing training programmes for banking practitioners in Hong Kong.

The board is ultimately responsible for the conduct of an AI's affairs, but the HKMA recognises that it may be beneficial for supervision of major functional areas to be delegated to certain specialised committees such as an executive committee, credit committee, asset and liability committee, remuneration committee and audit committee. It is also recognised that key functions and policies of an AI that is a subsidiary of another banking institution may be determined and centralised at the holding company level.

Outsourcing

The Supervisory Policy Manual module SA-2 (outsourcing) sets out the HKMA's supervisory approach to outsourcing and the major points that the HKMA recommends AIs to address

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when outsourcing their activities. The HKMA's main concerns are with accountability, risk assessment, the ability of service providers, confidentiality of customer data, the degree of control the AI maintains over outsourced activities, contingency planning, and access to outsourced data by the HKMA's examiners and the AI's internal and external auditors.

iii Regulatory capital, loss-absorbing capacity and liquidity

Capital adequacy ratio

The HKMA must be satisfied that an AI has financial resources that are adequate for the inherent risks in its business to reduce the risk of insolvency. All AIs are required under the Banking Ordinance to maintain minimum levels of share capital. As regards Hong Kong-incorporated AIs, the HKMA's framework for capital adequacy is based on Basel III (which was implemented in Hong Kong on 1 January 2013).

A Hong Kong-incorporated AI is required under the Banking (Capital) Rules to maintain a CET1 capital ratio of at least 4.5 per cent, a Tier 1 capital ratio of at least 6 per cent and a total capital ratio of 8 per cent. Branches of foreign banks are not subject to this requirement but, based on the HKMA's past practice of generally requiring any foreign bank that wishes to establish a branch in Hong Kong to maintain a capital adequacy ratio of at least 8 per cent, it is likely that the HKMA will continue to require foreign banks to meet the three minimum risk-weighted capital ratios.

Under the supervisory review process discussed above, the HKMA may require an AI to have a capital buffer to cater for risks and uncertainties that are not already captured by the three minimum risk-weighted capital ratios. The HKMA has the power under the Banking Ordinance to vary any capital requirement rule applicable to an AI.

Capital buffers

As mentioned above, the HKMA has implemented the following capital buffers: the capital conservation buffer, the countercyclical capital buffer and, for domestic systematically important banks (D-SIBs), the higher loss absorbency requirement.

The capital conservation buffer is being phased in in equal annual increments. The capital conservation buffer is an additional band of CET1 capital, which was increased to its upper level of 2.5 per cent in 2019.

The level of the countercyclical capital buffer is an additional band of CET1 capital base determined by the HKMA's analysis on whether there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. It is an extension of the capital conservation buffer. On 10 January 2018, the HKMA announced that the countercyclical capital buffer will increase from the current 1.875 per cent to 2.5 per cent with effect from 1 January 2019. This is in accordance with the maximum countercyclical counter buffer permitted for 2019 under the Basel III phase-in arrangement and the Banking (Capital) Rules. The HKMA regards a continued build-up of the buffer as appropriate given the risks associated with continued credit and property market conditions and external political uncertainties.

The HLA requirement applies only to D-SIBs. It is also an additional band of CET1 capital base that acts an extension of the capital conservation buffer. On 21 December 2018, the HKMA announced that Hong Kong's list of D-SIBs remains unchanged, covering six AIs: The Hongkong and Shanghai Banking Corporation Limited, Bank of China (Hong Kong) Limited, Hang Seng Bank Limited, The Bank of East Asia, Limited, Industrial and Commercial Bank of China (Asia) Limited and Standard Chartered Bank (Hong Kong)

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Limited. Each D-SIB will, in accordance with the Basel Committee arrangements, include a higher loss absorbency requirement into the calculation of its regulatory capital buffers. Of the six banks, the HKMA has designated to The Hongkong and Shanghai Banking Corporation Limited the highest HLA (2.5 per cent for 2019), and to The Bank of East Asia, Limited, Industrial and Commercial Bank of China (Asia) Limited and Standard Chartered Bank (Hong Kong) Limited the lowest HLA (1 per cent for 2019).

If a Hong Kong-incorporated AI's capital level erodes to a level falling within the capital conservation buffer zone, the countercyclical capital buffer zone, or for a D-SIB, the HLA buffer zone, restraints will be imposed on that AI's distributions. A Hong Kong-incorporated AI is expected to discuss with the HKMA if it anticipates that any of its capital levels will fall close to the buffer zones.

Loss-absorbing capacity rules

The Financial Institutions (Resolution) Ordinance[5] covers resolution, including bank resolution. On 14 December 2018, the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules were issued and came into operation. The rules enable the HKMA to prescribe loss-absorbing capacity (LAC) requirements for 'within scope' financial institutions that are Hong Kong-incorporated AIs, and for their Hong Kong-incorporated holding companies or Hong Kong-incorporated affiliated operational entities. Not all Hong Kong-incorporated AIs will be classified as within scope, meaning that not all Hong Kong incorporated AIs will be subject to the LAC requirements. It is worth noting that the LAC consolidation group may differ from the regulatory capital consolidation group. The rules set out how to calculate LAC leverage ratios (both external LAC and internal LAC, and under a solo, solo-consolidated and consolidated basis), capital component ratios and resolution component ratios (which will often be the same as the related capital component ratio). External LAC will at a minimum be the sum of an AI's capital component ratio and its resolution component ratio. Internal LAC will be set at a fraction of the external LAC (likely 75 per cent in most cases). There is a requirement for at least a specified portion (likely one-third) of the LAC to be in the form of LAC debt, since LAC debt (unlike LAC equity) is not at risk of depletion before bank failure and so provides a fixed quantity of financial resources that can support an orderly resolution. The rules also cover disclosure requirements in relation to LAC and deductions for holding non-capital LAC liabilities.

The Banking (Capital) (Amendment) Rules 2018 amend the Banking (Capital) Rules. The amendments include the following:

a an AI must take into account its minimum LAC requirements, in addition to its minimum regulatory capital requirements, in calculating the CET1 capital remaining available to meet the capital buffer requirement;

b amendments are made to the capital deduction (or risk-weighting) framework for holding non-capital LAC liabilities;

c amendments are made to the qualifying criteria for recognition of instruments as regulatory capital to mirror the qualifying criteria for LAC debt instruments; and

d new provisions relating to sovereign concentration risk and risk-weightings.

5 Chapter 628 of the Laws of Hong Kong.

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Note that capital that counts towards meeting the regulatory capital requirement (i.e., those hard requirements, ignoring the softer capital buffers) will generally count towards meeting an LAC requirement. This means that the new additional burden for a within scope Hong Kong-incorporated AI will likely be the resolution component ratio.

Solo and consolidated capital adequacy ratio

In broad terms, the Banking (Capital) Rules impose capital requirements on Hong Kong-incorporated AIs at two levels: on a solo basis and a consolidated basis.

All Hong Kong-incorporated AIs are required to maintain a capital adequacy ratio on a solo basis, which provides a measure of each institution's (including its local and overseas branches) capital strength. A Hong Kong-incorporated AI may apply to the HKMA to include in its capital base, for the purposes of calculation of its solo capital adequacy requirement, the capital invested in any subsidiary that meets the criteria set out in the Banking (Capital) Rules such that the capital adequacy ratio of that institution will be calculated on a solo-consolidated basis.

Where a Hong Kong-incorporated AI undertakes other banking and financial business through subsidiary companies, the HKMA normally also requires the AI to maintain its capital adequacy ratio on a consolidated basis. This is to ensure that the Hong Kong institution's capital position is maintained at an adequate level taking into account its exposures to risks stemming from such subsidiaries. It is usually the practice of the HKMA to set the same minimum capital adequacy ratio requirement at both the solo and consolidated levels, unless the results of the supervisory review process justify otherwise.

Group supervision may also extend to controllers of the AI, including an assessment of controllers' financial resources to provide continuing support to the AI.

Composition of capital base

Under the Banking Ordinance, the capital base of an AI is the sum of its Tier 1 capital and Tier 2 capital. Tier 1 capital is the sum of an AI's CET1 capital and its additional Tier 1 capital. The key elements of the CET1 capital of an AI are the AI's CET1 capital instruments; the amount standing to the credit of the AI's share premium account (if any) resulting from the issue of the AI's CET1 capital instruments; the AI's retained earnings and other disclosed reserves; and the amount of minority interests arising from the CET1 capital instruments issued by the consolidated bank subsidiaries of the AI and held by third parties. The Banking (Capital) Rules also set out in detail how an AI's additional Tier 1 capital and Tier 2 capital are to be calculated. In respect of each category of capital, the Banking (Capital) Rules also specify which items are to be excluded from the calculation, as well as which deductions are to be made.

Risk-weighted amount

The Banking (Capital) Rules set out various alternative approaches that a Hong Kong-incorporated AI can use to calculate its risk-weighted amounts for credit risk, market risk and operational risk. Each Hong Kong-incorporated AI is expected to choose options based on the results of its own detailed feasibility study. However, there is a default approach for each relevant risk that every Hong Kong AI must adopt unless the prior approval of the HKMA has been obtained for using another approach.

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Most banks in Hong Kong use the standardised approach for both credit risk and market risk. For operating risk, the banks are split between the standardised approach and the basic indicator approach.

Banks in Hong Kong generally have strong capital bases. The consolidated capital adequacy ratio of Hong Kong-incorporated AIs was well above the 8 per cent requirement under the Banking (Capital) Rules (20.2 per cent in September 2018).

Liquidity risk

The risk-based supervisory approach includes the continuous supervision of each AI's liquidity risk. Central to this is an assessment of an AI's ability to maintain adequate liquidity in the event of a liquidity crisis. The HKMA considers the amount of high-quality liquid assets that an AI can readily dispose of or pledge for funding; the results of stress tests on its cash-flow and liquidity positions; and the stability of the AI's funding sources and its contingency measures for dealing with crisis situations.

Amendments to the Banking Ordinance have been enacted to remove the liquidity ratio from the main body of the legislation and to allow the HKMA to make subsidiary legislation prescribing liquidity requirements to implement Basel III reforms. On 1 January 2015, the Banking (Liquidity) Rules[6] implementing the Basel III liquidity coverage ratio (LCR) came into operation, which sought to promote banks' resilience to short-term liquidity risks by ensuring they have sufficient high-quality liquid assets to meet their obligations for at least 30 days under an acute stress scenario.

The LCR applies only to AIs designated by the HKMA as category 1 institutions under the liquidity rules. Category 1 institutions are those internationally active AIs or larger or more sophisticated AIs that are significant to the general stability of the local Hong Kong banking system. All category 1 institutions must maintain at all times an LCR of at least 100 per cent for 2019. Other AIs not designated as category 1 institutions (category 2 institutions) will be subject to the liquidity maintenance ratio (LMR), which is a modified version of the pre-existing liquidity ratio. All category 2 institutions must maintain on average in each calendar month an LMR of at least 25 per cent.

On 1 January 2018, a new net stable funding ratio (NSFR) and a new local core funding ratio (CFR) were brought into force. These apply to different categories of AI to ensure their assets are financed with sufficiently stable sources of funding. All category 1 institutions must maintain at all times an NSFR of at least 100 per cent, and all category 2A institutions must maintain on average in each calendar month a CFR of at least 75 per cent from 2019.

Whether incorporated in or outside Hong Kong, the LCR, LMR, NSFR or CFR (as applicable) will apply only to an AI's business in Hong Kong and its local branches (i.e., excluding any subsidiaries or overseas branches of the AI). For a Hong Kong-incorporated AI, the HKMA may require the LCR, LMR, NSFR or CFR (as applicable) to be calculated on a consolidated basis instead of an unconsolidated basis, or on both a consolidated and an unconsolidated basis.

6 Chapter 155Q of the Laws of Hong Kong.

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Liquidity of Hong Kong banks

Hong Kong banks' balance sheets have remained liquid in the aftermath of the global financial crisis, and moreover have improved over the past 12 months. The consolidated quarterly average LCR of category 1 institutions in Hong Kong stood at 144.5 per cent (September 2017), 156.6 per cent (June 2018) and 157.6 per cent (September 2018). The consolidated quarterly average LMR of category 2 institutions in Hong Kong stood at 50.2 per cent (September 2017), 51.3 per cent (June 2018) and 52.0 per cent (September 2018).

iv Recovery and resolution

The HKMA is a member of the Financial Stability Board (FSB), and has committed in principle to improving the effectiveness of its own resolution regime in light of the FSB policy paper, Key Attributes of Effective Resolution Regimes, published in October 2011 and updated in October 2014. The Financial Institutions (Resolution) Ordinance,[7] which is the primary legislation setting out Hong Kong's resolution regime, came into operation on 7 July 2017. The Ordinance establishes a cross-sector resolution regime for relevant financial institutions (including all AIs) with a view to avoid or mitigate the risks otherwise posed by their non-viability to the stability of Hong Kong's financial system.

The HKMA is contributing to the process of drawing up international resolution and recovery plans as a member of the crisis management groups of several G-SIBs.

In addition to the powers given under that Ordinance, the HKMA may also exercise a number of powers under the Banking Ordinance if, inter alia, an AI informs the HKMA that it is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment. The HKMA may also take such action unilaterally. In these circumstances, the HKMA, after consultation with the Financial Secretary of Hong Kong, may give directions to the AI in relation to its affairs, business and property.

The Supervisory Policy Manual contains a guideline on recovery planning, RE-1, which informs AIs of the key elements of effective recovery planning, and sets out the HKMA's approach and expectations in respect of its review of recovery plans. The Banking Ordinance was amended on 2 February 2018 to give explicit statutory backing to recovery planning. The legislation covers the powers of the HKMA to:

a require the preparation and maintenance of a recovery plan;
b the imposition of requirements on an AI to ensure a recovery plan is fit for purpose;
c the imposition of requirements on an AI to revise its recovery plan;
d directions to implement recovery plan measures under specific conditions;
e AI requirements to notify trigger events; and
f the extension of recovery powers to an AI's locally incorporated holding company.

On 7 July 2017, the HKMA issued three codes of practice: Resolution Planning – Core information Requirements (CI-1); Operational Independence of the Monetary Authority as Resolution Authority (RA-1) and The HKMA's Approach to Resolution Planning (RA-2).

7 Chapter 628 of the Laws of Hong Kong.

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IV CONDUCT OF BUSINESS

i Conduct of business rules

The HKMA requires AIs to establish a code of conduct setting out the standards of behaviour expected of their management and employees. The code of conduct should discourage conflicts of interest, the granting and receiving of credit by members of staff to themselves or their relatives, bribery, personal investments when in possession of price-sensitive information and outside employment. It should also encourage staff to handle personal data carefully, and to contribute to the good reputation of the AI by reporting any illegal activities. The HKMA requires the effectiveness of the code of conduct and related systems to be audited regularly.

Furthermore, from 1 January 2018, AIs are expected to implement the requirements set out in the revised module IC-1 (risk management framework) of the HKMA's Supervisory Policy Manual. The revised module provides guidance on establishing an effective risk management framework (such as delineating responsibilities of the board and different committees of AIs), monitoring risk-taking activities and the risk management process, and maintaining procedures to facilitate firm-wide risk.

ii The Code of Banking Practice

The Code of Banking Practice (Code), issued jointly by the Hong Kong Association of Banks and the Deposit-taking Companies Association and endorsed by the HKMA, gives wider protection to customers and promotes good banking practices by aligning with international standards on financial consumer protection. The Code is issued on a voluntary basis, although the HKMA expects all AIs to comply with it and the HKMA monitors compliance. It covers areas such as terms and conditions, fees and charges, use of customer information, residential mortgage financing, card services and electronic banking services.

iii Banking confidentiality

Under common law, a term imposing a duty of confidentiality may be implied in contracts between a bank and its customer. The duty of confidentiality applies to information arising directly from the customer's account, and other information obtained through the relationship between the bank and the customer or in coming to decisions about the bank's treatment of its customers. For the purpose of this duty, where a banking group is structured through subsidiary companies, each subsidiary is considered as a separate entity. Therefore, restrictions on disclosure apply equally to transfers of information within a banking group as to transfers to a third party. In contrast, branches of a single corporate entity are considered to form part of the same entity. Therefore, information may be transferred freely between them subject to any applicable data protection laws.

There are four heads of acceptable disclosure of a customer's confidential information by a bank:

a compulsion of law;
b duty to the public;
c interests of the bank; and
d express or implied consent of the customer.

Head (c) is only applicable where disclosure is needed to protect the bank and not simply where it would be commercially advantageous.

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Personal data is regulated in Hong Kong by the Personal Data (Privacy) Ordinance (PDPO).[8] The purpose of the PDPO is to protect the privacy interests of living individuals in relation to personal data. It applies to any person (a data user) who controls the collection, holding, processing or use of personal data in Hong Kong. A person for the purposes of identifying a data user includes 'any public body, any body of persons, corporate or unincorporated'. Branches as well as subsidiary companies may constitute separate data users, and transfers between them should be in accordance with the PDPO. A third party to whom data is outsourced (e.g., for the completion of IT tasks) will not be a data user for the purposes of the PDPO in relation to data it 'holds, processes or uses solely on behalf of another person' if it does not hold, process or use that data for any of its own purposes. This exemption is not available where the third party is involved in the collection of data.

According to the Code, AIs should treat their customers' (and former customers') banking affairs as private and confidential, and should at all times comply with the PDPO and any relevant codes of practice issued or approved by the Privacy Commissioner in the collection, use and holding of customer information.

In October 2014, the Office of the Privacy Commissioner for Personal Data, Hong Kong (PCPD), published a Guidance Note on the Proper Handling on Customers' Personal Data for the Banking Industry, which explains for the benefit of banks the PDPO requirements in relation to the collection, holding, processing and use of customer data. The Guidance Note contains a number of useful case studies that are based on matters that have been considered by the Privacy Commissioner. In October 2015, the PCPD published a revised edition of its frequently asked questions on Understanding the Code of Practice on Consumer Credit Data in relation to the Sharing of Mortgage Data for Credit Assessment Purpose. The publication addresses common questions regarding the regulations on the sharing of mortgage data by credit providers through a credit reference agency under the Code of Practice on Consumer Credit Data.

iv Potential sources of liability

The Supervisory Policy Manual reminds directors of AIs to be aware of their legal obligations under all applicable laws and regulations, including but not limited to the Banking Ordinance, the Companies Ordinance,[9] the SFO, the PDPO, the Financial Institutions (Resolution) Ordinance, the Drug Trafficking (Recovery or Proceeds) Ordinance,[10] the Organised and Serious Crimes Ordinance,[11] the Anti-Money Laundering and Counter-Terrorist Financing Ordinance[12] and the Prevention of Bribery Ordinance.[13]

The SFO contains provisions on market misconduct (insider dealing, market manipulation, disclosure of false or misleading information, etc.). The SFO also contains several key provisions applicable to AIs that are registered with the SFC to carry on a business in one or more regulated activities. In general, AIs are subject to the provisions of the SFO in the same way as licensed corporations (i.e., institutions that are licensed by the SFC)

8 Chapter 486 of the Laws of Hong Kong.
9 Chapter 622 of the Laws of Hong Kong.
10 Chapter 405 of the Laws of Hong Kong.
11 Chapter 455 of the Laws of Hong Kong.
12 Chapter 615 of the Laws of Hong Kong.
13 Chapter 201 of the Laws of Hong Kong.

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in respect of their regulated activities. The major areas of difference, arising from the need to avoid regulatory overlap with the Banking Ordinance, are capital requirements and the handling of client money.

Directors may be held personally liable for non-compliance with many of the requirements under the Banking Ordinance and the SFO. In certain circumstances, such as under some offences under the Theft Ordinance,[14] directors may be held criminally liable for offences committed by companies of which they are a director.

V FUNDING

Customer deposits are the most important source of funding for retail banks in Hong Kong. As at the end of June 2018, they accounted for 54.5 per cent of total liabilities. The high level of customer deposits has kept customer deposit rates at a low level: the monthly average savings deposit rates per annum of less than HK$100,000 quoted by leading licensed banks has remained at 0.13 per cent since February 2019, an increase from just 0.01 in August 2018. The high level of customer deposits also contributes to the low rate of interest offered on Hong Kong dollar loans by licensed banks in the Hong Kong interbank market (HIBOR): the quarterly average of one-month HIBOR stood at 1.68 per cent (September 2018).

i Stable funding requirement (SFR)

The HKMA introduced a stable funding requirement (SFR) in October 2013, which required AIs with significant loan growth to ensure they had adequate stable funding to support their lending business. The HKMA conducted a review of the SFR in 2014 and introduced several refinements that took effect from January 2015. These refinements were primarily aimed at streamlining the SFR and reducing AIs' reporting burden.

ii Provision of liquidity assistance by the HKMA

Intraday liquidity

The HKMA provides liquidity assistance to licensed banks on their request, if necessary, through conducting foreign exchange swaps between the US dollar and the Hong Kong dollar, and lending money against collateral of a credit quality acceptable to the HKMA. Intraday repos that fail to be reversed before the close of the business day will be carried into overnight borrowing through the discount window arrangement described below. These two arrangements were introduced in 2008 as part of five precautionary and temporary measures to enhance the framework of liquidity provision to the banking system in Hong Kong in light of the global financial conditions at that time. The other three measures were withdrawn in March 2009, but these two arrangements remain in place.

Overnight liquidity

Temporary overnight funding is available to licensed banks in Hong Kong through the discount window. The discount window facility was introduced in September 1998 as a mechanism through which licensed banks can borrow Hong Kong dollar funds from the HKMA through repurchase agreements using eligible securities as collateral. The HKMA

14 Chapter 210 of the Laws of Hong Kong.

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also operates a Hong Kong dollar discount facility for Hong Kong Government Bonds to all licensed banks in Hong Kong, which can provide up to HK$10 billion overnight liquidity against a sale and repurchase of Hong Kong Government Bonds.

Renminbi Liquidity Facility

The Renminbi Liquidity Facility was introduced by the HKMA to address potential short-term liquidity demands in the offshore renminbi market, which may be due to seasonal factors or capital market activities. The Facility was first launched in June 2012. In the light of experience in operating the Facility and developments in the offshore renminbi market, the HKMA has made numerous enhancements to the Facility over the years. Under the Renminbi Liquidity Facility, banks can obtain renminbi from the HKMA on an overnight, one-day, one-week or intraday basis.

Lender of last resort

The HKMA has the ability to provide liquidity to AIs as the lender of last resort (LOLR) using the resources provided by the Exchange Fund, which the HKMA uses to regulate the exchange value of the Hong Kong dollar. It is believed that the HKMA has never had to exercise its function as LOLR.

The HKMA issued a policy statement in March 2009 explaining its role as the LOLR. The guiding principle governing the provision of LOLR support to an AI is whether the failure of that institution, either by itself or through spreading contagion to other entities, would damage the stability of the exchange rate, or the monetary or financial systems. Given LOLR support will only be provided when failure of the AI might have systemic implications, LOLR support will not normally be given to branches of foreign banks operating in Hong Kong. The HKMA expects the head office of such a branch to be its source of LOLR support and, in the absence of such support, such a branch may have to close its operations in Hong Kong.

Deposit protection scheme

The LOLR arrangement is complemented by the deposit protection scheme (DPS), which was launched in 2006 under the Deposit Protection Scheme Ordinance (DPSO)[15] under which eligible deposits are protected. Eligible deposits exclude:

a structured deposits;
b bearer instruments;
c term deposits with a maturity exceeding five years;
d deposits where the repayments are secured on the assets of the member of the DPS;
e offshore deposits;
f deposits held for the account of the Exchange Fund;
g deposits held by an excluded person under the DPSO; and
h financial products other than deposits.

The HKMA acts as an executive arm of the Hong Kong Deposit Protection Board in administering the DPS.

15 Chapter 581 of the Laws of Hong Kong.

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Only licensed banks are required and eligible to participate in the DPS. This is consistent with the aim of the DPS, which is to protect small depositors. A small number of licensed banks, which are branches of overseas-incorporated banks that are already covered by appropriate overseas deposit protection schemes, are exempted from the DPS.

The DPS is pre-funded by contributions from each member of the scheme. Further, the Deposit Protection Board has secured a credit facility from the Exchange Fund. The size of the credit facility is sufficient to cope with the simultaneous failures of two medium-sized banks.

Compensation will be paid to depositors when the court issues a winding-up order, or the HKMA, after consultation with the Financial Secretary, instructs the Deposit Protection Board to pay compensation. Under the DPS, each depositor (whether an individual or a corporate) who is not an excluded person under the DPSO is entitled to a maximum of HK$500,000 of compensation for each failed scheme member with which it places deposits. The amount of compensation entitlement will be calculated net of any liabilities owed by that depositor to the scheme member.

To allow affected depositors to gain quicker access to the payout, the DPSO was amended in 2016 to adopt a gross payout approach for the determination of compensation. This enhanced protection for depositors so that any compensation paid to depositors is determined on the basis of their aggregate protected deposits held with a failed bank (up to HK$500,000 per depositor) without deducting the amount of liabilities owed by those depositors to the same bank.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Control of Hong Kong-incorporated AIs

The Banking Ordinance provides that no person shall become a controller of a Hong Kong-incorporated AI without the prior approval of the HKMA. A controller includes the following:

a an indirect controller: a person in accordance with whose directions or instructions the directors of the institution are accustomed to act;

b a majority shareholder controller: a person who controls over 50 per cent of the voting rights of the institution; and

c a minority shareholder controller: a person who controls between 10 and 50 per cent of the voting rights of the institution.

Note-issuing banks

Pursuant to Section 3(5) of the Legal Tender Notes Issue Ordinance,[16] the Financial Secretary may amend any terms and conditions on which the authorisation to issue bank notes was granted. Shortly after Temasek Holdings, a Singapore state investment company, acquired a stake in Standard Chartered in 2006, the Financial Secretary of Hong Kong approved an additional policy requirement relating to the continuing authorisation of banks to be note-issuing banks. This provided that a note-issuing bank shall not have any close association with any foreign government or foreign government-controlled entity that either alone or with

16 Chapter 65 of the Laws of Hong Kong.

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associates is entitled to control 20 per cent or more of the voting power of the note-issuing bank or its holding company. In effect, the policy requirement is a barrier to controlling 20 per cent or more of the voting power of any of the three note-issuing banks in Hong Kong (although a determined bidder may not view the note-issuing status as a fundamental issue).

Overseas-incorporated AIs

While the acquisition of shareholdings and control in AIs incorporated outside Hong Kong do not need to be approved by the HKMA, the HKMA still needs to be satisfied that a person who is to be a controller of an AI is a fit and proper person to hold such a position. In doing so, the HKMA will rely heavily on the views of the home supervisor of the overseas-incorporated AI.

ii Approval process for controllers of Hong Kong-incorporated AIs

Application

A person seeking to become a controller of a Hong Kong-incorporated AI must first serve on the HKMA a written notice of intention. The written notice must be submitted together with any supporting documents requested by the HKMA.

It is generally the policy of the HKMA that a person who intends to hold 50 per cent or more of the share capital of a Hong Kong-incorporated AI should be a well-established bank or other supervised financial institution in good standing in the financial community and have appropriate experience. If a prospective majority controller does not fulfil this requirement, the HKMA's primary concern will be to ensure that any risks posed to the AI by the controller and the group to which the controller belongs are understood and well contained. To achieve this, the HKMA may impose conditions on the controller. If the controller is incorporated outside of Hong Kong, or is not a financial holding company or a subsidiary of a financial holding company, the controller will generally be asked to establish a Hong Kong-incorporated holding company whose sole purpose will be to hold the shares of the AI. This holding company will be subject to conditions such as capital adequacy, liquidity, large exposures, intragroup exposures and charges over assets, group structure, activities undertaken, risk management, fitness and proprietary of officers, and submission of financial and other information.

Timing

The Banking Ordinance does not specify when written notice needs to be submitted to the HKMA. However, the HKMA's preference is to be approached at the earliest appropriate opportunity, and experience has indicated that the HKMA expects to be approached for an approval in principle before the formal application process begins. This includes an expectation to pre-vet any proposed announcement of the sale of an AI (regardless of whether or not they are incorporated in Hong Kong).

The HKMA then has up to three months from the date of service of the notice to serve a notice of consent, and the HKMA may need the full three months, particularly if the proposed controller is not an established bank or financial institution. In other, more straightforward cases, this period is normally six weeks to two months. The HKMA will be taken to have consented to a person becoming a controller of a Hong Kong-incorporated AI if it does not serve on him or her a notice of objection within the three-month period.

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Considerations

In granting a notice of consent, the HKMA:

a must be satisfied that the person is a fit and proper person to become a controller of the Hong Kong-incorporated AI;

b must be satisfied that the interests of depositors and potential depositors of that Hong Kong-incorporated AI would not be threatened by that person becoming a controller;

c takes into account the person's likely influence on that Hong Kong-incorporated AI if he or she were to become a controller; and

d will take into account the financial position, reputation or conduct of the applicant to determine whether the controller could potentially damage the Hong Kong-incorporated AI through contagion.

In granting the notice of consent, the HKMA may specify such conditions as it thinks proper to safeguard the interests of depositors and potential depositors.

Although not explicitly set out in the legislation, the HKMA will take similar considerations into account when considering controllers of non-Hong Kong-incorporated AIs, which it will review in the context of whether an AI remains fit and proper.

Approval

If the HKMA has served a notice of consent to the applicant, that person must become a controller before the expiration of 12 months from the date on which he or she was served the notice of consent.

Controller financial support

Where a minority or majority shareholding in a Hong Kong-incorporated AI is being acquired, the HKMA will generally require the acquiring shareholder controller to provide a letter of comfort committing to provide capital support, liquidity support or both to the AI, if necessary. The form of the letter of comfort is set out in the HKMA's Guide to Authorization.

Transfers of banking business

While other common law jurisdictions have a court-sanctioned scheme process to effect the transfer of banking business without the consent of the depositors or other counterparties, Hong Kong does not have an equivalent process.

Notification to the HKMA

A Hong Kong-incorporated AI cannot make any arrangement, or enter into any agreement for the sale or disposal of all or any part of its banking business or its business of taking deposits, without the prior written approval of the HKMA.

Private member's bill

In a business or asset transfer in Hong Kong, private legislation is the only alternative to obtaining individual customer consent.

A private member's bill is a special type of legislation intended to affect or benefit some particular person, association or corporate body. It may be used to transfer all or part of a company's business to another company, to extinguish the rights of any creditor of the company, or both. The private member's bill procedure has been used for a number of bank

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mergers with a Hong Kong element (e.g., Citibank, Dao Heng Bank, Standard Chartered and, most recently, Bank of Communications), although this procedure is rare and is not currently favoured by the HKMA.

The customer consent route was used, among others, in the Standard Chartered–American Express Bank integration in 2008, the Australia and New Zealand Bank–Royal Bank of Scotland integration in 2009, the Union Bancaire Privée, UBP SA–Coutts integration and the OCBC/Bank of Singapore–Barclays integration in 2016, and the OCBC/OCBC Wing Hang Bank–National Australia Bank integration in 2017.

VII THE YEAR IN REVIEW

A number of significant regulatory developments have occurred since 2017.

i Update to the Banking Ordinance

The Banking (Amendment) Ordinance 2018, enacted on 2 February 2018, is being brought into operation in stages. As mentioned earlier, under the Ordinance, primary legislation in connection with recovery planning came into operation on 2 February 2018. On 13 July 2018, the following areas were brought into operation: the removal from the primary legislation of substantive rules limiting an AI acquiring shares of another company; and the removal from the primary legislation of substantive rules setting out aggregate holding limitations.

The remaining parts of the legislation will be brought into operation on 1 July 2019. These include removing from the primary legislation substantive rules relating to credit exposures (which will be replaced with rules contained in subsidiary legislation). The rules cover areas such as:

a prohibiting an AI making advances against the security of its shares;
b limitations on advances by an AI;
c limitations on advances to directors and other senior managers and any of their related persons;
d limitations on advances to employees;
e further limitations on an AI acquiring shares of another company; and
f limitations on an AI holding land.

Secondary legislation, namely the Banking (Exposure Limits) Rules, has been amended to consolidate and update the rules referred to above that have been removed from primary legislation. The amendments implement standards set out in the supervisory framework for measuring and controlling large exposures published by the Basel Committee in April 2014. The amendments come into operation on 1 July 2019.

ii Update to Banking (Capital) Rules

Loss-absorbing capacity requirements

As described above, on 14 December 2018 the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules came into operation. The Rules are closely aligned to international standards on LAC requirements.

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iii Fintech

Hong Kong regulators have continued to focus on ways for Hong Kong to support fintech schemes and businesses. In December 2016, the HKMA and others launched a scheme providing 70 openings in 11 participating banks, whereby candidates are exposed to banking fintech projects, and receive regulatory briefings from the HKMA and technical training from the Applied Science and Technology Research Institute. Separately, a fintech cooperation agreement was entered into in December 2016 between the HKMA and the UK Financial Conduct Authority.

The HKMA has since entered into further fintech cooperation agreements with the Monetary Authority of Singapore (in October 2017), the Dubai Financial Services Authority (in December 2017), the Swiss Financial Market Supervisory Authority (in January 2018), the Polish Financial Supervisory Authority (in March 2018), the Financial Services Regulatory Authority of Abu Dhabi Global Market (in June 2018) and the Central Bank of Brazil (in September 2018). The HKMA is also working with its Shenzhen counterparts on a number of fintech initiatives, including exploring the feasibility of establishing cross-border soft-landing facilities to encourage Hong Kong fintech firms to expand their business to the Mainland and vice versa.

On 9 January 2019, the HKMA hosted a roundtable discussion attended by six international organisations and 30 central banks or regulatory authorities to exchange ideas and discuss current fintech topics and strengthen cross-border fintech collaboration. In the same week, the HKMA hosted a financial stability board financial innovation network meeting.

On 6 September 2016, the HKMA launched a fintech supervisory sandbox to facilitate pilot trials of fintech initiatives of AIs before they are launched on a fuller scale. As of the end of January 2019, 43 new technology products involving nine banks have been tested in the sandbox, covering biometric authentication, soft token, chatbot, distributed ledger technology and other technologies.

On 7 August 2018 the HKMA, in collaboration with 11 financial regulators and related organisations, announced an initiative of the Global Financial Innovation Network to seek to provide a more efficient way for innovative firms to interact with regulators and to create a framework for cooperation between financial services regulators.

On 23 July 2018, the HKMA published its Open Application Programming Interface (API) Framework for the Hong Kong Banking Sector. The purpose is to enable collaboration between banks and third-party service providers, and bring innovative, convenient and safe banking services to customers.

In a boost to Hong Kong's payment systems infrastructure, the HKMA announced the launch of the Faster Payment System (FPS) on 17 September 2018, a new, leading-edge retail payment system through which participating banks and stored value facility (SVF) operators are able to provide real-time credit transfer and direct debit services to facilitate payments between merchants and customers, as well as peer-to-peer fund transfers. A key feature of the FPS is that it supports the use of mobile phone numbers or email addresses for payments in Hong Kong dollars and renminbi. On the same day, the HKMA also announced a

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common QR code standard, which will enable merchants to connect to the payment systems of different operators by only displaying a single QR code. The FPS is subject to HKMA oversight under the Payment Systems and Stored Value Facilities Ordinance.[17]

In the sphere of trade finance, the HKMA announced on 31 October 2018 the launch of eTradeConnect, a blockchain-based trade finance platform developed by a consortium of 12 banks in Hong Kong. The eTradeConnect system aims to improve trade efficiency, build better trust among trade participants, reduce risks and facilitate trade counterparties to obtain financings by digitising trade documents, automating trade finance processes and leveraging the features of blockchain technology. It is intended that in the future eTradeConnect will link with platforms from other regions to enable cross-border trade financing.

Another initiative announced by the HKMA is the promotion of virtual banking. The HKMA defines a virtual bank as a bank that primarily delivers retail banking services through the internet or other forms of electronic channels instead of through physical branches. As of the end of August 2018, the HKMA received 30 applications for virtual banking licences. Of those applicants, on 27 March 2019, the HKMA granted virtual banking licences to three applicants. The HKMA continues to process another five virtual bank applications. The existing Guideline on Authorization of Virtual Banks, previously updated in September 2012, was updated on 8 June 2018.

iv Independent non-executive directors

On 3 October 2018, the HKMA, continuing its theme of equipping and empowering independent non-executive directors (INEDs), hosted an annual conference for INEDs. The conference was attended by nearly 80 per cent of all INEDs in the banking industry. A particular focus was the sustainability of sound cultures in banks. On 24 April 2018, the HKMA issued a 'knowledge kit' to all INEDs of Hong Kong-incorporated AIs.

v Retail payment systems

A regulatory regime for SVFs (such as Octopus cards) and retail payment systems commenced on 13 November 2015. On 4 August 2017, the HKMA made its first designations of retail payment systems. The following entities were designated: VISA, Mastercard, UnionPay International and American Express. On 31 August 2018, the HKMA made two further designations: JETCO and EPSCO. The policy behind designations is to ensure the designated retail payment systems are safe, sound and efficient (including having access to sufficient financial resources), and will contribute stability to Hong Kong's financial and payment systems.

vi Resolution regime

The Financial Institutions (Resolution) Ordinance, which is the primary legislation setting out Hong Kong's resolution regime, came into operation on 7 July 2017. In January 2018, a consultation paper was issued on rules on loss-absorbing capacity (LAC) requirements for AIs (including both external LAC and internal (intragroup) LAC). In July 2018, the HKMA released its consultation conclusion, and stated that AIs should be required to have sufficient

17 Chapter 584 of the Laws of Hong Kong.

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LAC to facilitate the orderly failure of such entities. On 14 December 2018, the Financial Institutions (Resolution) Loss-absorbing Capacity Requirements – Banking Sector) Rules came into effect.

vii Anti-money laundering and counter-terrorism

On 13 December 2016, the HKMA introduced the Enhanced Competency Framework on Anti-Money Laundering and Counter-Terrorist Financing (the measures of which are outlined in its Guide). The framework is a collaboration between the HKMA and the banking sector to establish a common set of competency standards to raise professional competence.

On 11 October 2017, the HKMA confirmed it will remove the address verification requirements currently stipulated in the Guideline on Anti-Money Laundering and Counter-Terrorist Financing. The amendments are reflected in the latest Guideline, published in October 2018.

viii OTC derivatives

Mandatory reporting of over-the-counter (OTC) derivatives came into effect on 10 July 2015 (although licensed banks were previously reporting OTC derivatives under simplified interim reporting requirements introduced in 2013). The scope of mandatory reporting was expanded on 1 July 2017 and currently covers certain interest rate swaps, non-deliverable forwards, FX derivatives, equity derivatives, credit derivatives and commodity derivatives.

Mandatory clearing (and related recordkeeping requirements) of OTC derivatives commenced on 1 September 2016. This first phase of mandatory clearing focuses on certain standardised interest rate swaps denominated in US dollars, euros, sterling, Japanese yen or Hong Kong dollars and entered into between major dealers such as AIs, approved money brokers and licensed corporations (or entered into between a major dealer and a financial service provider specified on a list prepared by the SFC and approved by the HKMA). AIs that exceed the relevant average three-month clearing threshold (currently US$20 billion, which is determined in respect of all outstanding OTC derivatives (other than certain deliverable FX forwards and deliverable FX swaps)) may – depending upon the size of the counterparty's OTC derivatives business – be subject to mandatory clearing and recordkeeping obligations in respect of the relevant interest rate swaps.

On 27 January 2017, the HKMA issued a new Supervisory Policy Manual module on margin and risk mitigation standards for non-centrally cleared OTC derivatives. The phase-in of initial margin and variation margin for the relevant institutions (being those with substantial OTC business (generally, with a notional amount exceeding HK$15 billion)) started from 1 March 2017 and is subject to a six-month transitional period. Further phase-in after that date (with reducing thresholds) applies to variation margin and risk mitigation standards.

On 27 June 2018, the HKMA and SFC published their joint conclusions on further enhancements to the OTC derivatives regulatory regime. Such enhancements include a mandatory requirement to use a legal entity identifier, a unique 20-digit alpha-numeric code identifying entities on a reporting entity's side of a financial transaction, for new transactions, and daily valuation information from 1 April 2019.

ix Bank culture reform

On 2 March 2017, the HKMA issued a circular seeking to promote sound corporate culture for banks. The circular concentrates on governance (emphasising the importance of senior

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management setting an appropriate tone from the top and leading by example), incentive systems (to avoid incentivising short-term business performance at the expense of the interests of customers and the safety and soundness of a bank) and assessment and feedback mechanisms (to monitor adherence to banks' cultures and behavioural standards, and to set out escalation steps, including whistle-blowing mechanics). Necessary enhancement measures were required to be implemented by 2 March 2018.

On 19 December 2018, the HKMA announced further measures to gauge the progress of bank culture reform in Hong Kong, stating that it will implement a number of supervisory measures. These include AI self-assessments being extended to cover the banking culture; the HKMA, via site visits and off-site reviews, assessing and benchmarking AIs' practices; and the HKMA meeting with senior management and board members of AIs to gather insights and any lessons they have learnt.

x Green finance

The HKMA noted in September 2018 that Mainland China has become the second-largest green bond issuer in the world, and that as domestic investment alone will likely not be sufficient, Hong Kong will be a preferred location for international investors to tap into the Mainland China bond market. Hong Kong's position is enhanced by the 2017 launch of Bond Connect and by the increasing issuance of offshore bonds by Mainland issuers.

The HKMA is actively supporting green finance, and on 14 June 2018 co-hosted the 2018 Green and Social Bond Principles Annual General Meeting and Conference with the International Capital Market Association.

xi AML fines

The HKMA continues to reprimand and fine banks for failures to comply with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance, including rules relating to wire transfer identification and handling, customer due diligence and monitoring of business relationships. One bank was fined HK$5 million in August 2018 and another was fined HK$12.5 million in December 2018.

VIII OUTLOOK AND CONCLUSIONS

We anticipate the following areas of focus or development for the next 12 months:

a further work by AIs to prepare themselves for Hong Kong changes to implement recommendations from the Basel Committee;

b AIs to take steps to prepare for internal and external LAC; and

c AIs to position themselves to take advantage of the increasing issuance of green finance, including in particular issuers located in Mainland China, to international investors.

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Chapter 16

HUNGARY

Péter Köves and Szabolcs Mestyán[1]

I INTRODUCTION

The Hungarian banking industry has undergone major changes since the beginning of the global economic crisis. At the same time, a combination of bank consolidation, coupled with a regulatory-driven cleansing of balance sheets, have left Hungary's banks in a strong position.

From a legislative perspective, two important sets of EU laws have been implemented: Markets in Financial Instruments Directive II and Regulation, offering protection for investors and more transparency in all asset classes. At the same time, PSD2[2] has been implemented in Hungary to lift the monopoly of banks over their customers' account information and payment services. The implementation of the new legislation affects the capital market and investment services framework as well as the payment services and fintech markets significantly. Further, a strategy for implementing artificial intelligence is being developed: some are already using it, while others are in the process of introducing it into their systems and daily work.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Banking business in Hungary is regulated by the Banking Act.[3] The Banking Act sets out in a codified form the Hungarian law regulating the provision of banking and financial services, and implements the Basel III measures, the Capital Requirements Directive (CRD IV) and Regulation (CRR) into Hungarian law.

Most banks are financial institutions or specialised financial institutions (such as mortgage credit institutions). Two major banks were acquired by the state or state-owned entities in 2014. There are a number of subsidiaries of foreign banks (including Austrian, Italian and German banks). Some large international financial institutions also operate a branch in Hungary. In principle, the local conduct of business regulations also apply to branches, while prudential regulation is the responsibility primarily of their home regulators. The offering of cross-border services (without having a physical presence in Hungary) by banks regulated in a Member State of the European Union is also widespread, in particular in the corporate and interbank sectors.

1 Péter Köves and Szabolcs Mestyán are partners at Lakatos, Köves and Partners.

2 Directive (EU) 2015/2366 of 25 November 2015 on payment services.

3 Act CCXXXVII of 2013 on credit institutions and financial enterprises.

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III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The National Bank of Hungary (NBH) is responsible for both monetary policy and the regulation of financial institutions, investment and insurance service providers.

The Banking Act also implements corresponding EU legislation on prudential regulation: consequently, a market participant familiar with the reporting requirements and types of inspections and monitoring a regulator in other EU jurisdictions expects and conducts will not be surprised by the Hungarian rules, which broadly correspond with the EU laws.

ii Management of banks

The primary objectives of the management regulation in the Banking Act are to:

a ensure a transparent corporate structure;

b prevent conflicts of interest;

c facilitate the application of the procedures by which risks could be effectively identified, measured, monitored and mitigated;

d oblige banks to follow a remuneration policy linked to the effectiveness of risk management; and

e generally maintain the undisturbed and effective operation of financial institutions and the trust vested in the sector.

The NBH issued a guideline (recommendation) regarding the application of remuneration policies implementing the guideline of the European Banking Authority regarding the principles of remuneration in 2017.

The core principle that forms the basis of the detailed provisions regulating requirements with regard to shareholders and members of management is the good business reputation. The NBH has wide discretion in determining (on a case-by-case basis) what it considers to be evidence of this, but it has published a good business reputation form on its website, which must be completed in respect of the management and owners during the licensing process.

Members of boards and supervisory boards (or, in the case of a branch, all managers) are responsible for compliance with the prudential rules. Financial institutions must always be represented by at least two persons with joint signatory rights.

Conflict of interest principles are based on reporting obligations as well as on certain prohibitions. Other requirements aim to ensure that decisions are made in a financial institution's interests, and there is no room for undue influence by third parties. Financial institutions are also obliged to set up and operate an internal monitoring system and department.

Remuneration rules follow the principles set out in the relevant EU laws. Remuneration of management and employees must be proportionate to the size and risks of the business, and the remuneration policy should not motivate employees to expose themselves to improper levels of risk. The policy is prepared and enforced by the supervisory board, while the board of directors monitors this in tandem with the internal monitoring department. Any institution with a market share of at least 5 per cent must set up a remuneration committee, which is responsible for setting the remuneration of employees who are in charge of managing risks and ensuring compliance with laws.

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Remuneration may consist of a base element and a performance-based element, but the latter may not exceed 100 per cent of the base salary. There is, however, an exception where the cap is 200 per cent, which may be applied if the general meeting of shareholders authorises it after detailed discussions of the reasons for applying the higher cap, and the institution notifies the regulator of the proposal and the shareholders' resolution prior to its application (in this case, the financial institution has to certify to the regulator that applying a higher cap does not infringe the prudential rules or EU laws).

When determining the performance-based element of the remuneration, a financial institution has to evaluate not only the performance of the employee concerned, but the performance of the entire department and the financial institution as well. No undertaking may be assumed by the institution in respect of the performance-based element of salaries, and the relevant amounts may be paid only if the financial position of the institution is sustainable and the actual performance provides adequate grounds for the bonus. The elements of the performance-based salary (e.g., a percentage of shares and other instruments) must also be elaborated in detail. A bonus may not be paid in full at once, but has to be deferred for a period of between three and five years.

Branches of EEA institutions may apply the remuneration policy applicable in the Member States in which such institutions are registered.

iii Regulatory capital and liquidity

The Banking Act reflects the provisions of the Capital Adequacy Directive and does not contain provisions that are regulated by the directly applicable Capital Adequacy Regulation.

iv Recovery and resolution

The framework for the resolution of failed banks rests on three pillars. The first is an extraordinary loan available from the NBH. The principle is that, if circumstances arise due to which the operation of a financial institution endangers the stability of the financial system, the NBH may grant a loan, provided that the restrictions related to monetary financing are complied with.

The second pillar is the power of the state to increase the capital of a bank for the purposes of preserving and ensuring the stability of the financial system. This action may be implemented on the basis of a proposal of the NBH, either with the consent and further to the request of the financial institution, or *ex officio*, provided in the latter case that the government adopts a decree in respect of the particular financial institution, the insolvency of which would result in serious damage to the Hungarian financial system. The trigger for adopting such a decree is the point in time when the financial institution does not meet certain capital adequacy requirements. The shares to be acquired by the state upon a capital increase will be preference shares (either in respect of distribution or voting rights). Rules otherwise regulating the acquisition of controlling interests in financial institutions are not applicable in the event of such a capital increase.

Hungary has implemented Directive 2014/59/EU on establishing a framework for the recovery and resolution of credit institutions and investment firms. The resolution regime made available under the Directive may be applied by the NBH to reach the objectives of the implementing act. The main objectives are the following:

a ensuring continuity of critical functions;

b avoiding adverse effects on the financial system;

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c protecting public funds by minimising reliance on extraordinary public financial support;
d protecting depositor interests; and
e protecting client funds and client assets.

The types of tools available to achieve these objectives and the form of the resolution process follow what is stipulated in the framework Directive. The tools applied or to be applied in a given resolution process are set out in the resolution plan prepared by the NBH. The particular resolution document is not public.

The third pillar consists of the administrative measures of the regulator (i.e., the NBH). The NBH has the power to apply a wide range of administrative steps in cases where a financial institution breaches the provisions of the Hungarian Banking Act, particularly if prudential obligations are not complied with. These measures include the power to:

a instruct the institution to adopt a mitigation plan;
b appoint a monitoring officer;
c prohibit the payment of dividends and other distributions, the granting of loans to shareholders, or the assumption of guarantees and similar obligations;
d order the institution to comply with additional capital requirements;
e order the institution to dispose of assets not required for the banking operation; and
f convene a shareholders' meeting or suspend the voting rights of certain shareholders who, on the basis of the facts available, endanger the prudent operation of the institution or the financial market.

IV CONDUCT OF BUSINESS

It is a phenomenon unique to the Hungarian banking market that the conduct of business rules were not the primary focus of the legislator, the regulator, clients or the banks themselves. There were legal provisions regulating the principles of marketing, the way the general terms and conditions should be made available or the means available for clients to submit complaints, but consumer protection and banking behaviour were only loosely regulated, and issues regarding these have rarely arisen.

The global economic crisis and the widespread focus on banks' behaviour and responsibility for the crisis changed the situation dramatically. Not only were high banking sector taxes introduced, but consumer protection and conduct of business regulation also became a priority for governments (and, unfortunately, the subject of political campaigning). Stricter and more detailed regulation was inevitable, since in the years preceding the crisis, households and companies were indebted mainly in euros or Swiss francs; following the crisis, both interest rates and exchange rates increased, resulting in dramatically growing repayment instalments for the many borrowers with income in Hungarian forints.

The first attempts to deal with the situation targeted the regulation of the provision of information and the barriers to amending general terms and conditions unilaterally. This was followed by restrictions on foreclosures, and the introduction of unorthodox measures such as enabling retail borrowers to repay their loans at historical exchange rates or to continue to pay instalments at mandated exchange rates (while banks collect on a forint account the amounts of debt arising out of the difference between the mandated exchange rate and the market rate, generating a debt in forints to be repaid at a later stage).

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The Hungarian Banking Association adopted a Code of Conduct in 2009 in respect of retail loan clients. The core content of this Code is a list of grounds on the basis of which banks may unilaterally amend their general terms. The purpose of the list was primarily to make unilateral amendments more transparent. Although this is widely used, some elements of the list became controversial, since court decisions in subsequent years declared amendments on this basis to be invalid.

The regulator also became very active in protecting consumers. Significantly increased fines are being imposed on banks, not only by the financial market supervisor, which is closely monitoring compliance with the conduct of business rules, but also by the Hungarian Competition Office, on the basis of unfair market behaviour. The amount of banking litigation reached record levels. Due to the failure of the laws in force before the crisis to regulate very important matters (such as the maximum interest rate that may be applied with regard to retail clients, the exchange rates that may be determined when collecting forints to discharge a Swiss franc or euro payment, or the conditions of prepaying loans), courts in many cases were not in a position to rule in favour of customers, since the laws were either silent or very vague on these issues, and therefore only the contractual provisions and general principles of consumer protection rules could be relied upon. To rectify the situation, Parliament enacted several acts concerning these issues, which are now regulated. The underlying problem – the existing loans – remains, as most of the new rules can only be applied in respect of new loans, not retrospectively. Consequently, to resolve the problem of existing borrowers, the legislator had to find ways to interfere in the civil law contractual relationship between banks and borrowers.

In 2014 and 2015, further (and probably final) rules on settlement regarding former loan arrangements were introduced. The NBH developed a complex formula on the basis of which banks had to make settlement with their consumers during 2015. By way of new legislation relating to the general terms and conditions of banks, it has been presumed (with retrospective effect) that those terms and conditions have been unfair during the past decade. Amendments were also made to existing conduct of business regulations in autumn 2014: the Fair Banking Act details the rules of the referred settlement, and imposes (on the basis of lessons learned following the financial crisis) additional obligations to provide information and disclose data before a consumer enters into a financial agreement.

V FUNDING

Many Hungarian banks are subsidiaries of foreign (primarily EEA-based) parents. Consequently, funding is typically provided by their parents through capital contributions and interbank loans. Traditional funding, such as collecting deposits, became increasingly important from 2009 onwards. Shares of some Hungarian banks are traded on the stock exchange. Finally, as might be expected, liquidity facilities are available from the NBH in various forms (loans and open market instruments).

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

In respect of the control regime, the Banking Act follows the provisions of the Acquisition Directive, in many respects word for word.

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ii Transfers of banking business

The transfer of all or part of the assets of a bank could take a number of forms. Transferring a portfolio of deposits and other repayable financial instruments requires the approval of the NBH. Approval is refused if the transfer endangers the fulfilment of the obligations assumed under the deposit agreements. Security interests do not cease to exist during the course of the transfer, and the consent of the client is not required, but within 30 days of receiving approval from the NBH, the transferee has to notify all counterparties.

The transfer of loans and loan participations is possible. Under the former Civil Code, the means of such a transfer (in the case of Hungarian law, governed by underlying agreements) were the assignment of rights and receivables and simultaneous assumption by the transferee of obligations. In respect of the assignment of rights or receivables, no consent is required from the debtor (although, to perfect the assignment and enable the transferee to enforce its rights against the debtor, the transferor has to notify the debtor of the assignment). Based on case law, this is so even if assignability is restricted or prohibited under the agreement between the transferor and the debtor (a breach of which clause may nevertheless give rise to claims for damages). For the part assuming obligations, however, obtaining the consent of the debtor is recommended since, in the absence of that consent, the assumption is not effective as regards the debtor. These consents are usually given contractually at the outset, as part of the principal agreement.

The new Civil Code, which entered into force on 15 March 2014, introduced the concept of novation.

Since mid-2015, there is a new transfer of business regime under the Banking Act. To facilitate the trade of non-performing loans and the sale of business units (such as a retail or corporate business, loan or credit card portfolio), the Banking Act enables banks to dispose of particular assets or a pool of assets as a standalone portfolio. The disposal requires NBH approval, but if received, no consent of debtors is required. Under the new regime, debtors are notified of the transfer and have the opportunity to terminate their contracts with the transferor bank prior to the date the transfer is taking place. Another important advantage of this regime is the automatic transfer of all security interests, quasi-collaterals (such as set-off rights, collection rights, security assignments) and certain financial services (such as issuing credit cards) relating to the principal legal relationship (which is primarily a loan or a financial lease). The regime may be applied only if at least 20 contracts form the underlying portfolio or the aggregate value of the exposures to be transferred exceeds 10 billion forints.

An alternative solution could be a demerger, whereby the business to be transferred is separated from the other business of the transferor, then allocated to a vehicle, thus enabling a share transfer to be made. The principal drawback of this alternative may be that the vehicle should be licensed.

There is no specific law on securitisations in Hungary. Such transactions may be made under the framework of general civil and commercial law principles (e.g., assignment of receivables or factoring).

The following particular issues must be taken into account when structuring various types of transfer in Hungary:

a whether a licence is required (e.g., purchasing receivables may trigger licensing requirements);

b whether the transferor remains the servicer (this is relevant from a notification perspective, and could be essential in respect of licensing and enforcement);

c whether the transfer is restricted under underlying agreements;

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d whether security interests survive the transfer, and (even if they do survive) whether there is any need for re-registration of the beneficiary to ensure due enforceability;
e to the extent the general terms of the transferor were applicable to the underlying contract, whether tripartite or bilateral amendments are needed (this is relevant especially if a Hungarian bank transfers particular loans to a foreign bank); and
f whether the approval of the regulator (or, in the event of a large portfolio deal or merger and acquisition deal, the approval of the Hungarian Competition Office) is required.

VII THE YEAR IN REVIEW

Three major events that are likely to have a substantial impact on the future development of the Hungarian market are:

a the appearance of fintech companies;
b the introduction of a number of important laws affecting banking business in Hungary; and
c the effects of Brexit on the businesses of UK-licensed passporting financial institutions in Hungary.

VIII OUTLOOK AND CONCLUSIONS

The growth of fintech companies and further digital innovation are likely to continue, and an increase in competition within the banking market can therefore be expected. The NBH seems to support these developments through the introduction of an innovation hub and a regulatory sandbox. In addition, alternative banking, artificial intelligence and automatisation will most likely mark out the road to the future of finance.

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Chapter 17

INDIA

Gunjan Shah, Shubhangi Garg and Akshita Agrawal[1]

I INTRODUCTION

Banking business in India is supervised and regulated by the Reserve Bank of India (RBI), the apex banking authority. Among other things, the RBI acts as banker and treasurer to the government, and is the lender of last resort. The RBI is responsible for regulating currency issuance and circulation, foreign exchange control management, public debt management and safeguarding the overall financial health of the country.

i Categories of banks

Historically, the three main categories of banks in India have been public sector banks (PSBs),[2] private sector banks[3] and foreign banks.[4] Recent entrants in the banking space include holders of limited banking licences known as small finance banks (SFBs) and payments banks.

All categories of banks are further sub-divided into two types: scheduled[5] or non-scheduled.[6] The RBI grants the status of a scheduled commercial bank (SCB) to eligible banks, which typically include PSBs, private sector banks, foreign banks and regional rural banks (RRBs),[7] and even SFBs on a case-by-case basis.[8]

1 Gunjan Shah and Shubhangi Garg are partners and Akshita Agrawal is a senior associate at Shardul Amarchand Mangaldas & Co.

2 Public sector banks are those in which a majority stake is owned by the government.

3 Private sector banks are those that are incorporated as companies in India and have been granted a banking licence by the RBI.

4 Foreign banks are incorporated as banks outside India and generally operate in India through branch offices by obtaining a banking licence from the RBI.

5 Scheduled commercial banks are those that are required to maintain an average minimum daily balance with the RBI in a prescribed form of cash and securities to meet their net demand and time liabilities.

6 Unlike SCBs, non-scheduled banks are not entitled to borrow from the RBI for normal banking purposes, except in emergency or abnormal circumstances. Non-scheduled banks are not permitted to deal in a foreign exchange or be licensed as authorised dealer banks in India.

7 Regional rural banks are specialised banks with a focus on agricultural and rural lending in a specified region.

8 While typically all SCBs are subject to the same regulations, the RBI sometimes prescribes a different set of regulations for RRBs and SFBs and excludes them from the scope of certain general permissions granted to SCBs.

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SCBs are generally permitted to undertake universal banking, that is, fully fledged banking business including both core banking[9] and para banking.[10]

In the past, the banking sector in India has been owned, controlled and supervised by the state. Until 1993, PSBs dominated the traditional banking space.

In 1993, the RBI issued guidelines for licensing private sector banks (i.e., non-state owned banks incorporated in India) and granted licences to 10 new private sector banks. Over the years, the RBI has continued to update the licensing regime for private sector banks, and issued four banking licences during the limited windows that were opened periodically, between 1993 and 2013. However, on 1 August 2016, in an unprecedented move, the RBI introduced an 'at will' licensing regime for private sector banks, permitting them to apply for a universal banking (or fully fledged banking business) licence at any point in time. As of March 2016, private sector banks accounted for more than 21.5 per cent and 24.1 per cent respectively of the deposits and credits in India.

Apart from PSBs and private sector banks, the third category of primary players in the industry are foreign banks, which are large global banks that operate in India through branches or representative offices, and have been permitted to set up wholly owned subsidiaries (WOS). As at March 2015, foreign banks such as Standard Chartered, HSBC and Citibank accounted for about 4.6 per cent and 5 per cent respectively of the deposits and credits in India.[11]

While there is parity in regulation between the above-mentioned categories of banks, the regulatory regime and ownership guidelines vary for each category. This chapter aims to set out the applicable legal regime for all major categories of banks in India.

ii New developments

The RBI and the government have undertaken various measures to move towards a cashless economy by the digitisation of payment services. Earlier this year, the RBI set up the country's first Ombudsman Scheme for Digital Transactions with a specific objective of providing a cost-free and expeditious complaint redressal mechanism relating to deficiencies in customer services in digital transactions undertaken by non-bank entities regulated by the RBI. Further, with a view to reviewing the existing status of the digitisation of payments in the country, identifying current gaps in the ecosystem and suggesting ways to bridge them, the RBI has constituted a committee on the deepening of digital payments. The RBI is also keen to minimise concentration risk in retail payment systems and has issued a policy paper on the authorisation of new retail payment systems, seeking comments from the public and stakeholders. The government has also issued a framework mandating large corporates to use bond markets to finance one-fourth of their fund needs, which not only signifies a shift from the traditional mode of bank financing, but is hoped will also boost the debt capital markets in India.

9 Banking Regulation Act, 1949, Section 5(b): 'Banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.'

10 Para banking activities include activities such as equipment leasing, hire purchase and factoring, underwriting, credit card, insurance distribution, mutual fund businesses, portfolio management and other financial services.

11 Ibid.

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Following the global financial crisis and recommendations of the Financial Stability Board (FSB),[12] the RBI has also adopted a framework for designating certain domestic and foreign banks in India that are too big to fail as domestic systemically important banks (D-SIBs) and global systemically important banks (G-SIBs), respectively.[13] In addition to ICICI Bank Ltd and the State Bank of India (SBI), the government has identified HDFC Bank Limited as a D-SIB, as the continued functioning of these banks is critical for the uninterrupted availability of essential banking services to the Indian economy. The RBI has prescribed additional capital requirements and increased supervision for these banks.

Recently, IDFC Bank Limited (a private sector bank) and Capital First Limited (a financial institution specialising in debt financing) merged to form IDFC First Bank, pursuant to which IDFC Bank Limited has transformed its portfolio from a dedicated infrastructure financier to a well-diversified universal bank. The banking industry in India is looking at consolidation (such as the merger of the SBI with its subsidiaries in 2017, the merger of IDFC Bank Limited with Capital First Limited in 2018 and the proposed merger of Vijaya Bank Limited and Dena Bank Limited with Bank of Baroda) with a view to strengthening the loan portfolio and financial soundness of banks and reaching a wider customer base.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The RBI is the key regulator for all banks, and it regulates all public deposit-taking and lending business in India. Any entity accepting demand deposits from the public and lending to the public must necessarily be licensed with the RBI as a bank.

i Licensing of banks

Licensing for public sector banks

All banks in India (including foreign banks operating through RBI licensed branches) are governed by the RBI Act, 1934 (RBI Act) and the Banking Regulation Act, 1949 (BR Act). In addition, most PSBs are incorporated, governed and licensed by and under their specific legislative enactments. Most of the PSBs are listed on the stock exchanges in India, with the government holding and controlling a majority stake in them.

Licensing for private sector banks

Private sector banks are primarily governed by the BR Act and the RBI Act, and are licensed to undertake banking activities by the RBI.

To encourage competition and innovation in the banking sector, the RBI issued at will banking licensing regulations for granting universal banking licences to eligible entities. Moving away from the previous stop-and-go licensing policy, the RBI now permits resident

12 The FSB is an international body based in Basel, Switzerland, that coordinates and monitors the work of national financial authorities and international standard setting bodies to develop, promote and monitor the implementation of effective regulatory, supervisory and other financial sector policies across all member countries.

13 Global systemically important banks are so prescribed by the FSB and are considered to be too big to fail. In other words, a G-SIB is a financial institution of which the distress or disorderly failure would cause significant disruption in global economic activity.

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individuals and professionals, entities and groups in the private sector that are owned and controlled by residents, and existing non-banking financial companies that are controlled by residents, to apply to the RBI to set up a universal bank.[14]

Licensing for foreign banks

Typically, foreign banks (i.e., those incorporated and registered as banks outside India) that wish to engage in banking business in India must be licensed by the RBI to set up branches in India. Pursuant to the Scheme for Setting up of Wholly Owned Subsidiaries by Foreign Banks in India, issued in November 2013 for the setting up of WOS by foreign banks, the RBI has now mandated certain foreign banks to incorporate WOS in India.[15]

Licensing for payments banks

Payments banks are a relatively new category with a limited banking licence, and are not permitted to undertake lending activities. They are expected to provide small savings accounts and digital payments and remittance services to migrant labour workforces, low-income households, small businesses, other unorganised sector entities and other retail users.

Unlike universal banks, payments banks are permitted to undertake only limited activities, including acceptance of demand deposits, issuance of debit cards, internet banking and acting as business correspondents[16] for other banks. So far, the RBI has issued final licences to 11 payments banks, out of which only seven have started their operations.

Licensing for small finance banks

SFBs are expected to cater for the banking requirements of micro and small enterprises, agriculture and banking services in unbanked and under-banked regions of the country.

These banks are permitted to undertake the basic activities of accepting deposits (both demand and term deposits) and lending to non-served and underserved sections. Many entities have shown an interest in the SFB space, and 10 entities have already received a final licence from the RBI.

Licensing for regional rural banks

The RBI has also issued banking licences to RRBs to further its goal of financial inclusion and agricultural financing. RRBs are established under specific legislative enactments and are regulated by the National Bank for Agriculture and Rural Development, an independent financial institution focused on agricultural lending.

14 New private sector banks that are granted a universal banking licence must be designated by the RBI as SCBs for the commencement of operations. The new private sector banks will then have to comply with the net demand time liabilities and other requirements as applicable to SCBs.

15 Foreign banks that were in operation in India before August 2010 have been exempted from this requirement. A few foreign banks are reported to have applied for a WOS conversion. State Bank of Mauritius has converted its local branch into a wholly owned subsidiary and The Development Bank of Singapore Limited is in the process of doing the same, pursuant to approval of the RBI, while other applications are pending.

16 Business correspondents are retail agents engaged by banks for providing banking services at locations other than a bank branch or cash dispensing machine.

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ii Other activities permitted to be undertaken by banks

SCBs in India are generally permitted to undertake core banking and para banking activities. Certain para banking activities, such as investment advisory and stockbroking, may only be undertaken by an SCB through a separate entity, such as a subsidiary (and not departmentally), whereas certain other businesses, such as insurance distribution, may be undertaken either departmentally or through a separate entity.

The RBI has mandated all banks, both Indian and foreign (including those not having an operational presence in India), to obtain prior approval from the RBI for any schemes marketed by them in India to residents either for soliciting foreign currency deposits for their foreign or overseas branches, or for acting as agents for overseas mutual funds or any other foreign financial services company.

iii Priority sector lending

The RBI has mandated separate priority sector lending (PSL) targets for all SCBs (including foreign banks and SFBs). Agriculture, micro, small and medium-sized enterprises, export credit, education, housing, social infrastructure and renewable energy are a few PSL sectors identified by the RBI. Typically, SCBs must allocate 40 per cent of their adjusted net bank credit[17] or credit equivalent amount of off-balance sheet exposure, whichever is higher, to PSL sectors. SFBs, however, must allocate 75 per cent of their adjusted net bank credit to PSL sectors.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

General powers of the RBI

The RBI was constituted under, and derives its statutory powers to regulate market segments from, specific provisions of the RBI Act. The RBI holds a fairly tight rein over banks, quasi-financial institutions and non-banking financial institutions, and has wide powers of inspection and audit under law, over all banks in India (including foreign banks operating through branches in India). To strengthen banks' balance sheets, the RBI prescribes and monitors prudential norms with regard to income recognition, asset classification and provision, capital adequacy, investment portfolios and capital market exposures. The major market segments under the regulatory ambit of the RBI are interest rate markets, government securities market, money markets, foreign exchange markets, derivatives on interest rates and prices, repo, foreign exchange rates and credit derivatives.

In terms of the BR Act, a bank must submit monthly returns setting out its assets and liabilities in India to the RBI and provide all other information in relation to its banking business as may be requested by the RBI. The RBI also prescribes standards for the quality of the statutory audit and internal audit functions in banks and financial institutions. The government notified changes to the BR Act to empower the RBI to issue directions *suo moto* to banks to initiate insolvency resolutions under the Insolvency and Bankruptcy Code, 2016 (Insolvency Code) to recover bad loans.

17 Adjusted net bank credit is to be calculated in accordance with the 'Master Direction – Priority Sector Lending – Targets and Classification', dated 7 July 2016, issued by the RBI.

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ii Management of banks

Private sector banks

The RBI closely controls the appointment and removal of directors of private sector banks, and its prior approval is required before the appointment of the chairperson, managing director and other full-time directors of a private sector bank. At least half the board of a private sector bank must consist of independent directors.[18]

The directors on the boards of private sector banks must also comply with the fit and proper criteria[19] prescribed by the RBI and the board's composition must meet the specified qualifications as set out above. Further, no two private sector banks are permitted to have common directors. The RBI also has the power (in the public interest or in the interest of depositors, or to secure the proper management of a bank) to supersede the board of directors of a private sector bank, to appoint an administrator to undertake its management, and to reshuffle and reconstitute the board of directors.

Specific provisions governing public sector banks

In addition to the conditions mentioned above for private sector banks that are also applicable to PSBs, the government has set up the Banks Board Bureau[20] as an autonomous body to appoint heads of PSBs. With effect from 1 April 2016, the Banks Board Bureau is tasked with the responsibility of appointing full-time directors and the non-executive chairperson of the board of directors of PSBs in a transparent manner using a merit-based selection approach.

Small finance and payments banks

The regulations applicable to private sector banks in respect of board composition and management are also applicable to SFBs and payments banks.

Board constitution norms for foreign banks

Currently, all foreign banks undertake operations in India through their branches and are therefore not subject to corporate governance norms issued by the RBI. Having said that, the appointment of the chairperson, managing director and other full-time directors of any branch of a foreign bank in India (if appointed) requires prior approval of the RBI. However, in terms of the RBI guidelines applicable to WOS (once incorporated by foreign banks in India), the WOS are required to ensure that at least 50 per cent of the board of directors comprises Indian residents, at least one-third of the directors are Indian nationals and resident in India, the chief executive officer is an Indian resident, and at least two-thirds of the directors of the WOS are non-executive directors. The regulations that govern the appointment of the board of directors of private sector banks also apply to WOS of foreign banks in India.

18 An independent director is a non-executive director of a company who does not have any material or pecuniary relationship with the firm, its directors or promoters. Independent directors cannot be managing directors, full-time directors or promoters of the company, its holding company or subsidiaries.

19 Educational qualifications, experience and field of expertise, track record and integrity are some of the factors considered by the RBI to assess the fit and proper status of the directors on the board of private sector banks. The fit and proper criteria for private sector banks is broadly similar to the criteria prescribed by the RBI for private sector banks.

20 The Banks Board Bureau comprises seven members and includes representatives from the RBI, the government and recognised experts in the field of banking.

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iii Restrictions on remuneration and the payment of bonuses

Generally, employees of all banks in India (including foreign banks operating through branches) are not permitted to be paid remuneration in the form of commission or a share in the profits of the bank. No Indian bank or branch of a foreign bank is permitted to approve or amend the terms of remuneration of its full-time directors or chief executive officer without the prior approval of the RBI. In consonance with the principles of the FSB, the RBI discourages banks in India (including foreign banks operating through branches) from adopting any remuneration structures that encourage or reward an excessive risk-taking approach by the management. The RBI also has the power to restrict compensation for directors and management, including the chief executive officers and executive directors of those SCBs that do not meet the financial parameters set by the RBI.

Private sector banks

In private sector banks, the variable component of the compensation payable to full-time directors and chief executive officers is not permitted to exceed 70 per cent of the fixed component in a year. However, where the variable pay constitutes a substantial portion of the fixed pay, an appropriate portion of the variable pay must be deferred for a period. Notwithstanding the general provisions of the BR Act, the RBI has granted general permission to private sector banks to pay compensation (not exceeding 1 million rupees) to non-executive directors in the form of profit-related commission if the bank in question has declared profits.

Public sector banks

The RBI in consultation with the government fixes the rate of sitting fees payable to directors on the boards of PSBs. Any performance-based compensation structures for the management of PSBs are also devised by the RBI in consultation with the Ministry of Finance.

Foreign banks

The compensation policy of all foreign banks operating through branch offices in India is governed by their head office policies. However, a foreign bank must submit a declaration to the RBI annually from its head office to the effect that its compensation structure in India, including that of the chief executive officer, conforms with the FSB principles and standards.

iv Regulatory capital and liquidity

In May 2012, the RBI issued guidelines on the implementation of the Basel III capital regulations that were brought into effect from 1 April 2013. The Basel III norms are being implemented in phases, and were to be fully implemented by 31 March 2019. However, in November, 2018, the RBI extended the timeline for implementation of the Basel III capital regulations by a year. Typically, all SCBs can issue ordinary equity shares with voting rights as part of the Common Equity Tier 1 (CET1) capital. However, if SCBs issue non-voting ordinary equity shares as part of CET1 capital, they must be identical to voting ordinary shares of the issuing bank in all respects except the absence of voting rights.

Typically, SCBs must maintain a total capital equivalent to 9 per cent of their total risk-weighted assets. The RBI has prescribed a minimum capital requirement of 15 per cent of total risk-weighted assets for payments banks and SFBs. Universal banks proposed for a

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licence under the new at will licensing guidelines are required to maintain a capital adequacy ratio of 13 per cent of their risk-weighted assets for a minimum period of three years after the commencement of operation.

To enable the banking industry to sustain the advantage of healthy financial profiles, the RBI has generally prescribed higher capital adequacy norms than those proposed under the Basel III regulations prescribed by the Basel Committee on Banking Supervision (BCBS). For instance, SCBs must typically maintain CET1 capital of at least 5.5 per cent of risk-weighted assets, as opposed to the 4.5 per cent prescribed by the BCBS. Similarly, according to the Basel III regulations, the total capital required to be maintained by SCBs is 8 per cent, as opposed to the threshold of 9 per cent prescribed by the RBI.

For universal banks proposed for a licence under the new at will licensing guidelines, and any foreign banks setting up WOS, the initial minimum paid-up voting equity capital of the bank must be 5 billion rupees.

v Recovery and resolution

Under Indian law, no separate guidelines or procedures have been prescribed on the bankruptcy of a bank or financial institution. Typically, if a weaker bank is facing bankruptcy, it is merged with a stronger and financially sound bank.

Under the BR Act, the RBI has wide powers to manage the financial health of a bank, including the power to supersede the board of directors, impose a moratorium on the bank's functions, prepare a scheme for amalgamation or restructuring, and apply for winding-up. No court in India can approve a winding-up petition against a bank unless the RBI certifies its inability to pay its debt in writing. The RBI can also apply to the courts to suspend an entity's banking business if the bank's business is being conducted in a manner detrimental to the interests of depositors. In the case of a bank being wound up, the RBI may even be appointed as the liquidator.

While there is no separate bankruptcy resolution regime, in terms of the Deposit Insurance and Credit Guarantee Corporation Act, 1961, the government has established the Deposit Insurance and Credit Guarantee Corporation, which automatically insures customer deposits with all commercial banks, up to a limit of 100,000 rupees per depositor. The Insolvency Code seeks to consolidate the laws relating to the reorganisation and insolvency of companies. However, the Insolvency Code is not applicable to reorganisation or insolvency, or both, of any bank in India (including foreign banks operating through branches).

IV CONDUCT OF BUSINESS

i Banking confidentiality

The principles of banker–customer confidentiality recognised in *Tournier v. National Provincial and Union Bank of England* [21] are recognised in India.[22] Banks in India (including foreign banks operating through branches) are required to maintain the secrecy of their

21 *Tournier v. National Provincial and Union Bank of England*, (1924) 1 KB 461.

22 'Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds', 21 January 2011, available at rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=609.

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customers' accounts and all information collected by them as part of the know your customer (KYC) norms, at all times, unless the disclosure is required under law or is made with the express consent of the customer.

Banks are required to maintain confidentiality of any sensitive personal data or information[23] and personal information of a customer as per the data protection rules issued under the Information Technology Act, 2000. Typically, any sensitive personal data or information or personal information available with a bank in India (including foreign banks operating through branches) may only be disclosed with the prior specific consent of the customer.

ii Liability of banks

The RBI may also impose stringent penalties on banks in India (including foreign banks operating through branches) for violation of the BR Act or any instructions of the RBI, and has the power to cancel banking licences issued by the RBI. The provisions of the Indian Penal Code, 1860 are also applicable to the full-time chairperson, managing director, auditor, liquidator, manager and other employees of banks in India (including foreign banks operating through branches); in certain cases, the officers in charge are even liable to imprisonment.

The RBI is known to adopt a proactive approach towards ensuring banks' compliance with KYC norms, including rules for customer identification, acceptance and monitoring transactions, and anti-money laundering (AML) norms. In several instances, the RBI has levied stringent monetary penalties on banks for violating KYC or AML norms and disclosure requirements prescribed under the extant foreign exchange laws and instructions of the RBI.[24]

The RBI is also empowered to cancel the licences of banks (including foreign banks undertaking banking activities in India) in certain instances, such as non-compliance with licensing guidelines issued by the RBI as applicable to that bank.

V FUNDING

Broadly, the elements of total regulatory capital of SCBs[25] include Tier I capital[26] (comprising two elements: CET1 capital[27] and Additional Tier 1 capital) and Tier 2 capital.[28] SCBs are generally permitted to issue perpetual non-cumulative preference shares, perpetual cumulative preference shares, redeemable non-cumulative preference shares and redeemable cumulative

23 Sensitive personal data or information are defined as including bank accounts, credit card and debit card details.

24 'RBI slaps fine on 5 foreign banks for violating FEMA rules', *The Hindu*, 21 December 2016. 'RBI fines three govt-run banks for violating KYC norms', *Business Standard*, 30 April 2015; 'RBI slaps Rs. 27 cr penalty on 13 banks', *The Hindu*, 25 July 2016; 'RBI imposes penalty of Rs. 2 crore on IndusInd Bank', *Business Standard*, 28 July 2016.

25 The RBI has also prescribed certain regulatory norms for non-scheduled banks such as non-scheduled state cooperative banks and non-scheduled urban cooperative banks. The source of capital fundraising of non-scheduled banks is restricted as compared to SCBs.

26 Tier 1 capital is going-concern capital, i.e., capital that can absorb losses without triggering the bankruptcy of the bank.

27 Typically, for SCBs, ordinary equity shares (paid-up equity capital issued by the bank), stock surplus and capital reserves are a few components of the Common Equity Tier 1 capital.

28 Tier 2 capital is classified as gone-concern capital, i.e., capital that acts as support for depositors in receivership, bankruptcy or liquidation.

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preference shares as part of Tier 1 and Tier 2 capital. SCBs are also generally permitted to issue perpetual debt instruments as part of additional Tier 1 capital and debt instruments with a minimum maturity of five years for inclusion in Tier 2 capital. SCBs are permitted to issue Indian rupee-denominated bonds to eligible persons overseas for inclusion as additional Tier 1 capital and Tier 2 capital, respectively.

Banks are permitted to obtain funding from the money market through instruments such as government bonds, treasury bills, commercial paper, certificates of deposit and ready forward purchases. Since the money market is a source for short-term funds, banks rely on the money market for short-term liquidity requirements, including for meeting cash reserve ratios and statutory liquidity ratio requirements.[29]

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Ownership and voting limits

Public sector banks

The ownership and control requirements for PSBs are prescribed in their respective governing legislation. The government is required to own and control a shareholding in PSBs of at least 51 per cent at all times.

Private sector banks

To meet the additional capital requirements under the Basel III regulations, the RBI overhauled the regulations governing the shareholding structure of private sector banks in May 2016, and issued a new set of regulations for ownership in private sector banks: the Private Sector Banks Ownership Guidelines. The RBI has prescribed different limits for shareholding in private sector banks by a single entity, corporate entity or group of related entities, and has prescribed different thresholds for different categories of shareholders based on their organisation, constitution and ownership.

Further, in terms of the Private Sector Banks Ownership Guidelines, there is a requirement of a minimum shareholding by promoters, a promoter group or a non-operative holding financial company (NOHFC) of the private sector bank (currently 40 per cent of the paid-up capital of the bank), which is subject to a lock-in for a period of five years. The RBI introduced the NOHFC model to ring-fence the banking and financial businesses of new bank applicants.

Any persons seeking to acquire or agreeing to acquire shares or voting rights of a private sector bank by themselves or with persons acting in concert, where the acquisition results in the aggregate shareholding of the acquirer and persons acting in concert to be 5 per cent or more of the paid-up share capital of that bank, or entitles the acquirer and persons acting in concert to exercise 5 per cent or more of the voting rights in that bank, require prior approval by the RBI.

29 The cash reserve ratio is a percentage of the total demand and time liabilities in India of the bank required to be maintained in cash with the RBI. The statutory liquidity ratio is the percentage of the total demand and time liabilities in India of the bank required to be maintained in the form of prescribed assets such as cash, gold or approved unencumbered securities in India.

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No person holding shares in a private sector bank can exercise voting rights on a poll in excess of 15 per cent of the total voting rights of all shareholders of the bank. The RBI may, however, consider an application to increase the ceiling on voting rights in phases up to 26 per cent.

Small finance and payments banks

The Private Sector Banks Ownership Guidelines are also applicable to SFBs and payments banks in relation to their respective constitution and ownership.

No person holding shares in an SFB or payments bank can exercise voting rights on a poll in excess of 10 per cent of the total voting rights of all shareholders of the bank. The RBI may, however, consider an application to increase the ceiling on voting rights in phases up to 26 per cent.

ii Foreign investment

Foreign investment in public sector banks

Foreign investment in PSBs (including by way of foreign direct investment and by registered portfolio investors under the portfolio investment scheme) is permitted up to 20 per cent with the prior approval of the government.

Foreign investment in private sector banks

Foreign investment in private sector banks shall not exceed 74 per cent of the paid-up share capital of the bank. Foreign investment in private sector banks is permitted up to 49 per cent under the automatic route (i.e., without any approval of the government). Further investments between 49 and 74 per cent require prior approval of the government. This limit does not apply to foreign banks intending to establish a WOS in India. So far, only two foreign banks have received the approval of the RBI to offer banking services under the WOS model.[30]

Foreign investment in small finance and payments banks

The foreign investment limits applicable to private sector banks are also applicable to SFBs and payments banks.

iii Financial assistance by banks to purchase their securities

Under the Companies Act, 2013, public companies are not permitted to directly or indirectly provide financial assistance (by means of a loan, guarantee or other security) for the purpose of or in connection with a purchase or subscription of shares made or to be made in that company or in its holding company.

Under Indian law, banks are also prohibited from securing their assets for the purpose of or in connection with a purchase or subscription of shares made or to be made in that bank, or in connection with any financial assistance granted to the bank or its associate company.

30 The Development Bank of Singapore Limited and State Bank of Mauritius.

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iv Transfers of banking business

The procedure for the merger and amalgamation of PSBs is different from that applicable to private sector banks, and is specifically set out in the statutes governing them.

For private sector banks licensed under the BR Act, the RBI requires that the draft scheme of amalgamation must be approved by a resolution of at least two-thirds of the total number of members of the board (and not just of those present and voting), and two-thirds of the shareholders of both the merging banks. The scheme of amalgamation must then be approved and sanctioned by the RBI.

The merger or amalgamation of SFBs and payments banks is governed by the provisions of the BR Act in terms of which the draft scheme of amalgamation must be approved by a resolution of at least a two-third majority of the shareholders of both the merging banks. The draft scheme must thereafter be approved and sanctioned by the RBI.

Banks are also required to notify the Competition Commission of India regarding any proposed merger, except in cases where the RBI or the competition regulator have prescribed specific exemptions.

VII THE YEAR IN REVIEW

The key focus of the RBI and the government in recent times has been on easing the stress on the balance sheets of Indian banks on account of bad loans, and on the consolidation and reorganisation of PSBs. The RBI has also been keenly focusing on the digitisation of payment systems as a medium to increase access to banking services and promote financial inclusion.

i Digitisation of payment services

The RBI issued a revised set of directions bringing about some significant changes to the pre-paid instrument regulatory framework that, inter alia, seeks to permit interoperability between different digital wallets and between wallets and bank accounts of users. The government is currently considering proposals in relation to en
hanced cybersecurity measures for such transactions.

ii Empowering the RBI to initiate insolvency resolution processes

The government amended the BR Act to empower the RBI to *suo moto* issue directions to banks to initiate insolvency proceedings under the Insolvency Code in respect of a default. As per the RBI's directions, insolvency proceedings have been commenced against 39 large defaulters amounting to about 2,690 billion rupees of funded exposure (as of December 2017).

iii Revised Restructuring Framework

As a further move to ensure early identification and speedy resolution of stressed assets, on 12 February 2018, the RBI published the Revised Restructuring Framework (Framework), which replaces a number of extant restructuring schemes for the identification and resolution of potential non-performing assets (i.e., before they become non-performing assets) that had been issued by the RBI during the past two decades or so. The Framework acts as a precursor to insolvency or resolution proceedings under the Insolvency Code. One of the most critical features of the Framework is that, from 1 March 2018, large accounts (i.e., more than 20 billion rupees), including existing large accounts undergoing a restructuring,

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must be restructured according to the parameters set out in the Framework within 180 days of 1 March 2018 (or the date on which a new default occurs after February 2018), and if the restructuring plan is not implemented within this timeline, the loan accounts must be mandatorily referred for insolvency resolution under the Insolvency Code.

iv New initiatives to resolve stressed assets

In July 2018, the government proposed a five-pronged strategy under Project Sashakt to address stressed assets in the banking sector. One of the strategies proposed by the Sashakt committee is to incorporate an independent and professionally managed asset management company that will, in partnership with an asset reconstruction company, take over large non-performing assets (with a base size of 5 billion rupees or more) from Indian banks. Another suggestion that has been put forward by the committee is to set up a digital asset trading platform to facilitate trading of stressed assets among banks and select non-banking players.

VIII OUTLOOK AND CONCLUSIONS

An insistence on financial inclusion and a move away from a cash-based economy are the two pillars of the various banking sector reforms being undertaken by the RBI and the government. The implementation of various schemes proposed by the government and the RBI to achieve these ends, however, continues to be a challenge, and it remains to be seen whether the proposed developments are effectively implemented to benefit marginalised sections of society.

With an increase in the number of banks, the digitisation of payment services and greater access to banking services, the government must take steps towards addressing potential cybersecurity challenges and strengthening the current data protection laws. While significant strides have been made in introducing a time-bound and efficient insolvency regime for corporates, there still remains an urgent need for reforms regarding liquidation and bankruptcy of banks and financial institutions to protect depositor interests and secure the financial sector from potential global and domestic systemic failures.

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Chapter 18

IRELAND

Robert Cain and Sarah Lee[1]

I INTRODUCTION

Ireland took a series of exceptional steps to contain the crisis in the banking sector that emerged in 2008. Its strategy was to provide liability guarantees, to transfer non-performing eligible assets to a government-backed entity, the National Asset Management Agency (NAMA), established by legislation enacted in 2009, and to provide capital and liquidity to weakened and distressed banks and building societies.

The strain on the state's resources ultimately led to the intervention of the European Union and the International Monetary Fund (IMF) in November 2010. The EU–IMF Programme of National Support for Ireland (Programme of Support) necessitated a restructuring and downsizing of the banking sector. Legislation to facilitate the immediate stabilisation of the domestic banking sector was passed in December 2010 in the form of the Credit Institutions (Stabilisation) Act 2010 (Stabilisation Act). A permanent resolution regime was introduced under the Central Bank and Credit Institutions (Resolution) Act 2011 (Resolution Act). The Bank Recovery and Resolution Directive (BRRD)[2] was transposed into Irish law by the EU (Bank Recovery and Resolution) Regulations 2015 (BRRD Regulations), which supersede existing domestic resolution legislation where applicable.

Ireland exited the Programme of Support in December 2013 with a restructured banking system that is recovering well in line with a much-improved domestic economy. Bank of Ireland and Allied Irish Banks, plc (AIB), in particular, now act as pillar banks in the Irish retail banking system, and it is envisaged that additional competition in the sector will be provided by subsidiaries of foreign-owned banking groups, including the Royal Bank of Scotland and KBC groups, and Permanent TSB.

Banking regulation has undergone considerable change since the beginning of the crisis. Institutionally, there has been a reconstitution of the regulator, the Central Bank of Ireland (Central Bank), while regulatory policy and objectives have also been refocused. Ireland is also part of the Single Supervisory Mechanism (SSM).

Domestically, the largest retail banks are AIB, Bank of Ireland, Permanent TSB, KBC and Ulster Bank. There are also a number of large international financial institutions with branches or licensed banks in Ireland, and these numbers are expected to increase as a result of Brexit.

1 Robert Cain is a partner and Sarah Lee is an associate at Arthur Cox.

2 Directive 2014/59/EU.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

i The regulator

The Central Bank is responsible for the prudential regulation and conduct of business of financial institutions in Ireland, and was established under the Central Bank Act 1942. This legislation has been subject to extensive amendment since its enactment.

From November 2014, banks have been subject to EU-wide regulation under the SSM. On 29 October 2013, the two regulations comprising the SSM were published in the Official Journal of the European Union. The first, conferring specific tasks on the European Central Bank (ECB) in relation to the prudential supervision of credit institutions, came into force five days later, and the second, amending the regulation governing the operation of the European Banking Authority, came into force on 30 October 2013. The ECB assumed its supervisory role on 4 November 2014.

ii Objectives

The Central Bank is required to ensure proper and effective regulation of financial institutions and markets, to ensure that the interests of consumers are protected and to ensure the stability of the financial system overall.

In the context of the regulation of financial institutions and markets, the objective of regulation in Ireland is to minimise the risks of systemic failure or insolvency of an institution by ensuring compliance with prudential and other requirements.

The Central Bank is responsible for developing rules governing the authorisation of financial services providers and for the continuing supervision of the entities that it has authorised (including as part of the SSM).

iii Legislation in respect of the regulation of financial institutions

The primary legislation in respect of the regulation of banks is the Central Bank Acts 1942 to 2018.

Building societies and credit unions are primarily regulated under the Building Societies Act 1989 and the Credit Union Act 1997 respectively.

In addition, certain guidelines and codes have been issued by the Central Bank with which regulated entities are obliged to comply. For example, the Central Bank's Consumer Protection Code sets out conduct of business requirements applicable to banking services (and other types of financial services) provided in Ireland.

iv Legal structures of banks

Most banks are established as limited liability companies, although in the past, the Central Bank has authorised banks established as unlimited companies with limited liability holding companies. Building societies and credit unions are typically constituted as mutual societies.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The Central Bank employs a risk-based approach to regulation, supported by its ability to take enforcement action where breaches of its requirements are identified. The risk-based approach is used so that resources are focused on financial institutions with the highest impact and risk profile.

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In November 2011, the Central Bank introduced a risk-based supervisory mechanism called PRISM (Probability Risk and Impact SysteM), which allocates the Central Bank's supervisory resources based on risk to the economy. This allows the Central Bank to focus on those financial institutions that pose a greater threat to the financial stability of the economy. The SSM approach to supervision is also risk-based. It takes into account both the degree of damage that the failure of an institution could cause to financial stability and the likelihood of such a failure occurring. Where the SSM judges that there are increased risks to a credit institution or group of credit institutions, those banks will be supervised more intensively until the relevant risks decrease to an adequate level. The SSM approach to supervision is based on qualitative and quantitative approaches, and involves judgement and forward-looking critical assessment.

Compliance monitoring

Central Bank compliance monitoring involves reviewing regulatory returns provided by banks, and conducting both on-site and off-site review meetings and inspections. Those institutions that carry the greatest risk to the stability of the financial system or that deal directly with customers are subject to a higher level of scrutiny.

The Central Bank has the power to impose administrative sanctions to ensure compliance with the regulatory requirements imposed on banks through the Central Bank (Supervision and Enforcement) Act 2013 (2013 Act). This legislation substantially strengthened the Central Bank's powers and increased its potential enforcement remedies. The 2013 Act also gave the Central Bank power to direct regulated financial services providers to make appropriate redress to affected customers for widespread or regular relevant defaults, and provided affected customers with a right of action if they have suffered loss as a result of a breach of regulatory requirements.

The Central Bank's Strategic Plan 2019–2021 sets out the Central Bank's strategic themes, statutory objectives and organisational objectives for the period. The Strategic Plan states that the Central Bank will engage strategically with the SSM framework and the European Supervisory Authorities in the development of regulatory guidelines, standards, methods and risk analyses, as well as with EU legislative bodies in relation to sectors regulated by the Central Bank. Among its key strategic themes are mitigating the impact of Brexit, enhancing consumer protection and strengthening resilience.

Disclosure obligations

The Central Bank has broad supervisory powers and can compel licensed banks to make disclosures relating to any aspect of their business. Under the Companies Act 2014, licensed banks are also required to disclose increased levels of detail relating to certain transactions (including loans) with directors and connected persons in their annual accounts. The 2013 Act also introduced protection for persons who disclose to the Central Bank alleged contraventions of financial services legislation.

On 1 July 2013, the Central Bank's revised Code of Practice on Lending to Related Parties came into force. It sets out statutory requirements (including disclosure obligations) in relation to lending by banks and building societies to related parties, including subsidiaries and senior office holders.

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Principal matters in which the regulator will become involved

The most common form of enforcement issue is failure by a bank to comply with the technical requirements of a regulation or code, particularly consumer protection, anti-money laundering and regulatory capital requirements. Based on an analysis of the Central Bank's recently published sanctions, a major concern of the Bank is system and control failures by regulated entities and failure to comply with their internal policies and procedures. Sanctions are disclosed on the Central Bank's website.

ii Management of banks

The Central Bank must be satisfied that the structure of the board and senior management of a bank and its internal control systems and reporting arrangements are such as to provide for the effective, prudent and efficient administration of its assets and liabilities. In this respect, it is necessary for all banks to have in place such committees of directors and management and other management structures as are necessary to ensure that the business of the credit institution is being managed, conducted and controlled in a prudent manner.

The Central Bank's fitness and probity regime, established under Part 3 of the Central Bank Reform Act 2010, came into effect on 1 December 2011 and was fully implemented on 1 December 2012. Regulated financial services providers, including banks, are responsible for ensuring that persons performing pre-approval controlled functions or controlled functions comply with the Fitness and Probity Standards (Standards), both on appointment to such functions and on an ongoing basis. Specifically, a regulated financial services provider must not permit a person to perform a pre-approval controlled function or controlled function unless it is satisfied on reasonable grounds that the person complies with the Standards and has obtained confirmation that the person has agreed to abide by those Standards.

The Central Bank must be satisfied that directors and senior executives are fit and proper persons and have appropriate competence and experience in banking and financial services to enable them to fulfil their duties.

Previously, all appointments to the board of a bank and certain senior management appointments were subject to the prior approval of the Central Bank. However, following the implementation of the SSM, the ECB is now the exclusive competent authority regarding the fitness and probity of the management boards of significant credit institutions and the management boards of all credit institutions applying for authorisation.

A proposed director or senior manager must complete an individual questionnaire disclosing details of his or her interests, background and any regulatory censures to which he or she has been subjected. A detailed curriculum vitae outlining the proposed appointee's relevant experience must also be attached. All retirements from the board must also be notified to the Central Bank.

The Central Bank requires that the ultimate decision-making body of a bank be located in Ireland and that the bank be adequately staffed to carry out its head office operations in Ireland.

The Corporate Governance Requirements for Credit Institutions 2015 (Corporate Governance Requirements) set out minimum statutory corporate governance requirements for Irish incorporated credit institutions. Compliance with the Corporate Governance Requirements is mandatory, and there is no scope to explain departures from them.

In addition to the regulatory requirements imposed on directors of Irish banks, directors must also comply with the directors' duties imposed by Irish company law and Irish common law.

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The Central Bank's Minimum Competency Code 2017, and its Minimum Competency Regulations (the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(2)) Minimum Competency Regulations 2017) set out minimum professional standards for staff of regulated financial services providers (including banks) when dealing with consumers in relation to retail financial products, and with retail clients and elective professional clients in respect of MiFID investment services and activities.

Remuneration

The CRD[3] and the CRR[4] (together referred to as CRD IV) were implemented in Ireland by the European Union (Capital Requirements) Regulations 2014 (2014 Regulations) (which transposed the CRD) and the European Union (Capital Requirements) (No. 2) Regulations 2014 (which gave effect to a number of technical requirements necessary to ensure the effective operation of the CRR). The 2014 Regulations place an obligation upon firms to have remuneration policies that are consistent with and that promote sound and effective risk management, and that place restrictions on variable remuneration in particular. The 2014 Regulations also contain disclosure requirements related to remuneration policies and practices. Remuneration practices that are not consistent with effective risk management or that run contrary to the CRD IV remuneration principles will be scrutinised by the Central Bank.

In November 2013, the Central Bank confirmed to the European Securities and Markets Authority (ESMA) its intention to comply with ESMA's Guidelines on Remuneration Policies and Practices. All affected firms (including credit institutions that provide investment services) are required to comply with the guidelines and to take the guidelines into account when formulating their remuneration arrangements. On 31 January 2017, the Central Bank published a policy statement setting out its position in relation to proportionality relating to the payout process applicable to variable remuneration for Irish less significant credit institutions and CRD IV investment firms.

The Corporate Governance Requirements also contain certain guidelines relating to remuneration, including a prohibition on remuneration policies that encourage risk-taking and a requirement that major institutions appoint a remuneration committee.

iii Regulatory capital and liquidity

Under CRD IV, a bank is required to have initial capital of at least €5 million and then to comply with risk-based ongoing capital requirements. The purpose of CRD IV is to implement the Basel III global regulatory standards and to strengthen the EU banking sector to enable it to better withstand any future economic or financial crisis.

A range of sanctions may be imposed by the Central Bank to ensure enforcement of the 2014 Regulations, but in any event the Central Bank will require a bank to inject additional capital immediately should it fail to meet the minimum capital requirements.

In 2014, three credit institutions were fined €650,000, €315,000 and €100,000 for breaches of the European Communities (Capital Adequacy of Credit Institutions) Regulations

3 Directive 2013/36/EU.

4 Regulation (EU) No. 575/2013.

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2006 (these Regulations have been revoked by the 2014 Regulations). The breaches included having exposures to sovereign bonds and clients in excess of the permitted limits. In 2015, one firm was fined €49,000 in respect of breaches of its obligations under the CRR.

The Central Bank published detailed requirements for the management of liquidity risk in June 2009, which must be complied with by Irish banks.

The Solvency II regime for insurance and reinsurance companies has been given legal effect in Ireland by the European Communities (Insurance and Reinsurance) Regulations 2015.

The Credit Union Act 1997 (Regulatory Requirements) Regulations 2016, which came into force on 1 January 2016, deal with reserves, liquidity, lending, investments, savings and borrowings for the credit union sector.

Insolvency

In the event that a bank becomes insolvent, an examiner may be appointed to that bank. If a bank is, or is likely to become, unable to pay its debts, the Central Bank may present a petition to the court for the appointment of an examiner to the bank. The petition to appoint an examiner must be accompanied by a report prepared by an independent accountant, a statement of the bank's assets and liabilities, and the opinion of the independent accountant as to whether the bank, or part of it, would have a reasonable prospect of survival, and whether an attempt to continue the whole or part of the business would be more advantageous to the members and creditors than a winding up.

An examiner may be appointed for 70 or 100 days, during which time no proceedings for the winding up of the bank may be taken, no receiver may be appointed over any part of the bank's property, and no attachments, sequestration, distress or execution may be carried out. An examiner is required to formulate proposals for a compromise or scheme of arrangement in relation to the bank and may carry out such other duties as the court may direct.

In the event that a bank is unable to pay its debts, a creditor may petition the court to have the bank wound up or the shareholders may convene a meeting of the shareholders to resolve to wind up the bank. In the former case, the court may appoint a liquidator. If the shareholders resolve to wind up the bank, the creditors will appoint a liquidator.

Under the Resolution Act, the Central Bank may present a petition to wind up an authorised credit institution. Other persons may only do so if the Central Bank is notified and confirms that it does not object. If a petition is presented by a person other than the Central Bank, the Central Bank retains a key role. For example, the Central Bank must be given notice prior to certain steps in the process being taken, and a liquidator cannot be appointed without its prior approval. The Resolution Act also sets out specific objectives for liquidators of authorised credit institutions.

The EU Insolvency Regulation will also apply to an insolvency when a bank has a place of establishment in another EU Member State (other than Denmark).

The EC (Reorganisation and Winding-Up of Credit Institutions) Regulations 2011 (CIWUD Regulations) give effect to the Credit Institutions Reorganisation and Winding-Up Directive. These Regulations apply to banks whose head office is located in Ireland and to branches of those institutions located in EU Member States.

The Resolution Act, which came into effect on 28 October 2011, aims to provide an effective and expeditious regime for dealing with failing credit institutions while minimising the cost to the state. The Resolution Act has applied to credit institutions in Ireland since

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31 December 2014, when the temporary emergency regime under the Stabilisation Act expired. The Resolution Act has now largely been superseded by the BRRD Regulations. The resolution mechanisms under the Resolution Act now only apply to credit unions. The Central Bank has sweeping powers to intervene where a credit institution is failing. Further details on the Stabilisation Act, the Resolution Act and the BRRD Regulations are set out below.

Future developments

At this stage, there are no plans for purely domestic legislation that would alter the Irish capital adequacy requirements.

iv Recovery and resolution

Ireland has introduced three specific pieces of resolution legislation following the crisis of recent years.

The Stabilisation Act

The Stabilisation Act came into effect on 21 December 2010. It provided a legislative basis for the immediate restructuring and stabilisation of the Irish banking system as set out in the National Recovery Plan 2011–2014 and agreed in the Programme of Support. The powers in the Stabilisation Act were temporary and expired on 31 December 2014.

The Resolution Act

The Resolution Act came into effect on 28 October 2011, and granted the Central Bank sweeping powers to intervene where any Irish credit institution is failing. The powers in the Resolution Act became fully effective upon the expiry of the Stabilisation Act on 31 December 2014. The Resolution Act was largely superseded when the BRRD Regulations came into force during 2015, but is still applicable to credit unions.

There are various preconditions that must be met before the Central Bank can intervene under the Resolution Act, which include:

a the existence of a present or imminent serious threat to the financial stability of a credit institution, or serious concerns relating to its financial stability or that of the state;

b a credit institution failing, or the likelihood that a credit institution will fail, to meet a regulatory requirement; and

c the existence of circumstances under which it is not in the public interest to wind up the credit institution immediately.

The Resolution Act established a fund for the resolution of financial instability in credit institutions. This fund is financed by a levy on credit institutions and any contribution from the Minister for Finance.

If the preconditions are met, and if it is considered necessary, the Central Bank is able to make an application to the High Court seeking an order to transfer the assets or liabilities of a failing institution, impose a special management regime on that failing institution, or both.

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The Central Bank is empowered to present a petition to the High Court for the winding up of a failing credit institution in certain circumstances; further, no person is allowed to petition to wind up a credit institution without giving the Central Bank notice and receiving its approval.

The Central Bank is able to direct an ailing credit institution to submit and implement a recovery plan. If deemed necessary, the Central Bank can itself prepare a resolution plan in relation to a credit institution.

The BRRD Regulations

The BRRD was transposed into Irish law on 9 July 2015 by the BRRD Regulations. The Central Bank was designated as the competent authority in Ireland under the BRRD Regulations, save as regards the specific tasks conferred on the ECB as part of the SSM, in which case the ECB will function as the competent authority. The Central Bank was appointed as the resolution authority in Ireland for BRRD purposes under the BRRD Regulations. The BRRD Regulations also require the Central Bank to publish internal rules (including rules on professional secrecy) on information exchanges between it as resolution authority and its other functional areas. These internal rules were published by the Central Bank on 17 August 2015.

The following conditions must be met for the resolution of an institution to be regarded as necessary:

a the competent authority, having consulted with the Central Bank as resolution authority, must determine that the institution is likely to fail;

b there is no reasonable prospect of an alternative private sector measure (i.e., a sale to, or merger with, a private sector purchaser) that could remedy the situation;

c resolution must be necessary in the public interest; and

d the Minister for Finance must be informed.

There are four resolution tools available under the BRRD Regulations, which can be exercised individually or in a combination of two or more:

a the sale of business tool;

b the bridge institution tool;

c the asset separation tool; and

d the bail-in tool).

To avail of one of the four resolution tools, the Central Bank must make a proposed resolution order and then make an *ex parte* application to the High Court for a resolution order. The institution itself, a shareholder or the holder of a capital instrument or liability affected by a resolution order may apply to the Court, within 48 hours of publication of the order, for the order to be set aside. The resolution order may provide for (among other matters):

a a transfer of shares, assets and liabilities;

b a reduction of principal under a capital instrument or in respect of eligible liabilities (or their conversion into shares);

c the cancellation of debt instruments (other than secured liabilities);

d the close-out or termination of financial contracts; and

e the removal and replacement of management by a special manager.

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The BRRD Regulations provide for another resolution measure whereby the Central Bank can apply to the High Court for a capital instruments order to write down or convert relevant capital instruments into shares, or other instruments into shares or other instruments of ownership in respect of an institution that requires resolution.

Stabilisation Scheme and Restructuring Support Scheme for credit unions

In November 2014, the Minister for Finance announced the introduction of two schemes of support for the credit union sector: the Stabilisation Scheme and the Restructuring Support Scheme. The Minister signed the Credit Union Fund (Stabilisation) Levy Regulations 2014 into law on 26 November 2014, giving effect to the introduction of a stabilisation levy to provide stabilisation support for credit unions under the Stabilisation Scheme. Separately, the Minister announced the introduction of a Restructuring Support Scheme for credit unions. The latter will provide financial assistance to restructuring credit unions that are not in a position to finance the process themselves for excess capital within participating credit unions.

IV CONDUCT OF BUSINESS

i Consumer Credit Act 1995

The Consumer Credit Act 1995 (CCA) applies to consumer lending in Ireland. It is not, however, limited to banks and financial services companies. The CCA also regulates some credit-related activities, such as money lending and credit and mortgage intermediation. In addition, the CCA contains detailed provisions relating to housing loans. Certain of the consumer credit provisions of the CCA have been replaced by the EC (Consumer Credit Agreements) Regulations 2010, which give effect to Directive 2008/48/EC. Nevertheless, the CCA remains in force in relation to credit agreements outside the scope of these regulations. The regulations transposing the Mortgage Credit Directive[5] into Irish law (European Union (Consumer Mortgage Credit Agreements) Regulations 2016) were published with effect from 21 March 2016.

ii Consumer Protection Code

A general Consumer Protection Code for financial institutions providing financial services (except MiFID investment services), including banks, was introduced by the Central Bank in 2006 and substantially overhauled with effect from 1 January 2012 (and subsequently amended further between 2016 and 2018). Regulated entities must comply with the Consumer Protection Code as a matter of law, and the Central Bank has the power to administer sanctions for a contravention of it.

The Consumer Protection Code contains a set of general principles combined with more detailed requirements in certain areas, and applies to financial services providers operating in Ireland, as well as those passporting into Ireland on a branch or services basis.

5 Directive (2014/17/EU).

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iii Code of Conduct on Mortgage Arrears

The Central Bank has issued the Code of Conduct on Mortgage Arrears (CCMA), which applies to the mortgage lending activities of all regulated entities operating in Ireland, including mortgage lending provided by a regulated entity into Ireland on a branch or cross-border basis. A revised CCMA was introduced from July 2013.

The CCMA contains a number of requirements with which mortgage lenders must comply. Under the CCMA, lenders are restricted from bringing repossession proceedings any sooner than three months after the date of the letter that specifies whether a repayment arrangement will be offered or, if later, eight months from the date on which the arrears arose. Where a borrower is classified as not cooperating (as defined in the CCMA), repossession proceedings may be started immediately.

iv Mortgage arrears resolution strategies

Mortgage arrears resolution strategies are implemented by mortgage lenders in their dealings with consumers who have fallen into arrears. The Central Bank requires all lenders to deliver effective strategies and plans for dealing with consumers in difficulty and to cover pre-arrears, arrears and forbearance, and loan modifications or resolution. The Central Bank aims to ensure that dealing with mortgage arrears is a top priority for mortgage lenders.

v Central Bank (Supervision and Enforcement) Act 2013 (Section 48) (Lending to Small and Medium-Sized Enterprises) Regulations 2015 (as amended)

The Central Bank (Supervision and Enforcement) Act 2013 (Section 48) (Lending to Small and Medium-Sized Enterprises) Regulations 2015 (as amended) (SME Regulations) came into force on 1 July 2016 and replaced the Code of Conduct on Lending to Small and Medium Enterprises. The SME Regulations apply to credit provided to micro, small and medium-sized enterprises, which can include natural persons acting within the course of a business, trade or profession. The SME Regulations contain conduct of business requirements, including in relation to communications with borrowers, information to be provided to borrowers and dealing with borrowers in financial difficulties.

vi Personal insolvency and bankruptcy reform

The Personal Insolvency Act 2012 (as amended) (Act) was signed into law on 26 December 2012, and its provisions were brought into effect during the course of 2013. The Act introduced reforms to the Bankruptcy Act 1988 and three forms of non-judicial debt settlement arrangements, which allow (subject to certain conditions being met) the write-down or restructuring of both secured and unsecured debt owed by certain eligible individuals: personal insolvency arrangements, debt settlement arrangements and debt relief notices.

The Act provides debtors with a process whereby they can apply for write-downs; however, it is unlikely that mortgage lenders will frequently be compelled to accept a write-down of secured debt. It is also worth noting that the Act provides certain protections for secured creditors, including a clawback provision.

As regards bankruptcy, the Bankruptcy (Amendment) Act 2015 has reduced the standard bankruptcy term from three years to one year.

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vii Investment services

The Central Bank regulates a wide range of investment services carried on in Ireland, including the provision of investment advice, dealing in financial instruments, receiving and transmitting orders, and portfolio management. Where a bank intends to provide investment services, it must notify the Central Bank. The provision of investment services in Ireland is subject to detailed conduct of business rules, including those contained in the European Union (Markets in Financial Instruments) Regulations 2017 (as amended), which implemented MiFID II[6] in Ireland.

viii Payment services and e-money

Ireland has implemented the Payment Services Directive,[7] which contains certain licensing and conduct of business requirements for entities that provide payment services. The relevant implementing legislation is the European Union (Payment Services) Regulations 2018. Ireland has also implemented the E-Money Directive.[8]

ix Bank secrecy and confidentiality

An obligation of bank–client confidentiality arises from the operation of the common law. The common law implies a duty of confidentiality on a bank in its relationship with its customers subject to certain limited exemptions. Obligations in relation to personal data also arise under the Data Protection Acts 1988 to 2018.

V CREDIT REPORTING

The Central Bank established a central credit register (CCR), a national mandatory database of credit information, under the Credit Reporting Act 2013 (Reporting Act). The purpose of the CCR is to collect and hold information about credit applications, credit agreements and the parties to those agreements, and obliges lenders to report certain information relating to credit applications and agreements, borrowers (natural and legal persons) and guarantors in relation to loans of €500 or more.

Since 30 June 2017, lenders have been required to submit to the CCR personal and credit information in relation to loans provided to consumers. Since 30 September 2018, lenders have been required to submit borrower and credit information to the CCR in relation to business loans.

While the Reporting Act provides the statutory basis for the establishment and operation of the CCR, details of the type of personal and credit information to be provided to the CCR by lenders are set out in separate regulations, namely the Credit Reporting Act 2013 (Section 6) (Additional Personal Information) Regulations 2016 and the Credit Reporting Act 2013 (Section 11) (Provision of Information for the Central Credit Register) Regulations 2016.

Three further regulations provide details of how lenders and borrowers can access information about the CCR, the steps that lenders must take to verify the identity of potential

6 Directive 2014/65/EU.

7 Directive 2015/2366.

8 Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

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borrowers and guarantors, and the form and content of the warning notice that lenders must include on all credit application documentation. These regulations are the Credit Reporting Act 2013 (Section 17) (Access to the Central Credit Register) Regulations 2016, the Credit Reporting Act 2013 (Section 20) (Verification of Identity of Credit Information Subjects) Regulations 2016 and the Credit Reporting Act 2013 (Section 24) (Notices) Regulations 2016.

VI ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING

Irish banks are also subject to the Irish legislation that transposed the Fourth Money Laundering Directive[9] into Irish law: the Criminal Justice (Money Laundering And Terrorist Financing) Acts 2010 to 2018.

VII FUNDING

i Typical sources

In addition to the taking of deposits, domestic banks have typically relied heavily on wholesale funding and the capital markets through issuing bonds and short-term instruments.

ii Recent national measures to improve access to liquidity

State guarantees

On 20 September 2008, the government increased the limit for the deposit guarantee scheme for banks and building societies from €20,000 to €100,000 per depositor per institution. A depositor who suffers a loss must make a claim under this scheme before invoking any of the guarantees provided for below. The scheme was activated for the first time when the Irish Bank Resolution Corporation was liquidated in February 2013.

The Minister for Finance established the Credit Institutions (Financial Support) Scheme (CIFS Scheme) on 20 October 2008. This gave effect to the state bank guarantee announced by the government on 30 September 2008. Under the CIFS Scheme, the Minister guaranteed certain covered liabilities of covered institutions between 30 September 2008 and 29 September 2010, inclusively.

The Eligible Liabilities Guarantee Scheme (ELG Scheme) started on 9 November 2009. This enabled those domestic institutions (and certain of their subsidiaries) that benefited from the CIFS Scheme to issue debt securities and take deposits on a state-guaranteed basis. Eligible liabilities for the purposes of the ELG Scheme are any of the following:

a all deposits (to the extent not covered by deposit protection schemes in Ireland other than the CIFS Scheme or in any other jurisdiction);
b senior unsecured certificates of deposit;
c senior unsecured commercial paper; and
d other senior unsecured bonds and notes.

The closure of the ELG Scheme was announced in January 2013 so that new liabilities would not be guaranteed with effect from 28 March 2013. Liabilities already guaranteed as of 28 March 2013 are not affected by the closure.

9 Directive 2015/849/EU.

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NAMA

NAMA is a commercial, semi-state entity under the governance, direction and management of the National Treasury Management Agency. The central objective of NAMA is to stabilise Irish credit institutions by strengthening their balance sheets and reducing uncertainty in relation to their distressed loans so as to facilitate lending to individuals and businesses.

NAMA purchases eligible assets (e.g., credit facilities issued, created or otherwise provided by a participating institution to a debtor for the direct or indirect purpose, whether in whole or in part, of purchasing, exploiting or developing development land, or to a debtor for any purpose, where the security connected with the credit facility is or includes development land) from participating banks by issuing government-backed bonds to the participating banks.

VIII CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The Central Bank is opposed to an individual holding a dominant interest in a bank. The Central Bank has a preference that ownership of a bank be held by 'one or more banks or other financial institutions of standing', or that there be a wide spread of ownership (such as through a stock exchange listing). Historically, the Central Bank's position has been that an insurance company would not be permitted to hold a controlling interest in a bank.

There are no restrictions on foreign ownership of banks. Where a bank is owned by a foreign bank or financial institution, the Central Bank will consult with the relevant foreign supervisor before granting the application. There is no restriction on private equity ownership of Irish banks.

The 2014 Regulations require the Central Bank to supervise credit institutions and their subsidiary and associated companies on a consolidated basis.

An entity or individual that controls a bank will have certain duties and responsibilities. The Central Bank will require the controlling entity to give an undertaking that the bank will be in a position to meet its liabilities during such time as the controlling entity holds a majority of the bank's ordinary share capital. In the event that a bank becomes insolvent, the controlling entity will be required to provide sufficient capital to the bank to make it solvent.

There is a general prohibition under Irish company law where a company provides financial assistance (e.g., security) for the purchase of its shares (subject to certain exemptions).

Changes in control

Under the 2014 Regulations, the Central Bank must be notified and approval sought in advance of the proposed acquisition of a direct or indirect qualifying holding in a bank (i.e., 10 per cent or more of the voting rights or capital in the bank, or a holding that allows that person to exercise a significant influence over the bank's direction or management) and, therefore, this includes the acquisition of an interest in its parent. Notification and approval are also required in respect of direct or indirect increases (above thresholds of 10, 20, 33 or 50 per cent) in such a qualifying holding. Approval is granted by the ECB under the SSM.

A business plan must be provided with the application for regulatory approval in certain circumstances, including where the proposed acquisition would:

a result in a change of the legal form of the bank;

b result in a change of the management of the bank;

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c result in a change of any corporate governance; or
d have an impact on the day-to-day operations of the bank.

ii Transfers of banking business

The assets and liabilities of a bank can be transferred by operation of law under a procedure provided by Part III of the Central Bank Act 1971 (a Part III transfer). The assets and liabilities of certain entities can also be transferred by operation of law pursuant to new procedures provided under the Resolution Act where certain preconditions are met.

It is also possible to transfer the business of certain companies under the EC (Cross-Border Mergers) Regulations 2008, which implement the Cross-Border Mergers Directive[10] in Ireland.

Part III transfers

Whenever the holder of a banking licence agrees to transfer, in whole or in part, to another holder of a banking licence, the business to which the licence relates and all or any of the other assets and liabilities of the transferor, the transferor and transferee may submit a scheme for the transfer for ministerial approval.

Where the Minister for Finance approves the scheme by ministerial order (not less than two months before the transfer), the assets and liabilities described in the scheme will transfer under the order by operation of law without the need to obtain the consent of individual deposit holders or counterparties.

If the Minister is of the opinion that the order is made with the intention of preserving or restoring the financial position of the transferor, but could affect the rights of third parties existing before the transfer, the order must state that it is made with this intention and that it should take effect outside as well as inside the state. The CIWUD Regulations will then apply.

Resolution transfers

The BRRD Regulations empower the Central Bank to transfer assets and liabilities from one bank to another if certain conditions are met.

IX THE YEAR IN REVIEW

The past year has been a period of continuing stability following the enormous challenges and radical changes affecting both banking regulation and the banking sector in Ireland since the start of the financial crisis in 2008. In terms of regulation, the Central Bank has been active in the field of enforcement for regulatory breaches (as described in Section III).

In October 2015, the Central Bank commenced an industry-wide examination of tracker mortgage-related issues, including the transparency of communication with, and contractual rights of, borrowers with tracker mortgages. The industry-wide examination arose following a review by the Central Bank of practices adopted by certain lenders in which borrowers with tracker mortgages were switched to variable rate mortgages. The principal issue related to a failure by lenders to inform borrowers of the consequences of switching mortgage products, in particular that borrowers would lose their contractual right to a tracker mortgage. Between 2016 and 2018, lenders were cooperating with the Central Bank to develop detailed plans

10 Directive (EU) 2017/1132 relating to certain aspects of company law.

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and frameworks, including establishing appropriate governance and reporting structures, for conducting internal reviews of their mortgage books. The lenders involved have been carrying out internal reviews of their mortgage books to identify any customers who may have been affected by a failure to honour their contractual entitlements, or to comply with the regulatory requirements regarding disclosure and transparency of information. AIB, Bank of Ireland, Ulster Bank, KBC Bank and Bank of Scotland plc are just some of the lenders that are subject to this tracker mortgage examination.

Permanent TSB and its subsidiary company, Springboard Mortgages Limited (Springboard), have been the subject of enforcement investigations as a result of significant failings that were identified in relation to their tracker mortgage book. The majority of the affected customer accounts (1,152) are accounts of Permanent TSB, and the remaining 220 are accounts of Springboard. Permanent TSB agreed in 2016 to implement a major redress and compensation programme to address the detriment suffered by affected Permanent TSB and Springboard customer accounts. On 24 November 2016, the Central Bank announced that it had imposed a €4.5 million fine on Springboard. The Central Bank has confirmed that it has launched further enforcement investigations against other lenders involved in the tracker mortgage examination.

X OUTLOOK AND CONCLUSIONS

The Central Bank recommended (in January 2018 to the Law Reform Commission, and in July 2018 to the Minister for Finance) that reforms be introduced whereby responsibility would be assigned to senior managers within banks (and certain other regulated entities). A key aspect of its proposal is the introduction of a senior executive accountability regime, which would allow the Central Bank to require in-scope senior managers to present a statement of responsibilities that clearly states the matters for which they are responsible and accountable. The proposed senior executive accountability regime would also require banks and their senior managers to clearly delineate where responsibility and decision-making lies for their business, and comprehensive statements of primary responsibilities would be required for all senior roles. Conduct standards would be imposed on all staff in banks, and not just those within the scope of the Central Bank's fitness and probity regime. Those conduct standards would oblige banks and their staff to act with integrity, honesty, skill, care and diligence, and an additional layer of standards would be imposed on senior staff. The Central Bank is expected to consult on its proposed senior executive accountability regime during the course of 2019, and has expressed the view that the regime should be implemented via primary legislation.

The drafting of domestic legislation to transpose the Fifth Money Laundering Directive[11] is currently underway.

The Central Bank has indicated that the prudential regulatory regime will continue to be more intrusive in the future, and that it will follow the risk-based model that is now in place and apply supervisory measures in conjunction with the ECB under the SSM. While the legal and regulatory policy is likely to change further in the short or medium term as the government and Central Bank continue to respond to the effects of the financial crisis in Ireland, much of the change is likely to be EU-driven. It is anticipated that, after a number of years of radical change in Irish financial regulation and the banking sector, domestically at least, 2019 is likely to bring further evolution, rather than revolution.

11 Directive 2018/843/EU.

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Chapter 19

ITALY

Giuseppe Rumi and Giulio Vece[1]

I INTRODUCTION

As a result of the 2018 European Banking Authority (EBA) EU-wide stress tests, the four largest Italian banks – Unicredit SpA (Unicredit), Intesa Sanpaolo SpA (Intesa), Banco BPM SpA (BPM) and Unione di Banche Italiane SpA (UBI) – proved to be resilient to adverse market developments. This indicates an overall strengthening in the soundness of the Italian banking system. The parallel stress tests conducted by the European Central Bank (ECB) on all the significant banks (SIs) not included in the EBA sample resulted in the ECB requiring only Banca Carige SpA (Carige) to restore its compliance with the capital requirements. Against this backdrop, after Carige's shareholders voted against a €400 million capital increase, the ECB decided to place the bank under special administration (see Section VII).

In this context, following requests by the ECB and the Bank of Italy to further reduce non-performing loan (NPL) stocks and implement internal measures to improve efficient management, several Italian banks rationalised their loan portfolios through NPL disposals. They also benefited from a state guarantee on senior tranches of securitised bad loans – the Guarantee on Securitisation of Bad Loans (GACS), which was introduced by Law No. 49 of 8 April 2016 to facilitate NPL transfers (see Section VII). The GACS was issued on, among other things, the €26.1 billion securitisation of Banca Monte dei Pashi di Siena (MPS) and the €1.6 billion securitisation of Credito Valtellinese (Creval). In addition, Banca Popolare di Vicenza's and Veneto Banca's NPLs, which were liquidated under ordinary insolvency proceedings in June 2017 (see Section III.iv), were transferred to SGA, a financial intermediary specialised in managing and recovering NPLs and fully owned by the Ministry of Economy and Finance (MEF). As expected, NPL transaction volumes increased throughout 2018, leading to a significant reduction of NPL stocks.

Several extraordinary transactions occurred in 2018 involving medium-sized Italian banks, including acquisitions and mergers. Three regional banks were merged by incorporation into Crédit Agricole Cariparma SpA (Cariparma), and several other small and medium-sized Italian banks were acquired by foreign banks and investment funds that proved to be interested in entering the Italian banking market (see Section VII).

As to the reform of cooperative credit banks (CCBs) and mutual banks, Cassa Centrale Banca became the first parent company of a banking cooperative group consisting of 84 CCBs in January 2019, whereas the two largest mutual banks are still prevented from transforming

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into joint-stock companies following an Italian Administrative Supreme Court decision in October 2018 to further freeze the reform by requiring a preliminary ruling from the Court of Justice of the European Union (see Section II).

Against the current backdrop of uncertainty, including the government's instability, Brexit and the announced end of the European Central Bank quantitative easing programme, Italian banks are now focusing on the following:

a reviewing their internal governance structures to comply with the forthcoming implementation rules regarding the suitability of corporate bodies and adapting their remuneration policies to the newly introduced provisions aimed at aligning the Italian framework with the EBA guidelines (see Section III.ii);

b updating their models and systems to comply with the new regulatory framework regarding payment services, deriving from the implementation of the Second Payment Services Directive (PSD2);[2] and investment services, following the implementation the MiFID II[3] package (see Sections II, IV and VII);

c preparing for the upcoming entry into force of the new European legislative package governing capital and liquidity requirements (CRR2 package); and

d adapting their business models to the new fintech environment (see Section VII).

	Banking groups	**Common Equity Tier 1 ratio (%)**
1	Unicredit*	12.11
2	Intesa	12.4
5	BPM	12.9
3	MPS	12.5
4	UBI	11.79

Data updated as at 30 September 2018.

* Unicredit is included the list of global systemically important banks published by the Financial Stability Board (FSB) in November 2018.

Source: quarterly financial reports

II THE REGULATORY REGIME APPLICABLE TO BANKS

In addition to the EU legislation (specifically the Capital Requirements Directive (CRD IV)[4], the Capital Requirements Regulation (CRR)[5] and the Single Supervisory Mechanism (SSM) Regulation),[6] the principles governing banking activities and investment services are contained in the Banking Act[7] and the Financial Act,[8] respectively. In 2017 and 2018, both Acts underwent an indepth review to, inter alia, implement PSD2 and MiFID II, and align national legislation with the MiFIR.[9]

2 Directive (EU) 2015/2366.
3 Directive 2014/65/EU.
4 Directive 2013/36/EU.
5 Regulation (EU) No. 575/2013.
6 Regulation (EU) No. 1024/2013.
7 Legislative Decree No. 385 of 1 September 1993.
8 Legislative Decree No. 58 of 24 February 1998.
9 Regulation (EU) No. 600/2014 (Markets in Financial Instruments Regulation).

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The regulations implementing these principles are primarily set by the Bank of Italy, in particular through Circular No. 229 of 21 April 1999 and Circular No. 285 of 17 December 2013, as subsequently amended (Supervisory Instructions); and by Consob, the independent public authority responsible for regulating the Italian securities market, notably through intermediaries, issuers and market regulations. Further rules can be set by the MEF and the Inter-ministerial Committee for Credit and Saving (CICR, and all four together, the supervisory authorities).[10] Specific powers in the anti-money laundering (AML) field are ascribed to the Financial Intelligence Unit.

The laws and regulations on banking and financial markets govern lending, deposit taking, securities activities and cross-border operations. Although deposit-taking is reserved to banks, the Bank of Italy Regulation of 8 November 2016 clarified the conditions and limits under which certain activities (e.g., lending-based crowdfunding) fall outside the savings collection regime, and thus can also be performed by non-regulated entities. Lending activities can be carried out by banks, financial intermediaries, insurance undertakings, special purpose vehicles (subject to limitations), EU alternative investment funds and Italian investment funds, if certain requirements are met.

While Consob continues to be responsible for the securities market, following the SSM's entry into force in November 2014, the tasks ascribed to the Bank of Italy changed as a consequence of the distinction between SIs and less significant banks (LSIs), and the key role played by the ECB. Specifically, under the SSM:

a the ECB is responsible for:
- supervising Italian SIs, with the assistance of the Bank of Italy;
- resolving on applications to obtain and withdraw a banking licence, and the authorisation to acquire qualified or controlling shareholdings in banks, regardless of their significance (see Section VI); and
- ensuring the effective and consistent functioning of the SSM and the Bank of Italy; and

b the Bank of Italy's tasks mainly consist of:
- supervising LSIs;
- monitoring all Italian banks in relation to transparency, consumer protection and AML matters; and
- assisting the ECB in supervising Italian SIs.

As clarified through a letter addressed to EU SIs published in June 2017, the ECB also has supervisory powers granted under Italian law in relation to, inter alia, the following operations involving Italian SIs:

a outsourcing of activities;
b mergers and de-mergers;
c asset transfers and divestments; and
d amendments to by-laws.

10 The supervisory authorities can be divided into two categories: the Bank of Italy (a company limited by shares whose main shareholders are the most notable Italian banking groups) and Consob, which represent the independent authorities; and the MEF and the CICR, whose members are directly appointed by the government. The coexistence of both independent and political authorities is aimed at ensuring the balance of public and private interests and guaranteeing that any legislative reform is shared by both government representatives and exponents of the banking market.

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Foreign banks may carry out business in Italy through the establishment of a branch, or on a cross-border basis, in accordance with a procedure that differs for EU and non-EU banks. EU banks can start mutual recognition activities after a notification procedure between the home country authority and the Bank of Italy, whereas non-EU banks can only operate after being duly authorised to do so, and are subject to stricter requirements. Following the implementation of MiFID II, non-EU banks are now allowed to provide investment services for retail clients in Italy exclusively through the establishment of a branch.

Similar principles apply to Italian banks when they intend to undertake banking activities in other EU countries, including the Bank of Italy's authorisation for an Italian bank wishing to operate in a non-EU country.

Currently, there are 53 banking groups, 505 banks (of which 131 belong to banking groups)[11] and more than 25,000 active bank counters established in the Italian banking market. Regarding the presence of foreign banks, 692 operate in Italy without a permanent establishment (up 92 from 2018), and 37 have set up a local branch, bringing the total number of branches to 64 branches (a decrease of 29 from 2018).[12]

Regarding legal form, 137 banks are incorporated as companies limited by shares, 265 as CCBs and 22 as mutual banks.[13]

With Law Decree No. 18 of 14 February 2016, CCBs underwent significant changes that include, inter alia, mandatory adhesion to a cooperative banking group to obtain authorisation as a cooperative bank; the parent company duty to be set up as a joint-stock company; and the right to issue financial instruments. Subsequently, in November 2016, the Bank of Italy adopted implementing regulations to set, inter alia, the minimum organisational and operational requirements for parent companies of cooperative banking groups, and the minimum content of cohesion contracts between a parent company and its affiliated CCBs (Circular No. 285 of 17 December 2013 as amended in November 2016). Furthermore, in May 2018, the Bank of Italy published new supervisory instructions to align the special rules applying to CCBs with the new rules on banking cooperative groups (see Section III.ii).

Finally, following the reform of mutual banks introduced by Law Decree No. 3 of 24 January 2015, eight of the 10 largest mutual banks (those with an asset value above €8 billion) were transformed into joint-stock companies. Two of them subsequently merged, forming Italy's third-largest banking group. The remaining two largest mutual banks (Banca Popolare di Sondrio SCpA and Banca Popolare di Bari SCpA) were prevented from transforming into joint-stock companies following the suspension in December 2016 of the reform's implementing provisions as a result of questions regarding the constitutional legitimacy of the restrictions on shareholders' withdrawal rights. In March 2018, the Italian Constitutional Court concluded that the question of constitutional legitimacy was unfounded. However, in October 2018 the reform was suspended again by the Italian Administrative Supreme Court as a result of a preliminary ruling requested to the Court of Justice of the European Union (the deadline for the transformation was extended to 31 December 2019).

11 Data updated up to May 2018. Source: Bank of Italy Annual Report.

12 Data updated up to January 2019. Source: Bank of Italy registers.

13 Data updated up to January 2019. Source: Bank of Italy registers.

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III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The reach of the Bank of Italy's prudential supervision is extensive and penetrating. This widespread and strong supervisory regime managed to better mitigate the consequences of the financial crisis than was seen in many other countries, and encouraged significant capital increase transactions that led to an average increase of up to 13.2 per cent of the Common Equity Tier 1 ratio.[14]

In implementing the CRD IV and CRR principles, the Bank of Italy exercised its discretionary power to further increase banks' minimum initial capital from €5 million (as provided by CRD IV) to €10 million (see Section III.iii) and exempt banks belonging to a group from holding the liquidity requirements individually (see Section III.iii).

Currently, the supervisory review process consists of the internal capital adequacy assessment process (ICAAP) carried out by banks under the responsibility of their corporate bodies; and the supervisory review and evaluation process (SREP), entrusted to the Bank of Italy for LSIs and to the ECB for SIs. Whereas the ICAAP mainly aims to quantify the capital needed to face the risks of banking business (including country and transfer risks) and set liquidity management measures accordingly, the purpose of SREP is to assess the suitability of these measures – both capital and organisational – and establish the necessary relevant corrective actions (limitations to the distribution of own funds' financial instruments, imposition of own funds' add-ons and divestment of assets).

Starting from the 2016 SREP process, in addition to the imposition of the own funds' add-on (Pillar 2 requirements), the supervisory authorities may also issue Pillar 2 guidance that, in the event of non-compliance, would lead to intensified supervision and bank-specific measures designed to reestablish a prudent level of capital.

The supervisory review process is carried out in compliance with the proportionality principle, under which corporate governance and risk management processes and mechanisms for identifying the amount of capital due for risk prevention must be proportionate to the features, business size and complexity of each bank. The frequency and intensity of SREP must take into account the systemic importance, features and any problematic issues of each institution.

In 2017, the provisions of Circular No. 285 of 17 December 2013 on the supervisory review process were amended with respect to, inter alia, early intervention measures, interest rate risks on banking books and the limitation of exposures towards shadow banking entities.

ii Management of banks

Rules governing management and remuneration in banks and banking groups according to CRD IV are set under the Supervisory Instructions, as amended in May 2014. These rules strengthen corporate governance by setting, inter alia, further qualitative requirements to be met by banks' directors, self-assessment processes of corporate bodies and *ad hoc* committees for larger banks, and introduce several limits to variable remuneration with regard to its amount and nature.

14 Data updated up to June 2018. Source: Bank of Italy Financial Stability Report, No. 2, November 2018.

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Corporate governance requirements

To ensure sound and prudent management and to achieve their business goals, Italian banks are required to:

a choose between three management structures:
- a traditional system (the most common structure) encompassing a shareholders' meeting, a board of directors and an auditory board;
- a monistic system, whereby the control committee is appointed within the board of directors; and
- a dualistic system (adopted by only a few large Italian banks to date), which has a separate management board and supervisory board; and

b identify the bodies responsible for the three main prudential functions:
- strategic supervision, which concerns the identification of the bank's targets and supervision over their satisfaction (by examining and resolving upon financial and business plans, and strategic transactions);
- management (including the general director), which concerns the practical management of the bank to meet the targets set out by the strategic supervision body; and
- internal control, which concerns the supervision of the regular performance of the administration activity, and the adequacy of the organisation and accounting systems of the bank to the bank's targets.

Banks are required to choose a management structure that is in line with their business and medium to long-term strategic goals, and that safeguards the effectiveness of the internal controls system. A specific assessment must be conducted on the structure's implementing costs to ensure their sustainability.

The composition of the corporate bodies (both executive and non-executive) must be adequate for the complexity and size of the business, and diversified as to age, gender, skills and experience. Each member is required to be fully aware of the powers and tasks ascribed; act in the interest of the institution, without being influenced by the shareholders; and fulfil professional requirements tailored to the bank's features. In August 2017, the MEF published for consultation a draft decree on suitability requirements of members of banks' corporate bodies and key function holders in order to finalise the CRD IV implementation and align the Italian framework to the 2017 ECB guide and EBA guidelines on fit and proper assessment. The draft decree significantly strengthens the existing standards of suitability and introduces new criteria to assess the suitability requirements (i.e., fairness, competence, collective suitability, independence of mind, time commitment and limits on the number of directorships).

The appointment procedure must also consider the interlocking ban, which prevents members from holding similar positions in competitor banking, financial or insurance undertakings or groups.

Corporate bodies are subject to a periodic self-assessment process aimed at verifying the proper qualitative and quantitative composition of each body, and encouraging the active participation of each director. The process is described in a report at the request of the Bank of Italy.

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Further rules for larger banks (in terms of assets, size and complexity) are provided to ensure *ad hoc* committees (internal controls and risks, remuneration, appointments), and succession plans for the positions of chief executive officer and general director, to ensure business continuity and prevent economic and reputational effects.

Specific provisions to align the special rules on CCBs with the rules on cooperative banking groups were introduced in the Supervisory Instructions, concerning, among other things capital structure and shareholder categories, articles of association and extraordinary transactions, and territorial competence.

Finally, as a result of the amendments to the Banking Act under Legislative Decree No. 72 of 12 May 2015, the Bank of Italy has the power to remove corporate bodies from office when the sound and prudent management of a bank is compromised.

Remuneration policies

The management body is in charge of setting remuneration policies in line with the risk appetite and long-term interests of a bank, and coherent with its capital and liquidity ratios. Incentive mechanisms that may lead to breaches of the regulations or the taking of large risks are forbidden.

To this end, the Supervisory Instructions, as amended in October 2018 to meet the CRD IV provisions and the recommendations issued by the EBA and FSB policies, state that, among other things:

a the ratio between fixed and variable remuneration cannot exceed 100 per cent. The ratio may be increased up to 200 per cent if so provided in the by-laws and approved by a shareholders' resolution with a qualified quorum. The latter must be based on a proposal made by the strategic supervision body outlining the concerned personnel, the rationale of the decision and its compatibility with the prudential rules;

b at least 50 per cent of the variable component must consist of shares or equivalent ownership interest, which in any case the Bank of Italy can prohibit, depending on the bank's specific status;

c *malus* and clawback arrangements also apply to the incentives due or paid to personnel who contributed to significant losses for a bank or customers, acted fraudulently, or acted contrary to laws, regulatory or statutory provisions or ethics codes; and

d remuneration and incentive clauses that do not comply with EU and local regulations are void and automatically replaced by the parameters set out by these regulations.

Banks apply the above requirements in accordance with their features, size and complexity of business, based on their classification as major, middle or minor banks. Major banks must fully comply with the remuneration rules, whereas middle and minor banks benefit from some exemptions.

As to the amendments to the Supervisory Instructions on remuneration issued by the Bank of Italy in October 2018 to align the Italian regulatory framework with the EBA guidelines of December 2015, the new key provisions concern, among other things:

a the definition of fixed remuneration;

b the inclusion of carried interest payments in variable remuneration;

c amendments to the procedure to identify staff whose work has a material impact on the bank's risk profile; and

d the inclusion, under specific conditions, of golden parachutes in the calculation of the ratio between the fixed and variable components of remuneration.

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As a result of the new rules, Italian banks are now required to review their remuneration policies by no later than the date of approval of the 2018 financial statements, with particular focus on the variable component, to avoid reducing their capital bases and to ensure that a sound capital structure is maintained.

iii Regulatory capital and liquidity

Italian banks must hold regulatory capital at least equal to the minimum capital necessary to be authorised to exercise their activity (€10 million, except for cooperative banks, for which the minimum capital required is €5 million). This capital must consist of:

a 4.5 per cent of Common Equity Tier 1 ratio;
b 6 per cent of Tier 1 ratio (a favourable tax regime applies to additional Tier 1 items);
c 8 per cent of total capital ratio; and
d any additional capital requirements imposed under the SREP (see subsection i).

Additional requirements are:

a liquidity coverage ratio (100 per cent);
b leverage ratio (3 per cent based on the Basel Committee's framework, not yet implemented as a minimum requirement); and
c buffers, as follows:
- capital conservation buffer: 2.5 per cent;
- countercyclical capital buffer: from zero to 2.5 per cent; to date, the Bank of Italy has maintained the countercyclical capital buffer rate (for exposures to Italian counterparties) at zero;
- global systemically important institution (G-SII) buffer: only one Italian bank (UniCredit) has been identified as a G-SII, and must maintain a capital buffer of 1 per cent; and
- other systemically important institution (O-SII) buffer: three Italian banking groups – UniCredit, Intesa and Banco BPM – have been identified as O-SIIs and will have to achieve a buffer of 1, 0.75 and 0.25 per cent, respectively, by 2022 (the buffer from 1 January 2019 to 1 January 2020 is 0.06 for Banco BPM, 0.38 per cent for Intesa; and 0.50 per cent for Unicredit).

Italian banks belonging to a banking group are exempted from the application of the liquidity coverage requirement on an individual basis, while banking groups – subject to certain conditions – are exempted from calculating the leverage ratio of exposures to entities that belong to the same group and are incorporated in Italy.

In accordance with the ECB recommendations of December 2018, banks that meet the above regulatory capital requirements can conservatively distribute net profits in dividends, with the aim of continuing to fulfil all requirements even if economic and financial conditions worsen. Conversely, failure to comply with the above thresholds will prevent institutions from carrying out any such distribution.

For banking groups, compliance with the regulatory capital requirements is supervised by (1) 'Banking Supervision Desk I', with reference to banking groups subject to ECB direct supervision; and (2) 'Banking Supervision Desk II' and Bank of Italy branches, in respect of banking groups other than those under (1). Both Desks have extensive powers that mainly result in the supervision of national and transnational groups on a consolidated basis, analysis of risks and management of administrative proceedings.

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In the context of the prudential regulations, a key role is ascribed to management of the liquidity risk, both as a funding liquidity risk and market liquidity risk. To prevent these risks, Italian banking groups, Italian banks not belonging to a group and Italian branches of non-EU banks (the latter according to the proportionality principle)[15] are mainly required to identify and measure their exposure to a liquidity risk, establish a liquidity risk's tolerance threshold and carry out stress tests to assess the adequacy of the liquidity reserves on an ongoing basis.

iv Recovery and resolution

Italy implemented the BRRD through Legislative Decrees No. 180 and No. 181 of 16 November 2015, which set out the BRRD regime and updated the Banking Act and Financial Act accordingly. A few days after implementation of the BRRD, four banks that jointly covered approximately 1 per cent of Italian deposits were placed under resolution, in accordance with a programme issued by the Bank of Italy as resolution authority, which provided for:

a the full write down of the banks' shares and subordinated bonds for overall amounts that exceeded €1 billion and €500 million, respectively;

b the setting up of four bridge institutions with new corporate bodies and capital ratios;

c the assignment of the rights, assets and liabilities in force as at the resolution date to the bridge institutions, with the exclusion of the written-down shares and bonds;

d the transfer of NPLs from the bridge institutions to an asset management vehicle.

As a result of the resolution programme, the four bridge institutions restarted banking business and again played a key role in the local economy, supporting small and medium-sized regional enterprises. Furthermore, the government set specific measures to restore the written-down subordinated bondholders.

After short postponements of the deadline for the sale of the bridge institutions, between January and March 2017, three banks were sold for a symbolic purchase price to UBI and one to BPER Banca SpA at the end of a competitive bid process that lasted a year.

In addition to the BRRD implementing regulations, Italian banks are still subject to the existing local regime. This regime provides for the following proceedings, depending on the nature of the crisis affecting the bank in question:

a special administration: a short-term temporary measure aimed at verifying the possibility of restoring adequate capital buffers, and sound organisation and business conditions when the infringements in the bank's management, the breaches of the applicable regulations or the losses are serious but not irrevocable (as of January 2019, two banks are under special administration); and

b compulsory administrative liquidation: to be applied when a crisis appears to be irreversible and the conditions for resolutions are not fulfilled, and which is a direction to close down a bank and allow the competent court that handles the process to satisfy most of the creditors of that bank.

15 According to the proportionality principle, in exercising its supervisory tasks over these entities, the Bank of Italy may consider policies and strategies adopted by parent companies to face the liquidity risk.

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After having applied for a precautionary recapitalisation under Law Decree No. 237 of 23 December 2016, in July 2017 MPS completed a total recapitalisation of €8.8 billion covered through burden-sharing and the state's subscription of newly issued MPS shares. As a result, the state currently holds 68.2 per cent of MPS's share capital.

In the same year, Banca Popolare di Vicenza and Veneto Banca also applied for a precautionary recapitalisation, but did not obtain authorisation from the European Commission. In June 2017, the two banks were placed under compulsory administrative liquidation after the ECB declared the two banks as failing or likely to fail. In this case, the BRRD framework was not applied as the Single Resolution Board concluded that resolution action was not warranted in the public interest. The banking businesses of the two banks (along with some of their assets, liabilities, goods, rights and legal relationships) were acquired by Intesa for a symbolic purchase price; NPL subordinated bonds, shareholdings and other legal relationships were excluded from the acquisition.

With the 2018 Budget Law, the government set specific measures to further restore subordinated bondholders – and in this case, also shareholders – of banks placed under compulsory administrative liquidation between 16 November 2015 and 1 January 2018 that had suffered financial losses due to violation of fairness and transparency duties.

In January 2019, Banca Carige was placed under special administration by the ECB. Furthermore, to encourage the recapitalisation of the bank and the reduction of its NPLs, the government issued Law Decree No. 1 of 8 January 2019 (converted into Law No. 16 of 8 March 2019), which allows Banca Carige to obtain a state guarantee on newly issued liabilities and loans granted by the Bank of Italy at its discretion, and apply for a precautionary recapitalisation.

In line with recent amendments to the BRRD, the Banking Act was amended by Law No. 205 of 27 December 2017 to introduce a new class of unsecured debt instruments, which rank in an intermediate position between senior and subordinated liabilities in the insolvency hierarchy.

IV CONDUCT OF BUSINESS

Conduct of business is governed by the Banking Act (and the relevant implementing regulations) and is guided by the principles of sound and prudent management and proportionality. Banks are able to comply with the first principle when they manage to:

a contain the typical risks related to their banking activity (credit risk, market risk, liquidity risk, and operational or legal risk);
b maintain the conditions of liquidity and risk contractually established;
c ensure the service's continuity as regards customers; and
d perform their activity prudently and efficiently.

The proportionality principle is ensured when the banks set up their measures, procedures and systems in accordance with the size and complexity of their businesses.

During the past few years, both the supervisory authorities and the EU legislature have referred to the foregoing principles when issuing their laws with the aim of regulating the banking sector more strictly, but also of preventing minor banks from being subject to the stringent requirements provided for major institutions.

Consequently, Italian banks are required to conduct their businesses depending on the type of client, the relevant activity and their clients' knowledge of the services provided. This

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approach has led credit institutions to diversify their internal structures and procedures to safeguard each kind of client and adhere to mandatory out-of-court settlement systems, as seen in the subsequently adopted measures on transparency, investment services and AML, and in the banking and financial arbitrators' fields.

In 2018, the Bank of Italy published several consultation documents aimed at implementing European provisions on, among other things, product governance, AML and investment services.

On 5 December 2018, the Bank of Italy updated its 2009 transparency provisions to align the Italian regulatory framework with the EBA's guidelines on product oversight and governance arrangements for retail banking products. Banks are now required to, among other things, implement processes for the design and market launch of products, as well as for their reviewing over their life cycle.

On 13 April and 31 July 2018, new provisions were published for consultation by the Bank of Italy to implement Legislative Decree No. 231 of 21 November 2007 and align the Italian regulatory framework with AMLD IV.[16] The provisions concern, among other things, conservation and use of data and information for AML purposes; policies, controls and procedures; and customer due diligence.

To implement the MiFID II and MiFIR provisions, in August 2018 the Bank of Italy published for consultation a new regulation on the requirements to be met by intermediaries that provide investment and asset management services; and amendments to the Supervisory Instructions regarding the authorisation of Italian banks to provide investment services and the cross-border provision of investment services.

Conduct of business is also subject to disclosure duties with regard to the supervisory authorities, clients and the public, entailing both preventive and *ex post* information reports. The Bank of Italy and Consob are allowed to request further data and clarification related to the information provided.

A breach of the rules governing conduct of business may involve civil, criminal and administrative liability for both the banks and the individuals committing such violations, based on the following principles:

a civil liability is governed by the Italian Civil Code and may be classified, as per general principles, as contractual, non-contractual or pre-contractual liability:
- contractual liability mainly occurs when a bank does not comply with the provisions set out in the single contracts executed with its customers, or it breaches the best execution duties under the Markets in Financial Instruments Directive;
- non-contractual liability mainly refers to the liability provided by Article 2049 of the Civil Code, under which employers and principals may be deemed responsible for damage caused by their employees and agents during the fulfilment of their professional duties;[17] and
- pre-contractual liability occurs where contracts between a bank and its customers are not executed as a result of the unfair conduct of the bank;

b criminal liability primarily covers any unauthorised banking and financial activity. During the past few years there has been an increase in other crimes, such as obstructing

16 Directive (EU) 2015/849.

17 In the Italian banking sector, this kind of liability is frequently found in the working relationships between banks and their brokers with regard to the activities carried out by the latter on behalf of banks.

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the supervisory authorities' exercise of powers and the occurrence of transnational financial frauds, which entailed a review of deposit guarantee schemes at an EU level. The main rules are provided under the Italian Criminal Code and the Banking Act. At the beginning of 2016, most of the criminal sanctions established for breaching AML regulations (notably Legislative Decree No. 231 of 21 November 2007) were replaced by administrative sanctions (see Legislative Decree No. 8 of 15 January 2016). Although criminal liability is personal, a bank can incur an administrative liability when its corporate bodies and top management commit a crime in the bank's interest and no adequate measures were implemented to prevent this crime, in accordance with the criteria under Legislative Decree No. 231 of 8 June 2001; and

c administrative liability mainly consists of the liability of banks, corporate bodies, top managers and heads of internal functions that breach certain provisions concerning, inter alia, the integrity and reputation requirements and the regulatory fulfilments.

To minimise the risk of a breach of the applicable regulations, Italian banks are required to set internal whistle-blowing procedures that allow staff to flag any potential infringement of the law while keeping confidential the information concerning the involved individuals.

In determining a sanction, the Bank of Italy considers the extent and length of the breach, the economic status of the addressees and the damage caused to third parties. New provisions governing administrative liability under the Banking Act provide a tightening of the relevant sanctions, with maximum fines of up to €5 million, and the mandatory notification of these sanctions to the EBA.

Specifically, a Bank of Italy regulation of 3 May 2016 (which implemented the provisions on sanction proceedings) includes the provision of a possibility to submit defence arguments after the inquiry phase; the elements relevant to assess the financial capacity of natural persons and the revenues of entities to determine the sanction amount; and coordination with the ECB concerning the exercise of sanctioning powers over banks directly supervised by the ECB. The Bank of Italy regulation of 18 December 2012 was further amended in January 2019 to introduce the new AML provisions deriving from the implementation of AMLD IV.

A positive impact on the length of proceedings aimed at assessing the above liabilities, and particularly civil liability, arose from a reform by the Ministry of Justice. This reform, which was mainly aimed at strengthening the alternative dispute resolution mechanisms to streamline the judicial apparatus, contributed to lowering the number of Italian civil litigation cases to the European average (approximately 2,600 against 100,000 individuals[18]) and improving Italy's position in the enforcing contracts ranking published by the World Bank Group (111th in 2018, up 52 positions since 2013).

Among the political initiatives that affect the banking system are the agreements entered into by the government with various countries to resolve the issue of foreign banking confidentiality. Since the confidentiality duty for Italian banks was repealed in 2012, Italy has obtained an undertaking of Switzerland, Liechtenstein, the Principality of Monaco and the Vatican State to provide information and data concerning Italian clients, and undertook to implement the OECD Common Reporting Standard on financial activities from 2017. The automatic exchange of information between the Swiss and Italian tax authorities became effective on 1 January 2017.

18 According to the 2018 EU Justice Score Board edited by the European Commission.

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V FUNDING

Italian banks fund their activities in a wide variety of ways in terms of sources (retail, wholesale and central bank liquidity), types of securities (shares, bonds, deposits) and funding technique (capital raising, plain bond issuance, securitisation transactions and covered bond offers).

The funding structure is usually influenced by the bank's specific characteristics (mainly size, incorporated business form and financial strength), and the economic and financial environment. As a consequence, small banks tend to source funding through wholesale bonds far less frequently than medium-sized and large banks, and those channels that provide issuers with a lower cost of funding (such as secured financing) have been boosted in the past few years because of the financial crisis.

Still-weak credit growth and a reduction of public sector securities in bank portfolios have reduced banks' financing needs, which were largely satisfied by increased retail funding. Deposits have continued to expand strongly, offsetting the contraction on bond funding as a consequence of tension on the sovereign debt markets.[19] In September 2018, the funding gap (i.e., the share of loans not covered by retail funding) was below 2 per cent, compared to 4 per cent in September 2017.[20]

The funding structure of banks is influenced by the monetary policy of central banks, including the quantitative easing programme. Shrinking bank margins caused by withdrawing from the ECB bond-buying programme and tensions on interest rates could have negative effects on the financing of the real economy and on the banking system.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

In the past decade, the acquisition process of stakes in Italian banks has undergone intense revision following an increase of investments of foreign banks in the Italian market and the implementation of the Acquisitions Directive,[21] subsequently replaced by CRD IV.

A further noteworthy revision took place in 2014 following the entry into force of the SSM. In line with the SSM principles, the following are now subject to prior ECB authorisation, following the Bank of Italy's assessment: the direct or indirect acquisition of a controlling stake; a considerable stake (i.e., a stake ascribing to the prospective shareholder a quota of voting rights or share capital of the bank equal to at least 10, 20, 30 or 50 per cent); or a stake enabling the holder to exercise a significant influence over the bank's management (jointly, significant stake). Following the implementation of the BRRD, the Bank of Italy is the competent authority when authorisation for one of the above stakes is granted in a resolution.

The procedure entails:

a the filing, by the prospective shareholder, of an application with the Bank of Italy outlining, inter alia, a detailed business plan attesting to the financial solidity of the

19 Data updated up to September 2018. Source: Bank of Italy Financial Stability Report, No. 2, November 2018.

20 Data updated up to September 2018. Source: Bank of Italy Financial Stability Report No. 2, November 2018.

21 Directive 2007/44/EC.

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acquisition project, the strategy that will be adopted to purchase the significant stake and the suitability of the prospective shareholder's group to ensure full compliance with the supervisory rules;

b the Bank of Italy's notification to the ECB of receipt of the application (unless the Bank of Italy requires any amendments or supplements to be made to the application);

c the Bank of Italy's assessment of the application, with a focus on:
- the prospective shareholder's financial soundness, good reputation, integrity and professional requirements (see Section III.ii);
- the suitability of the medium to long-term (i.e., three to five years) business plan; and
- possible money-laundering issues;

d the Bank of Italy's filing with the ECB of a draft decision to authorise or oppose the significant stake; and

e the ECB's decision on the acquisition of the significant stake (based on EU and local regulations) and notification to the prospective shareholder.

The authorisation procedure takes 60 working days from the Bank of Italy's acknowledgement of the filing under point (a). The term can be suspended for up to 20 working days or – if the prospective shareholder is incorporated in a non-EU state, is subject to non-EU regulations or is not a supervised entity – 30 working days.

The authorisation is granted when the sound and prudent management of the target bank is ensured and the requirements under point (a) above are satisfied. The competent authorities' assessment covers elements such as the sustainability of financial leverage, the complexity of the corporate chain and the acquirer's ability to provide additional funds to target banks in a state of stress.

ii Transfers of banking business

Transfers of undertakings, going concerns or goods, or other obligations or rights (such as receivables, debts and contracts) identifiable as a 'bulk'[22] (transfer), are governed by Article 58 of the Banking Act and Title III of the Bank of Italy Circular No. 229 of 21 April 1999.

The transfer process provides that the transferee, which may be, inter alia, a bank, an entity belonging to a banking group or a financial intermediary enrolled with the register under Article 106 of the Banking Act, gives notice of the transfer to the competent companies register and publishes the notice in the Italian Official Gazette (notification duties).

The consent of the customers concerned is not required, but within three months of completing the notification duties, the parties to the contracts under the transfer may exercise the right of withdrawal if there is a grounded reason (in this case, the transferor is liable for any damage suffered by other parties because of the transfer). When the sum of the assets and liabilities transferred is greater than 10 per cent of the transferee's regulatory capital, the transfer must be authorised in advance by the Bank of Italy or by the ECB (see Section II).

22 The contractual relationships may be identified as a bulk when they refer to, inter alia, receivables presenting a common distinguishing element (e.g., the assignment under ex-Article 58 of the Banking Act of all the receivables owned by a bank as regards a certain person or individual, companies that are part of a certain group and all the enterprises placed in a certain region).

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The above-mentioned procedure allows banks to benefit from a simplified process that speeds up and reduces the costs of the transfer, ensuring at the same time that all charges and guarantees maintain their validity and priority once all the notification duties have been complied with, without any further formality being needed.

During 2018, banks have largely relied on this procedure to dispose of NPLs quickly and effectively, and it is likely that this trend will continue in 2019. The recent structural reforms adopted to reduce the duration of credit recovery procedures and the ECB guidelines on NPL of March 2017 have, in fact, increased the interest of investors in this kind of transaction.

VII THE YEAR IN REVIEW

Two developments witnessed in 2018 were a growing tendency towards consolidation and aggregation between banking operators, and the entry of new players on the financial markets.

More specifically, consolidation and bank recovery were achieved through capital increases and mergers (e.g., Creval's €700 million capital increase, the merger of three banks into Cariparma, and the acquisitions of medium-sized Italian banks by foreign investment funds).

Throughout 2018, several players – including Unicredit, Creval and MPS – rationalised their loan portfolios through large-scale NPL disposals using the GACS, which was introduced in 2016 to facilitate NPL disposal and recently extended to March 2019. Furthermore, this highly dynamic scenario has stimulated banks to establish or acquire entities specialised in the management and recovery of NPLs; one such example is the acquisition of FBS SpA by Banca IFIS, a listed bank that is one of the main players in the NPL sector. This acquisition has given rise to the first integrated platform of investment and NPL management on the Italian market.

The Italian banking system, which in 2018 was subject to both EBA and ECB stress tests, proved to be resilient to adverse market developments. Indeed, following the stress tests, only Carige was asked by the ECB to strengthen its capital ratios.

Regarding the reform of CCBs and mutual banks, the first CCB group was enrolled on the Bank of Italy's register in December 2018, with effect from 1 January 2019; and the 2018 Budget Law extended the original deadline for mutual banks to transform into joint-stock companies from 31 December 2018 to 31 December 2019.

The 2018 Budget Law also introduced a €1.6 billion fund to compensate retail junior bondholders and shareholders who were victims of mis-selling by banks placed under compulsory administrative liquidation between 16 November 2015 and 1 January 2018. Following the approval of the implementing decree of the 2018 Budget Law (currently under discussion with the European Commission), retail junior bondholders and shareholders will be entitled to apply for compensation corresponding to 95 or 30 per cent of their original investments, depending on the types of securities they subscribed (see Section III.iv).

From a regulatory standpoint, Italy introduced or placed under consultation significant new regulations to meet the EU framework requirements in accordance with the ECB's and EBA's suggestions.

One important change in the banking sector in 2018 concerned remuneration policies. Italian banks are now required to adapt their policies to the newly introduced rules no later than the approval date of their 2018 financial statements (see Section III.ii). Furthermore, through the implementation of MiFID II, the Italian legal framework has introduced

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significant changes for Italian banks that provide investment services. These changes concern, among other things, product governance, product intervention, investment advice on an independent basis, and inducements.

Following AMLD IV's entry into force, the Bank of Italy placed under consultation new regulations to adapt the Italian framework governing AML and terrorist financing to European rules. More specifically, the main changes that will be introduced aim to promote a risk-based approach in carrying out customer due diligence and allow remote identification of customers through biometric recognition.

Finally, the implementation of PSD2 is dramatically changing the financial services industry. Specifically, PSD2 provisions allow new entrants to leverage existing banks' data, thereby creating a more level playing field for new competitors to offer a range of products and services to banks' existing customers. Against this background, traditional banking operators are responding with strategies to adapt their current business model, specifically by developing platform services, acquiring or forming alliances with fintech companies, or becoming pure digital banks.

VIII OUTLOOK AND CONCLUSIONS

The global economy has been slowing down since mid-2018. Indeed, economic activity has declined markedly in the eurozone, and Italy has recorded a downturn primarily due to a reduction in foreign demand, companies' expectations and investments. Italian GDP decreased on the previous quarter for the second time in a row, having been further weakened by the negative performance of domestic demand.

Regarding the banking sector, the higher financing costs that banks are bearing have yet to be passed on to loan interest rates thanks to banks' increased capitalisation. However, signs of modest tightening of conditions for accessing credit have begun to appear.

Further progress in improving the health of Italian banks and strengthening their balance sheets was seen in 2018, and NPL stocks diminished at a remarkable pace (also due to several bad loan portfolio sales). The decrease in SIs' NPLs appears consistent with the plans agreed between banks and the supervisory authorities. The Bank of Italy is now examining NPL operational plans for LSIs.

Although profitability has improved, Italian banks need to strengthen their balance sheets and recover adequate efficiency and profitability levels. Major resources are now needed to cope with higher compliance costs, and major investments are required to exploit digital technology and improve service offerings to customers.

The main challenge that banks must now face is fintech: technology dramatically reduces the costs of transmitting, processing and storing data, and pushes market players towards new forms of financial intermediation. Fintech companies are gaining market share by using new methods of providing financial services (e.g., payment services, credit provision, securities trading and risk management).

Italian banks are facing significant changes, and important progress is underway to improve the health of the Italian banking system. Tail risks to the banking system have been reduced by measures to improve balance sheets and profitability; however, banks must now continue on all fronts to restore resilience in the banking system and enable it to fully support the real economy. More specifically, the priorities for Italian banks in 2019 remain:

a capital strengthening;

b credit risk, with a focus on NPLs;

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c risk management; and
d review of governance and business models.

Furthermore, banks must now comply with additional requirements, such as those deriving from the implementation of MiFID II and PSD2. They must also prepare for the upcoming entry into force of the new legislative package aimed at reducing risks within the EU banking sector by implementing Basel III framework elements such as a total loss-absorbency capacity, a net stable funding ratio and the leverage ratio (CRR2 Package).

Against this background, technical knowledge and familiarity with the Italian and European banking and financial regulations will be crucial in a regulatory environment that is becoming ever more sophisticated and complex.

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Chapter 20

JAPAN

Hirohito Akagami and Honami Sohkawa[1]

I INTRODUCTION

As the world's third-largest economy, Japan has a well-developed banking industry of approximately 200 banks. There are currently four mega banking groups: Mizuho, Sumitomo Mitsui, Mitsubishi UFJ and Resona. Approximately half of these banks are local banks, which provide more locally based services (principally in one or more specific prefectures).[2] There are also more than 50 overseas bank branches.

On 4 November 2015, Japan Post Bank Co, Ltd, which was formerly part of the government's postal division, had its shares listed on the First Section of the Tokyo Stock Exchange, concurrently with the listing of its parent company, Japan Post Holdings Co, Ltd and another subsidiary of the parent company, Japan Post Insurance Co, Ltd.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i The Banking Act and the Financial Instruments and Exchange Act

The principal source of regulation for banks engaging in business in Japan is the Banking Act,[3] to which all banks are subject. It regulates their corporate governance, banking business and capital adequacy as well as their principal shareholders and subsidiaries. The Banking Act also regulates holding companies that have banks as subsidiaries (bank holding companies).

The Japanese regulatory framework regulates commercial banking activities and investment banking activities separately. The Banking Act is, in principle, applicable only to the former (i.e., acceptance of deposits, provision of loans and transfer of funds: the core banking business). A large number of banks also engage in investment banking activities, which generally include securities and derivatives-related businesses. These activities are subject to separate restrictions (discussed in subsection iii), and these banks are concurrently regulated under the Financial Instruments and Exchange Act (FIEA)[4] for this purpose. Some banks also have affiliated securities companies engaging in investment banking business; these companies are also regulated by the FIEA.

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1 Hirohito Akagami is a partner and Honami Sohkawa is an associate at Anderson Mōri & Tomotsune.

2 From 2014 on, some businesses have been announcing their integration with local banks through the establishment of holding companies.

3 Act No. 59 of 1981.

4 Act No. 25 of 1948.

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ii Regulators

The principal regulator of the banking industry is the Financial Services Agency of Japan (FSA), whose authority to supervise banks in Japan is delegated by the Prime Minister. The Commissioner of the FSA also delegates a part of his or her authority to the directors of local finance bureaus in relation to local banks and the supervision of investment banking activities. On-site and off-site inspections of investment banking activities are performed by the Securities and Exchange Surveillance Commission. The Bank of Japan also has supervisory authority over banks, based primarily on its contractual agreements and transactions with them.

The regulator's powers as prescribed in the Banking Act include receipt of various reports, the ability to carry out on-site inspections (where a bank must, in practice, disclose any and all information it holds to the regulator), and the power to make orders of business improvement and suspension.

iii Entry into banking industries

Two organisational structures are available to overseas banks for establishing a core banking business in Japan. One scheme consists of the establishment of a joint-stock company with limited liability in Japan as a subsidiary or affiliate in accordance with the Companies Act of Japan.[5] This subsidiary or affiliate must obtain a banking licence from the Prime Minister of Japan, pursuant to the Banking Act (a local entity bank). The alternative consists of the establishment of branches of the foreign bank within Japan, and obtaining a foreign bank branch banking licence. For the foreign bank branch scheme, the opening of subsequent branches (which are also known as sub-branches) is also subject to prior approval by the FSA.[6] The granting of the necessary licences and approvals is at the discretion of the relevant authority in each instance.

To engage in investment banking activities, such as securities and derivatives business, a bank must also be registered with the competent local finance bureau, pursuant to the FIEA.[7] Registered banks are generally permitted to operate a wider range of derivatives and securities businesses, such as brokerage of government bonds and sales of unit trusts or non-discretionary investment advisory services; however, for historical reasons, banks are generally prohibited from engaging in certain categories of securities business, including brokerage and underwriting of corporate stocks and corporate bonds, and discretionary investment management services.[8] To conduct these activities, banks must establish a subsidiary or affiliate that is a separate legal entity, and register it pursuant to the FIEA as a financial instruments business operator.

In this connection, the scope of business of a subsidiary or affiliate that a bank may have is restricted to certain financial and related businesses,[9] but it has been expanded to some extent (to include fintech business) by an amendment of the Banking Act in 2016.

5 Act No. 86 of 2005.

6 Article 47-3 of the Banking Act.

7 Article 33-2 of the FIEA.

8 Article 33 of the FIEA.

9 Articles 16-2 and 16-4 of the Banking Act.

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iv Cross-border activities by overseas banks not having a branch

Overseas banks may not, in principle, enter into any part of the core banking business or investment banking business in Japan or with persons in Japan without establishing a branch and obtaining a banking licence as a foreign bank branch. Even where an overseas bank has a licensed foreign bank branch in Japan, it is generally understood that the other unlicensed overseas branches of the bank are prohibited from engaging in transactions, or with persons, in Japan.

In this regard, another regulatory framework – the foreign bank agency business – was implemented in December 2008, under which both overseas banks without a licensed foreign bank branch and the unlicensed branches of an overseas bank may conduct a core banking business with persons in Japan through either a local entity bank[10] or a foreign bank branch of the bank acting as an agent or intermediary. Both options require the local entity bank or foreign bank branch to obtain separate approval from the FSA.[11]

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Most banks have a close relationship with the regulators. We understand that the officials of the supervisory division of the FSA and local finance bureaus are each assigned to monitor specific banks.

The regulators tend to focus their attention principally on appropriate management of banking businesses, maintenance of sufficient financial conditions, including satisfaction of capital adequacy requirements and protection of customers, and the maintenance of robust internal control systems to ensure that a bank is always in compliance with the applicable laws.[12] It is fairly common that a bank will consult regulators in advance on occasions when it expects to receive particular attention from the regulators: for instance, if it launches a new business that is not covered clearly by existing legislation, or an issue has arisen that may affect the bank's financial condition.

ii Management of banks

Under the Banking Act, a local entity bank must have a board of directors and accounting auditors, as well as a board of corporate auditors or a subcommittee of the board of directors (comprising either an audit and supervisory committee or an audit committee, remuneration committee and appointment committee), pursuant to the Companies Act.[13] Directors and executive officers engaging in the ordinary business of a local entity bank must have the knowledge and experience to be able to manage and control the bank appropriately, fairly and efficiently, and must have sufficient social credibility (the Banking Act requires a bank

10 In principle, within the same group.

11 Chapter 7-2 of the Banking Act.

12 In September 2013, the FSA announced its new monitoring policy to enhance its supervisory oversight function by further integrating its on-site inspection and off-site supervision into a continuous and seamless monitoring process. This new monitoring policy may lead to significant changes in the relationship between banks and the FSA.

13 Article 4-2 of the Banking Act.

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to appoint directors who are trusted within society; however, what precisely is meant by this criterion is ambiguous).[14] For local entity banks that have a board of corporate auditors, the representative director shall:

a take command of the establishment and maintenance of the internal compliance framework;
b make risk management a primary concern;
c establish a sufficient internal control framework to properly disclose the bank's corporate information to the public; and
d ensure that appropriate internal audits are performed.[15]

The board of directors must:

a proactively oversee the representative directors;
b establish and review business management plans in line with the bank's business objectives;
c establish a clear risk management policy by taking these objectives into consideration; and
d ensure appropriate performance and review of internal audits.[16]

For foreign bank branches, although there is no required specific corporate governance structure such as that for local entity banks, a branch manager must also have the knowledge and experience to manage and control the branch appropriately, fairly and efficiently, and must also have sufficient social credibility (as referred to above). In addition, officers with sufficient knowledge and experience must be appointed to manage the branch, and the proper authority to do so must be delegated to those officers by the overseas head office. Of course, the head office is likely to want to oversee the management of the branch, and it is permissible for it to offer supervision and guidance. Therefore, it may be advisable to introduce appropriate systems for oversight and approvals; for example, that any problematic issues occurring within the branch should immediately be reported to the head office as well as to the regulatory authority.

In addition, however, it must be borne in mind that oversight by the overseas branch or holding company must not undermine the governance framework, and the management responsibility for such, which must be established within the local entity bank or foreign bank branch to manage its business properly as a licensed financial institution. Administrative action (in the form of an order to suspend part of the business or to improve part of the business) taken against a local entity bank subsidiary of a US-based bank group illustrates the FSA's position on how each financial institution within the same group should be managed. An FSA press release dated 27 January 2006 regarding its action states that the US parent appointed a person who had no directorship of the local entity bank but was given the title of 'Representative in Japan', and gave that person the primary management and control of the businesses of the local entity bank. This thereby undermined the authority and responsibility of each director of the local entity bank (despite the fact that such authority and responsibility is required under Japanese corporation law and the Banking Act). The FSA ordered the

14 Article 7-2 of the Banking Act.
15 III-1-2-1 (1) of the Comprehensive Guidelines for Supervision of Major Banks, etc., of the FSA (FSA Supervisory Guidelines).
16 III-1-2-1 (2) of the FSA Supervisory Guidelines.

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creation and development of independent governance and internal control systems, and the establishment of a clear system of responsibility within the local entity bank, predicated upon a fundamental re-evaluation of the current state of managerial involvement and monitoring of the bank by the US parent.

There is no express provision under the Banking Act that directly restricts the amount, form and manner of remuneration paid to the management or employees of banks or their affiliates. However, the regulators have been placing greater emphasis on ensuring appropriate remuneration in light of the need to avoid excessive risk-taking and to conform with the consensus of the Financial Stability Board. More specifically, as part of general prudential regulations, banks are expected to:

a have an independent committee or other type of organisation to sufficiently monitor the remuneration of management and employees;

b ensure financial sufficiency, appropriate risk control, consistency between incentive bonuses and actual performance (i.e., the level of incentive bonuses should substantially decrease in the event of poor financial performance), and the contribution to long-term profits in determining remuneration structures; and

c disclose important matters regarding remuneration.[17]

iii Regulatory capital and liquidity

The framework for regulating local entity banks' capital adequacy under the Banking Act has been amended in line with the implementation of Basel II. By March 2008, the regulatory framework of Basel II was fully introduced into Japanese banking laws through amendments of the FSA administrative notice,[18] including, inter alia, the internal ratings-based approach and the advanced measurement approach. Basel III is also being introduced into Japanese banking laws.

The status of the capital adequacy of banks, including the risk-adjusted capital ratio, must be reported and disclosed on a semi-annual basis.[19] If a bank's capital ratio falls short of the minimum requirement, the FSA may require the bank to prepare and implement a capital reform plan. In extreme cases, it may reduce the bank's assets, restrict the increase of its assets, prohibit the acceptance of deposits or take any other measures it deems necessary.[20]

Effective from April 2014, foreign bank branches, in principle, are required to maintain assets in Japan (in the form designated by a cabinet order) equal to or more than ¥2 billion at all times, which is equal to the required minimum capital amount of the local entity banks.[21]

17 III-2-3-5 and III-3-2-4-5 of the FSA Supervisory Guidelines.

18 FSA Administrative Notice No. 19 of 2006 and Administrative Notice No. 20 of 2006.

19 Article 19 of the Banking Act.

20 Article 26, Paragraph 2 of the Banking Act. Following final Basel III reforms in December 2017, the Order Providing for the Categories, etc., prescribed in Article 26, Paragraph 2 of the Banking Act and the FSA Supervisory Guidelines, will be amended and applied in March 2019 (or in September 2019 for some portions of the FSA Supervisory Guidelines) so as to establish a minimum ratio standard of the leverage ratio of 3 per cent and to introduce a system of early corrective action when going below that standard for banks to which unified international standards are applied.

21 Article 47-2 of the Banking Act. Certain transitional measures are set out in supplementary provisions of the Ordinance for Enforcement of the Banking Act.

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On occasion, a large transaction with any one bank may be restricted as a result of the large lending limit regulation. Pursuant to this regulation, aggregate exposure of a local entity bank to a single person (including that person's group companies) by means of extending loans or purchasing debt instruments or equity investments shall not exceed, in principle, 25 per cent of the amount of non-consolidated regulatory capital (with certain adjustments) of the local entity bank.[22]

The Banking Act does not contain an express provision that directly regulates banks' liquidity or any quantitative standards of liquidity, but the FSA Supervisory Guidelines provide some guidance on this point from a regulatory monitoring perspective.[23] These guidelines require a bank, inter alia, to:

a establish an internal framework to appropriately control liquidity risk (e.g., by separating the treasury division from the liquidity risk control division);

b maintain control methods as well as internal reporting procedures regarding the bank's liquidity that are subject to the approval of the board of directors; and

c monitor the status of its liquidity and be prepared for emergency circumstances.[24]

The Inspection Manual for Deposit-taking Institutions, prepared by the FSA for use by its inspectors, also includes detailed checklists for self-regulation by banks as part of the framework for managing liquidity risk. These requirements apply to both local entity banks and foreign bank branches. For the latter, however, it is understood that there will be broad variations as to what constitutes acceptable levels of, and procedures for, liquidity risk management, given that the business of foreign bank branches varies greatly. After April 2019, the FSA will repeal the Inspection Manual. In June 2018, the FSA announced the creation of a Supervisory Approaches Report that would provide underlying concepts, approaches and principles of supervision, without providing checklists.

iv Recovery and resolution

The Deposit Insurance Act[25] provides certain measures in cases where serious problems arise in maintaining the stability of the financial systems in Japan or in regions where a bank operates its business. These measures, which include capital injection, full deposit protection and temporary nationalisation, may be initiated subject to deliberation by the Financial System Management Council.[26]

Capital injection is designed to allow a bank with positive net worth to increase the amount of its capital by way of having its shares subscribed to by the Deposit Insurance Corporation of Japan. Full deposit protection is designed for banks with negative net worth,

22 Article 13 of the Banking Act.

23 FSA Administrative Notice No. 7 of 2014 will be amended and applied in March 2019 to provide the disclosure form for quantitative disclosure items regarding interest rate risk. The FSA Supervisory Guidelines will also be amended and applied in March 2019 to prescribe points to be noted in disclosing qualitative disclosure items on interest rate risk (e.g., risk management policy or risk calculation method).

24 III-2-3-4 of the FSA Supervisory Guidelines. As a result of the amendment of the FSA Supervisory Guidelines in January 2019, the minimum standard for the liquidity coverage ratio has decreased. Banks will be requested to report to the FSA when liquidity coverage ratios fall below this minimum standard.

25 Act No. 34 of 1971.

26 Article 102 of the Deposit Insurance Act.

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or that suspend or may suspend the repayment of deposits. Temporary nationalisation is intended for banks with negative net worth that suspend or may suspend the repayment of deposits.

In addition, since March 2014, other measures have been provided by the Deposit Insurance Act in the event of significant turmoil in financial systems, including the following:

a special oversight;
b capital injection;
c providing liquidity and debt guarantees for banks with positive net worth; and
d special oversight and financial assistance for banks with negative net worth, or that suspend or may suspend the repayment of deposits.

These measures may also be initiated subject to a deliberation by the Financial System Management Council.[27]

The provisions for bail-in, which were also implemented in March 2014, stipulate that, in the cases mentioned above, the Prime Minister will decide the treatment of certain types of subordinated bonds, or subordinated loans and preferred shares issued by banks with negative net worth, or that suspend or may suspend the repayment of deposits.

IV CONDUCT OF BUSINESS

The Banking Act obliges banks to carry on their business in compliance with various regulations, including:

a a prohibition on abuse of a dominant bargaining position;
b management of a conflict of interests;
c provision of an explanation of the risks associated with their products and other information to customers; and
d appropriate handling of personal information.

However, Japanese banking laws do not provide such comprehensive and strict banking confidentiality frameworks as those adopted in some jurisdictions. Questions about how and to what extent banks should protect and use information about their customers have been governed by general confidentiality laws and contractual arrangements between banks and their customers (including implicit agreements), the contents of which have been clarified and developed by court decisions made upon individual lawsuits alleging misconduct on the part of the relevant bank and by discussion within the banking industry.

The handling of information about individual clients is mainly governed by a general law applicable to all industries, the Act on the Protection of Personal Information (APPI),[28] although the general principles thereof have been brought into the Banking Act. Under the APPI, personal information may not, in general, be disclosed to third parties without the relevant individual's consent or without providing that individual with the right to prohibit the disclosure (an opt-out system).[29]

27 Article 126-2 of the Deposit Insurance Act.
28 Act No. 57 of 2003.
29 Article 23, Paragraphs 1 and 2 of the APPI.

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How banks should treat information about corporate clients is discussed in the Study Group Report on Desirable Sharing of Corporate Customer Information between Banking and Securities Businesses published by the Japanese Bankers Association on 15 April 2008. This suggests that information may be disclosed when:

a the explicit or implicit consent of the customer has been obtained;

b the information is public information; or

c the disclosure may be deemed legitimate, taking its necessity into account (leading to the conclusion that a rather wider range of disclosure to other companies within the same group for the purpose of, for instance, marketing activities, is permissible without the customer's consent).

It should, however, be pointed out that banks may disclose confidential information about both individual and corporate clients to governmental authorities without their consent if it is deemed necessary and appropriate. This could also apply to foreign governmental authorities, but this may not necessarily be the case (for instance, the APPI provides that it is permitted to disclose personal information if the disclosure is based on laws;[30] the term 'laws' for this purpose is interpreted to mean Japanese law only).

In relation to banks' fiducial duty towards customers, on 30 March 2017 the FSA released the principles that it considers to be useful for best practices in pursuing financial business in line with that duty. The FSA has stated that it announces the names of the banks that accept these principles and formulate policies so as to achieve fiducial duty, as well as their specific methods of doing so.

A registration system of electronic payment agents is to be introduced.[31] Banks must prepare and publish standards for the conclusion of contracts with these agents, and are prohibited by an amendment to the Banking Act, introduced in 2017, from unreasonably discriminating against electronic payment agents that meet those standards.[32]

V FUNDING

All types of funding methods, including equity and debt financing, call loans, repurchase transactions and central bank funding principally by way of open market operations, are substantially available to banks.

Open market operations are provided by the Bank of Japan (BOJ). Both local entity banks and foreign bank branches may participate, to the extent that they satisfy certain requirements prescribed by the BOJ.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Shareholders of local entity banks may be subject to regulation pursuant to the Banking Act if they qualify as a bank principal shareholder or a bank holding company.

30 Article 23, Paragraph 1(i) of the APPI.

31 Article 52-61-2 of the Banking Act.

32 Article 52-61-11 of the Banking Act.

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A bank principal shareholder is generally defined as a shareholder having 20 per cent (or in certain cases, 15 per cent) or more of the voting rights of a local entity bank.[33] A bank holding company is defined as a company that has paid an acquisition price for its Japanese subsidiaries' shares exceeding 50 per cent of the total assets of the company, and that holds more than 50 per cent of the voting rights in a local entity bank.[34] Once the shareholder qualifies as a bank holding company, it will be subject to regulations applicable to a bank holding company rather than a bank principal shareholder.[35]

Any person who wishes to become a bank principal shareholder must obtain prior approval from the FSA.[36] That person is also required to satisfy the following criteria:

a in light of matters concerning funds for the acquisition of shares, the purpose of holding shares or other matters concerning the holding of shares, there must be no risk of impairment to the sound and appropriate management of the business of the bank;

b in light of the status of property and income and expenditure of the person and his or her subsidiaries, there must be no risk of impairment to the sound and appropriate management of the business of the bank; and

c the person must have sufficient understanding of the public nature of the bank's business, and must also have sufficient social credibility.[37]

A principal shareholder may be required by the FSA to submit reports or materials; be inspected by the FSA at its offices and have to answer questions put by an FSA officer; and have to present accounting books and other documents.[38] If a bank principal shareholder fails to satisfy any conditions given out by the FSA in conjunction with the approval, the FSA may order the bank's principal shareholder to take any action the FSA considers necessary.[39] Further, a bank principal shareholder with more than 50 per cent of the voting shares of a local entity bank may be ordered by the FSA to submit an improvement plan, or otherwise take necessary measures to ensure the sound and appropriate management and operation of the local entity bank.[40] Necessary measures are interpreted to include certain kinds of 'keep well' directions aimed at the local entity bank: for instance, capital support to the local entity bank if it has any problems with capital adequacy.

The regulations applicable to a bank's principal shareholder are generally applicable in the same way to a bank holding company and its shareholder.[41] Improvement plans and keep well directions are also applicable to both. Further, the scope of business of a bank holding company and its subsidiaries is restricted to certain financial businesses.[42] However, the scope has been expanded to some extent (to include fintech business) by an amendment to the

33 Article 2, Paragraph 9 of the Banking Act.

34 Article 52-17, Paragraph 1 and Article 2, Paragraph 13 of the Banking Act.

35 Article 52-9, Paragraph 1 and Article 55, Paragraph 2 of the Banking Act.

36 Article 52-9, Paragraph 1 of the Banking Act.

37 Article 52-10 of the Banking Act.

38 Articles 52-11 and 52-12 of the Banking Act.

39 Article 52-13 of the Banking Act.

40 Articles 52-14 and 52-15 of the Banking Act.

41 Articles 52-31 to 52-34 of the Banking Act and Article 1-7 of the Ordinance for Enforcement of the Banking Act.

42 Article 52-21, Paragraph 2, Article 52-22, and Article 52-23, Paragraph 1 of the Banking Act.

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Banking Act in 2016.[43] The maximum amount of credit that may be extended to a single group of persons by a bank holding company and its subsidiaries is the amount calculated in accordance with a formula specified in the Banking Act.[44]

ii Transfers of banking business

Local entity banks may transfer their banking businesses in one of three ways: a business transfer for all or part of the bank's business; a corporate merger of the whole business; or a corporate split for part of the business. For foreign bank branches, a business transfer is commonly used to amalgamate the Japanese operations of two or more foreign banks. Other transfer procedures may also be available pursuant to the laws of their home countries, but there is some ambiguity regarding how the special procedures required under the Banking Act to protect customers will apply to transfers conducted pursuant to foreign laws. Both local entity banks and foreign bank branches may be a transferee of the banking business of another bank. A banking business cannot be transferred to an entity other than a bank unless that entity obtains a banking licence prior to the closing of the transfer.

Business transfer

In summary, the procedure for a business transfer under the Banking Act is as follows:

a execution of the business transfer agreement between the transferor and transferee;
b in the case of the transfer of a whole business, completion of procedures to protect creditors (among others);[45]
c application to the FSA by both the transferor and transferee for approval of the business transfer;[46] and
d closing of the transfer, once approval has been obtained.

The second step is performed by way of publishing a notice over a period of at least one month to creditors about the effect of the business transfer. This step essentially enables the transferor bank to replace individual consents (as would usually be required under the Civil Code) with the public notice.[47]

Corporate split and corporate merger

Corporate split and corporate merger procedures are similar to that of a business transfer:

a execution of the corporate split or corporate merger agreement;
b the procedures for creditors' protection as mentioned above;[48]
c application for the approval of the FSA;[49] and
d closing of the transfer after FSA approval has been obtained.

43 Article 52-21-2 of the Banking Act.
44 Article 52-22 of the Banking Act.
45 Article 34 of the Banking Act.
46 Article 30, Paragraph 3 of the Banking Act.
47 Article 34, Paragraphs 3 and 4 of the Banking Act.
48 Article 789, Paragraph 2; Article 799, Paragraph 2; Article 810, Paragraph 2; Article 789 of the Companies Act; and Articles 33 and 33-2 of the Banking Act.
49 Article 30, Paragraphs 1 and 2 of the Banking Act.

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The second step must be performed by way of issuing a public notice to creditors. By application of the provisions of the Companies Act, all contractual relationships pertaining to the transferred business are transferred to the transferee bank without the individual consent of the counterparties.[50] All the relevant steps required under the Companies Act and securities laws, as well as the rules of the securities exchanges, remain applicable under these procedures.

VII THE YEAR IN REVIEW

In line with a report released by a working group of the Financial System Council in December 2016 suggesting, inter alia, the establishment of an institutional framework to promote open innovation (i.e., innovation through collaboration between banks and fintech companies) and to ensure user protection, a law amending the Banking Act was adopted on 26 May 2017 that came into effect on 1 June 2018. The purpose of this amendment is to encourage collaboration between banks and electronic payment agents and to create a foundation on which highly convenient financial services can be created. The Banking Act was amended in May 2016 (see Section VI.i) with the purposes of:

a enhancing business management in financial groups;
b strengthening the financial intermediation function through the consolidation of common business;
c responding to the technological innovation that accompanies the progress of IT; and
d providing support for virtual currencies.

Furthermore, in June 2018, a Study Group on the Financial System, established under the Financial System Council, proposed a comprehensive shift from an entity-based regulatory framework to a function-based, cross-sectoral regulatory framework under which the same regulations would apply to activities with the same functions and risks, with close attention being paid to achieving the right balance between innovation and user protection. In January 2019, the Study Group released a report regarding data utilisation, suggesting that a cross-sectoral review of the data protection and utilisation rules would be required; and that it is appropriate to change the regulations on the scope of permissible business for traditional financial institutions considering the increasing use of data in society, and to allow financial institutions to engage in the business of providing data to third parties. In February 2019, it was reported that the Minister of State for Financial Services had expressed that the FSA's policy will be to further relax the regulations concerning the transfer of funds, one of the core businesses of banks.

VIII OUTLOOK AND CONCLUSIONS

For more than a decade, the government has continued to relax the regulations on financial institutions, aiming to increase the competitiveness of Japan's financial industries. However, in step with the worldwide movement to impose tougher constraints on the financial sector following the global financial crisis, the government seems also to be turning to stricter regulation.

50 Article 750, Paragraph 1; Article 754, Paragraph 1; Article 759, Paragraph 1; and Article 764, Paragraph 1 of the Companies Act.

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Owing to the changes in financial regulatory environments worldwide, it has become more difficult to predict the direction of banking regulation policies. All participants in the Japanese banking industry are strongly recommended to closely observe any trends and changes in Japan's financial regulations.

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Chapter 21

LIECHTENSTEIN

Mario Frick and Nils Vogt[1]

I INTRODUCTION

Liechtenstein, which is located in the heart of Europe, is known to be a niche player for financial services. Many investors and advisers know about its liberal company system, including the company limited by shares, Anstalt,[2] foundation and the Anglo-Saxon style trust. Liechtenstein banks support these companies by delivering the necessary banking services.

Over the years, there have been quite considerable changes in the financial and banking system of Liechtenstein. The turning point for Liechtenstein's banking and financial market system was seen in the mid-1990s. With internet technology, and especially through entering the European Economic Area (EEA), Liechtenstein left its principle of highest confidentiality and blocking of information in exchange for free access to the European market. In the ensuing years, this led to a situation in which cooperation in tax issues and in other aspects of international cooperation grew increasingly important. Today, Liechtenstein has 15 banks that mainly concentrate on asset management. In the past, transaction banking, and especially the field of fintech, has grown more important for the Liechtenstein market. Currently, Bank Frick & Co AG is the leading bank in this field.

Of the 15 banks licensed in Liechtenstein today, five are subsidiaries of Swiss, Austrian and Luxembourgian banks.

Liechtenstein banks traditionally focus on private banking. They do not engage in investment banking, and carry comparatively low risks. Thanks to Liechtenstein's participation in the European single market, Liechtenstein banks enjoy full freedom of services, capital, persons and goods throughout the entire EEA. This makes it possible to offer financial products from Liechtenstein that are based on the Swiss franc (Liechtenstein's official currency) and are authorised throughout the entire EU. Thanks to this special status, Liechtenstein offers attractive diversification options to globally orientated investors.

Three of the banks are systemically relevant for the Liechtenstein financial market: LGT Bank AG, Liechtensteinische Landesbank AG and VP Bank AG.

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1 Mario Frick is a partner and Nils Vogt is a personal assistant at Advocatur Seeger, Frick & Partner AG.

2 The Anstalt (establishment) is a capital company, which in many respects (organs, field of activity) is quite similar to a joint-stock company. The big difference is that an establishment does not have shares, but rather founders' rights. The establishment is therefore often used when there are only one or perhaps two owners. The establishment also benefits from some administrative simplifications (no obligation to publish the balance sheets).

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II REGULATORY REGIME APPLICABLE TO BANKS

Although Liechtenstein is a small country with roughly only 38,000 inhabitants, it has a workforce of approximately 37,000. The majority come from Liechtenstein's neighbouring countries, Switzerland and Austria. Hence, Liechtenstein is dependent on its close neighbours. Every day, 20,000 employees commute from Austria and Switzerland, as well as a few from Germany.[3] Liechtenstein enjoys the best of both worlds in this context: on one hand, there is a longstanding and traditional partnership with Switzerland, which is not a member of the EEA or the European Union; on the other, there is the strong relationship with the EU through Liechtenstein's membership of the EEA since 1995. Below is a brief summary of these aspects.

i Currency treaty

For Liechtenstein's financial services sector, the currency treaty with Switzerland[4] is of significance in several respects. The 1980 currency treaty not only declared the Swiss franc to be the official means of payment for Liechtenstein, but also declared certain Swiss legal and administrative provisions to be applicable in Liechtenstein under the currency treaty (see the annexes to the currency treaty). The Swiss National Bank (SNB) acts as the national bank for Liechtenstein. This means that certain financial intermediaries (banks, investment undertakings) have to comply with reporting obligations to the SNB for monetary policy reasons. However, supervision of all financial service providers licensed in Liechtenstein remains exclusively with the competent supervisory authority. The currency treaty is a bilateral treaty under international law that is regularly updated and, if necessary, adjusted.

ii The EEA and the EFTA Convention 2001 (Vaduz Convention)

As a member of the EEA,[5] Liechtenstein – together with Norway and Iceland – participates in the four economic freedoms (services, capital, persons, goods) within the EU. As a result, European guidelines, ordinances and directives concerning banking, alternative investment funds, UCITs, asset management and all the other financial market aspects in Liechtenstein are regulated according to EU legislation. As such, Liechtenstein has a European passport for its financial market companies as well as for its financial market products.

Because Switzerland did not join the EEA, this led to a situation where several transitional periods and solutions had to be implemented. With the signing into force of the Vaduz Convention, most of these problems were solved. Switzerland still does not have the same access to the European market – especially in the field of services – as Liechtenstein and other EEA members. However, the Vaduz Convention[6] helps.

The Vaduz Convention was a complete revision of the European Free Trade Association (EFTA) Convention, which was originally limited to trade in goods. This revision became necessary due to bilateral negotiations between Switzerland and the EU. This brings the contractual relations between Switzerland and the other three EFTA states to a level

3 Details can be found in the yearly report of Amt für Statistik: https://www.llv.li/files/as/fliz-arbeit-und-bildung-2018.pdf.

4 Currency agreement between the Principality of Liechtenstein and the Swiss Confederation. LR 0.951.910.11.

5 For detailed information see the website of EFTA: http://www.efta.int/eea/eea-agreement. EWR Agreement of 2 May 1992 on the European Economic Area. LR 0.110.

6 EFTA Agreement. LR 0.632.310.

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comparable to that created by the bilateral agreements between Switzerland and the EU. The Vaduz Convention entered into force on 1 June 2002 at the same time as the seven bilateral agreements between the EU and Switzerland. The EFTA Convention also contains provisions on trade in services and investments. The EFTA states grant each other access to markets that goes beyond WTO standards.

iii Main banking acts and laws

The main acts and laws governing the activities of banks[7] are:

a the Banking Act (BA);[8]
b the Banking Ordinance;[9]
c the Act of 18 June 2004 on Financial Market Supervision;
d the Act of 11 December 2008 on professional due diligence to combat money laundering, organised crime and terrorist financing;
e the Financial Market Stabilisation Institution Act;[10]
f the Restructuring and Winding-up Act;
g the Market Abuse Act;[11]
h the Asset Management Act;[12]
i the Consumer Credit Act of 24 November 2011; and
j the Persons and Companies Act of 20 January 1926 (PGR).

iv Licences

In the past, many new EU rules and regulations have been implemented in Liechtenstein that have made it necessary for market participants to have special licences for payment services, e-money and many other aspects in the field of financial market business.

Banking licences are the most comprehensive licence, putting banks in a special situation: with a full banking licence, they may engage in all of these activities without additional licences[13] as long as they provide the necessary knowledge, employees and organisation to undertake these activities.

Banks engage in activities set out in Article 3 Paragraph 3 BA on a professional basis. Natural and legal persons that are not a bank may not accept deposits or other repayable funds on a professional basis. According to Article 3 Paragraph 3 BA, banking activities are:

> *a) the acceptance of deposits and other repayable funds; in the case of an e-money transaction in accordance with subparagraph (f), the receipt of a sum of money shall not constitute an acceptance of deposits or other repayable funds if the received sum is directly exchanged against e-money;*
> *b) the lending of third-party funds to an indeterminate circle of borrowers;*
> *c) safekeeping transactions;*

7 These can be found at www.gesetze.li or www.fma-li.li.
8 Act of 21 October 1992 on Banks and Investment Firms.
9 Regulation of 22 February 1994 on banks and investment firms.
10 Act of 4 November 2016 on the Institution for the Financing of Financial Market Stabilisation Measures.
11 Act of 24 November 2006 on Market Abuse in Trading in Financial Instruments.
12 Asset Management Act of 25 November 2005.
13 Exception: according to Article 30t Paragraph 2 BA, the operation of a multilateral or organised trading facility requires a licence issued by the FMA.

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d) the provision of investment services and ancillary services referred to in Annex 2 Sections A and B [of the BA] as well as the execution of other bank related off-balance-sheet transactions;
e) [Repealed];
f) the issuance of electronic money pursuant to Article 3(b) of the E-Money Act.
g) the assumption of suretyships, guarantees, and other forms of liability for other parties where the obligation assumed is monetary in nature;
h) trading of foreign currency for one's own account or on behalf of others.

Liechtenstein has implemented the rules and regulations according to EU standards; reference is made to the guidelines of the European Banking Authority (EBA).

III PRUDENTIAL REGULATION

i Financial Market Authority

There is only one supervisory authority for Liechtenstein banks: the Financial Market Authority Liechtenstein (FMA).

The FMA has been a regular member of the International Organization of Securities Commissions since April 2011, has had observer status in the EBA and the European Securities and Markets Authority since May 2011, and also has observer status in the European Insurance and Occupational Pensions Authority.

ii Relationship with the prudential regulator

The Banking Division is responsible for supervising banks and investment firms in Liechtenstein, and it monitors compliance with the applicable legal norms. As part of the licensing procedure, submitted documents are reviewed for content and completeness. Ongoing monitoring is ensured with reports banks and investment firms are legally required to submit, as well as through direct and periodic contact with the boards of directors and management of institutions.

Similar to Switzerland, Liechtenstein has implemented the dual supervision model. This means that independent, qualified auditors supervise the fulfilment of a bank's legal duties. Additionally, internal audits are mandatory. Smaller banks often use other independent, qualified auditors for this part of the auditing process as well. The FMA may also carry out its own audits or accompany external audits. Where violations of legal norms or grievances come to the attention of the Banking Supervision Section of the FMA, it undertakes necessary measures to restore a lawful state of affairs.

To ensure transparency as well as to improve the working of the internal banking market, the Capital Requirement Directive[14] (CRD IV) obliges the competent authorities to disclose specific information. The published information should permit a meaningful comparison of the approaches adopted by the competent authorities of the different Member States.

The FMA keeps regular contact with members of boards of directors and management to discuss and address financial market observations and any potential conflicts. The FMA is a proactive financial market player: it not only takes on the role of supervisory authority but also that of researching partner for new developments within the field. For example, it has its own laboratory to research, inter alia, new technologies and new developments. This sandbox

14 Directive 2013/36/EU.

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allows financial market players to learn about new developments and approaches within the market, and thereby to not be surprised by them. Additionally, the size of Liechtenstein's financial market system, the accessibility of the authorities and the rapid processing of any potential issues are big advantages for the local market, which gives enterprises a competitive advantage when filing for licences across the EEA.

There are several reports[15] that banks must deliver to the FMA during the course of the year concerning financial stability, liquidity, fulfilment of different tasks and – as previously mentioned – auditors' reports. These reports must fulfil the general legal requirements according to the Basel III agreements (CRD IV and CRR[16]), and are part of the Single Supervisory Mechanism across the EU.

iii Management of banks

Banks are organised as public companies (companies limited by shares or joint-stock companies). Shares normally are registered shares in order to comply with the duty to identify shareholders for fit and proper evaluation (see below).

Pursuant to Article 22 BA, banks and investment firms must be organised in accordance with their business profile and business cases, and require:

a a board of directors responsible for overall direction, supervision and control;

b general management responsible for operations that consists of at least two members who perform their activities with joint responsibility and who may not simultaneously be members of the board of directors;

c an internal audit department that reports directly to the board of directors (see Article 33 of the Banking Ordinance on delegation of the responsibilities of the internal audit department);

d risk management that is independent of management responsible for the operational business;

e an audit committee of the board of directors; and

f appropriate procedures by which employees can report violations of the Banking Act and Regulation (EU) No. 575/2013.

The distribution of functions between the board of directors and the general management must guarantee proper monitoring of business conduct (Article 22 Paragraph 4 BA). The board of directors is responsible for the overall direction, supervision and control of the bank or investment firm (for details, see Article 23 Paragraph 2 BA).

In addition to the Banking Act, the Law on Persons and Companies (PGR) also applies. Article 261 et seq. of the PGR regulates the basic rules for joint-stock companies, such as rules on the structure of shares, organisation and capital increases.

15 The FMA sends to-do lists to the different banks. Forms and guidelines are published on the FMA-website: https://www.fma-li.li/de/finanzintermediare/bereich-banken/banken-und-wertpapierfirmen/meldewesen/formulare.html.

16 Regulation (EU) No. 575/2013.

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Remuneration and bonus system

According to Article 7a Paragraph 6 BA, banks and investment firms shall introduce and permanently maintain remuneration policies and practices that are consistent with sound and effective risk management. The FMA will share this information with the European supervision bodies.

This rule on remuneration was implemented in the wake of the financial crisis, and the bonus discussion with regard to Article 1 (3) of CRD III.[17] A risk-oriented and appropriate remuneration policy for banks and investment firms is stipulated to ensure that their remuneration policies are in line with the long-term interests of banks and investment firms. The details of these remuneration policies and practices, which must subsequently be introduced and maintained by institutions, can be found in Article 92 of Directive 2013/36/EU and in Annex 4.4 to the Banking Ordinance.

Liechtenstein follows the requirements of CRD IV, which gives clear rules concerning the relation between fixed salary and variable components. Most banks in Liechtenstein pay bonuses. Their systems vary: some banks pay bonuses connected to specific goals, while others pay bonuses as a fully discretionary add-on to the salary.

Within the framework of the principle of proportionality, the FMA has determined that certain rules do not apply to small institutions and to employees who receive relatively low variable remuneration compared with other international institutions. These are the provisions concerning:

a the composition of variable remuneration (Annex 4.4 No. 1 Paragraph 2 Subparagraph k Banking Ordinance;

b retention (Annex 4.4 No. 1 Paragraph 2 Subparagraph l Banking Ordinance; and

c the treatment of voluntary retirement benefits in the event of an employee leaving a company (Annex 4.4 No. 1 Paragraph 2 Subparagraph n Sentence 2 Banking Ordinance.

A bank qualifies as a small institution if its assets do not exceed 5 billion Swiss francs.

iv Regulatory capital and liquidity

CRD and CRR

Liechtenstein banks are distinguished by their financial strength and stability. They have solid and high-quality equity capital resources. With an average core capital (Tier 1 ratio) of more than 20 per cent, Liechtenstein banks hold, on average, more than what is required under BASEL III or the EU capital requirements of CRD IV. They are thus among the best-capitalised banks across Europe and worldwide. Since the beginning of the financial crisis, no bank in Liechtenstein has required state aid. Liechtenstein's AAA rating by Standard & Poor's underscores the country's reliability and stability.

In its Guidance 2017/10, the FMA defines the obligations with regard to own funds and capital adequacy requirements. In doing so, it relies on CRD, and especially CRR, which is implemented in the Banking Act and the Banking Ordinance. The guidelines ensure that banks have sound, effective and comprehensive strategies and procedures in place with which they can maintain the level, types and distribution of internal capital required under the

17 Directive 2010/76/EU.

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Internal Capital Adequacy Assessment Process (ICAAP). The required capital is related to current and possible future risks (Article 7a Paragraph 3 Banking Act). The FMA has issued a special directive on ICAAP.

Capital buffers

Pursuant to Article 7e and 7f Banking Ordinance, the FMA is obliged to conduct an annual analysis to identify other systemically relevant institutions in Liechtenstein, report results to the relevant institutions (A-SRIs) and publish those results. Pursuant to Article 4a Banking Act, such A-SRIs may be assigned an additional capital buffer of up to a maximum of 2 per cent of the total risk amount pursuant to Article 92 of CRR.

v Recovery and Resolution

The Recovery and Resolution Act (RRA), transposing the European Recovery and Resolution Directive (BRRD),[18] provides a framework for solving the too-big-to-fail issue, and hence contributes to strengthening the stability of the Liechtenstein financial system. The BRRD requires EEA Member States to establish a national resolution authority vested with specifically designed resolution powers. The RRA appointed the FMA as Liechtenstein's Resolution Authority. For this function, the FMA is obliged to create a separate organisational unit within its organisational structure. The FMA has to ensure that the Resolution Authority is able to exercise its functions operationally independent from the FMA's other organisational units and to prevent conflicts of interest between the resolution functions and the FMA's other functions. The Resolution Authority assumed its function on 1 January 2017. The Resolution Authority, among other things, is tasked with drawing up resolution plans. With regard to the resolution objectives, it is authorised to apply the resolution tools and to exercise its resolution powers (RAA Article 82).

The resolution objectives are:

a to ensure the continuity of critical functions;
b to avoid a significant adverse effect on the financial system;
c to protect public funds by minimising reliance on extraordinary public financial support;
d to protect covered deposits and investments; and
e to protect client funds and client assets.

The tools for resolution are as follows:

a sale of business tool;
b bridge institution tool;
c asset separation tool;
d bail-in tool.

IV CONDUCT OF BUSINESS

Banks and investment firms may be established only in the legal form of a public limited company or a European company (*societas Europaea*). However, in justified cases, the FMA may permit exceptions (Article 18 Paragraph 1 BA).

18 Directive (2014/59/EU.

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The main activity of banks is the management of the risks involved in taking people's money, managing it, and deciding how to invest assets or how to finance endeavours. The manner in which a bank conducts its business must ensure that risk management is carried out correctly, and especially in a manner that protects the interests of consumers and investors and supports financial stability. As such, a bank's organisation, its reporting system (especially concerning risks) and its management of liabilities are crucial.

i Organisation

A bank must have a board of directors that is responsible for the general organisation, strategy and supervision of the activities of the bank. The management of the day-to-day running of the bank must be delegated to a management team responsible for the details of the organisation and all reporting duties.

The following areas, among others, must be available:

a a sufficient number of employees and tools for know your customer and anti-money laundering tasks;
b automated control of the financial behaviour of the bank;
c a compliance department;
d a department for legal affairs; and
e a financial department for own accounting and for reporting to the FMA.

Furthermore, banks must guarantee they are able to undertake the necessary reporting on tax issues. Under various agreements with the EU,[19] the OECD, and other countries[20] and institutions, Liechtenstein reports several data streams concerning the bank accounts of people residing outside Liechtenstein. These common reporting standards (also called the automatic exchange of information on tax aspects) have been in place since 2017. The corresponding laws and duties are very specific, and require a thorough knowledge of clients' private details, hence the rising importance of client data departments.

ii Risk management

Article 7 BA states that banks must provide a risk management framework as well as regulations or internal directives outlining responsibilities and processes for the approval of risky business activities. In particular, banks must detect, mitigate and monitor market, credit, default, residual, settlement, liquidity, concentration, securitisation, counterparty, interest rate, reputational, operational and legal risks, as well as the risk of over-indebtedness.

iii Liability

Banks or the persons acting on their behalf are liable in several respects if they commit a misconduct. For example, if persons or companies are active without a banking licence, this is against the law and triggers liability.

19 AEOI-Agreement Liechtenstein-EU (Legal Gazette 2015 No. 354), which covers the exchange of information upon request and the automatic exchange of information of financial accounts.

20 Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (Legal Gazette 2016 No. 398).

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Criminal and administrative liability

Article 3 ss BA states it is a criminal offence to conduct banking business without a licence. Furthermore, breach of duties by management and the board of a bank, for example reporting duties, will be punished as a criminal offence. As these duties are far-reaching, this puts an enormous amount of pressure on banks and their employees. To mitigate this, Article 63b explicitly states that the principles of proportionality and efficiency must be respected when judging failures of duties. At the same time, Article 64 makes it clear that it will mainly be the persons who acted or should have acted who are responsible together with the legal person, which will be jointly and severally liable for monetary penalties.

Article 64a requires that the FMA has an effective and reliable reporting system through which employees of a bank can observe and report any violations, misconduct or unlawful behaviour of their institution.

Civil liability

In principle, the provisions of the General Civil Code (ABGB) apply. The requirements of Section 1290 ff ABGB also apply to banking law. In principle, therefore, there must be damage caused by unlawful and culpable conduct on the part of the bank, and the bank will have to pay for this damage. A person who violates a contractual obligation is therefore liable to his or her contractual partner for the resulting damages to the extent that those interests are violated. The conduct of an employee in the performance of his or her duties is generally credited to the bank.

There is a legal liability of a bank towards its clients if the bank fails to fulfil its duties and in this way causes damage to clients.

The basis for claims for damages on the basis of incorrect information is generally speaking to be found in Section 1300 Sentence 1 ABGB, whose conditions of fact are summarised as:

incorrect information or advice given to the injured party,
slightly negligent,
by an expert according to § 1299 ABGB within his field of expertise,
in exchange for a reward/fee.

Specific rules apply in the field of asset management. As long as an adviser follows the business judgment rules, it is not very likely that a bank will be held liable for losses in asset management. An asset manager's investment decisions are subject to the supervisory and civil law duty to safeguard interests. As a rule, the asset manager is responsible for observing due diligence in the management of a client portfolio, but not for the success of the investment. For loss-making investment decisions within the framework agreed upon with the client as the investment strategy, the asset manager has no liability discretion in favour of the client. The burden of proof for damages, amount of damages, causality and the violation of (objective) duties of care as prerequisites for the claim is borne by the investor. The asset manager is not obliged to disclose internal reports and decision processes, or to justify why he or she has made certain investment decisions within the framework of the agreed-upon investment guidelines.

Finally, there is also direct liability of managers towards clients. If a manager acts outside of normal banking activities, he or she will be held liable on a personal basis. This applies

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explicitly if he or she offers services that a bank no longer offers. For example, if a bank does not offer asset management services and a specific bank manager nevertheless does so, he /or she will be personally liable for any damage.

At the same time, managers are also liable towards the bank. Management and all other employees are liable to the bank for any damage they cause, whether intentionally or negligently (Article 218 ss PGR).

iv Banking secrecy

Article 14 Paragraph 1 BA reads:

> *The members of the governing bodies of banks and their employees as well as any persons otherwise working for such banks shall keep secret all facts that they are entrusted with or that become available to them as a result of business relations with clients. The obligation of secrecy shall apply without any time limit.*

However, this secrecy is not absolute. If a criminal court, the Supervisory Board of the Financial Intelligence Unit or foreign authorities within the framework of international agreements (e.g., common reporting standards, automatic information exchange in tax issues) ask for information, it will be granted. Thus, banking secrecy is no longer as absolute as it used to be.

V FUNDING

The high capitalisation of the Liechtenstein banking sector, healthy liquidity indicators and a very low ratio of non-performing loans simultaneously underscore the stability of the banking sector in Liechtenstein. Liechtenstein is part of the Swiss franc currency area, which means that banks have the same access to refinancing with the SNB as Swiss banks.

Aside from that, classical funding also applies for Liechtenstein banks. This means that they rely on deposits from customers, unsecured and secured capital market products, deposits from other banks and other money market instruments.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

Every proposed direct or indirect acquisition and every proposed direct or indirect disposal of a qualifying holding in a bank or investment firm must be notified in writing to the FMA by the person or persons interested in the acquisition and the disposal. Every proposed direct or indirect increase and every proposed direct or indirect reduction of a qualifying holding must also be notified if, as a consequence of the increase or reduction:

a the thresholds of 20, 30 or 50 per cent of the capital or voting rights of a bank or investment firm were to be reached or crossed in either direction;

b the bank or investment firm were to become a subsidiary of an acquirer; or

c the bank or investment firm would no longer be a subsidiary of the person disposing of the qualifying holding.

The FMA's Guidance 2017/20 provides guidelines regarding the supervisory assessment of the acquisition, increase or disposal of qualifying holdings in banks, investment firms, asset

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management companies and insurance undertakings. This guidance defines what must be delivered to make a change of control possible.

Shareholders with a qualifying holding (10 per cent or more) must be suitable and capable of ensuring the sound and prudent management of the bank or investment firm (Article 17 BA).

i Control regime

If a bank or investment firm forms part of a foreign group working in the financial sector, a licence is granted only if the group is subject to consolidated supervision comparable to Liechtenstein supervision and the supervisory authority of the home country does not object to the establishment of a subsidiary (Article 15(2) BA).

ii Fit and proper requirements

The professional and personal qualities of the persons entrusted with the administration or management of a bank or investment firm must always guarantee sound and proper business operation (Article 19 BA). In particular, according to Article 29(1) of the Banking Ordinance, the persons intended to serve as the following must have sufficient professional qualifications (training or education, or both; previous job experience) for the tasks that are to be assigned to them:

a members of the board of directors;
b the head of the internal audit department;
c members of the risk committee; and
d members of the general management.

iii Change of control

According to Article 26a BA, every proposed direct or indirect acquisition and every proposed direct or indirect disposal of a qualifying holding in a bank or investment firm must be notified in writing to the FMA. This also applies if the thresholds of 20, 30 or 50 per cent of the capital or voting rights of the bank or investment firm would be reached or crossed.

iv Transfers of banking business

There are no specific rules concerning the transfer of banking business from one bank to another: the general provisions of civil law apply. In principle, claims against others may be assigned to new creditors. In the case of assumption of debt by a third party, the consent of the old creditor is required. A special feature applies to the overall assumption of a transaction: anyone who takes over assets or a transaction with assets and liabilities is automatically obliged to the creditors for the associated debts as soon as the transfer has been notified to the creditors by the transferee or has been made public. However, the previous debtor shall be jointly and severally liable with the new debtor for a period of two years, beginning with the notification or termination of the contract in the case of receivables due and payable and with the due date in the case of receivables due and payable at a later date. Moreover, this assumption of debt has the same effect as the assumption of an individual debt.

With respect to banking secrecy, however, it is advisable to give clients the possibility to look for another bank on their own behalf.

With respect to consumer loans, it might be advisable to observe the respective law (consumer and credit law). If a loan is concerned with banking business, it is not possible to

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transfer anything from a bank to a non-bank. If a bank stops rendering certain services, for example discretionary portfolio management, it cannot transfer this business; rather, it must terminate the respective agreement with the client.

VII THE YEAR IN REVIEW

On 3 January 2018, new securities regulations came into force throughout the EU. The new Markets in Financial Instruments Directive (MiFID II)[21] replaced the Markets in Financial Instruments.[22] In addition to MiFID II, the Markets in Financial Instruments Regulation[23] came into force.

The most important changes include:

a increased investor protection;
b improved cost transparency;
c enforcement of specific rules for algorithmic trading; and
d regulation of non-regulated markets.

The increasing use of new technologies and IT systems is accompanied by numerous advantages, but also risks, in terms of confidentiality, integrity and availability of information. Due to the enormous damage potential, the FMA attaches great importance to cybersecurity. In its Communication 2018/3, the FMA sets out its expectations of financial intermediaries in dealing with these risks.

A few years ago, the FMA opened a laboratory for new regulations in this regard. In June 2018, it was decided that the laboratory will be directly under the management of the FMA. Many interested investors have approached the FMA for advice, especially in the field of fintech and blockchain technology, and to get clarity on what is possible, what is regulated and what is not regulated.

VIII OUTLOOK AND CONCLUSIONS

An important new development in 2019 will be a law on reliable technologies. This draft law is also known as the Blockchain Act. The government has sent the draft Act for consolidation. The Banking Association, lawyers' associations and private persons have all been invited to comment on the draft. The idea is to provide a framework law concerning the use of new technologies, and guidance about the different roles market players might have in that.

The Act is not a financial market act. Nevertheless, the FMA will play a specific role concerning trustworthy technologies, especially when it comes to distributing potential licences and supervising potential market participants. This, however, depends on the nature of the corresponding technological enterprise. The FMA is very interested in monitoring the development of cryptocurrencies and blockchain-based projects, especially when comparisons can be made with already existing legal structures and current frameworks.

It is expected that Parliament will deal with the draft Act in early spring and make it into law in the summer of 2019.

21 Directive 2014/65/EU.
22 Directive 2004/39/EC.
23 Regulation 600/2014/EU.

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Chapter 22

MALAYSIA

Rodney Gerard D'Cruz[1]

I INTRODUCTION

In May 2018, Malaysia found itself in the unfamiliar territory of having a new government at the helm after the opposition Pakatan Harapan's historic victory in the 14th general election in May 2018, the country's first change of government after 61 years of rule by the incumbent Barisan Nasional government. On the international front, the global economy of 2018 started off on a positive note following expectations for stronger growth momentum from the previous year. However, as the year progressed, multiple factors such as the escalation of trade conflicts, renewed volatility in commodity prices and global financial markets combined to moderate growth trends. On the domestic side, Malaysia's economy likewise had a positive start to 2018 that subsequently met with external and domestic challenges. Major policy and significant political shifts, arising from global trade tensions and the change of government, became sources of uncertainty for the economy. Unanticipated supply disruptions in the mining and agricultural sectors, as well as commodity exports, stifled Malaysia's economic performance, resulting in a greater-than-expected moderation in growth. Domestic demand continued to anchor growth, supported mainly by private sector expenditure. [2]

The Malaysian economy grew by 4.7 per cent in the fourth quarter of 2018 (down from 5.9 per cent in 2017), with a value of 1.23 billion ringgit at constant and 1.43 billion ringgit at current prices,[3] and is projected to expand by 4.3 to 4.8 per cent in 2019, with domestic demand continuing to be the key driver, underpinned by continued expansion in private sector activity. Overall, the Malaysian economy is expected to sustain its growth momentum against a backdrop of a challenging global environment, including slower-than-expected global growth, prolonged uncertainty surrounding Brexit in the United Kingdom, and unresolved trade disputes between China and the US.[4]

The ringgit saw a mixed performance in 2018, despite its strong performance in the first quarter of 2018. In the first quarter, the ringgit's performance was mainly driven by non-resident portfolio inflows as the increased overnight policy rate in January signalled a sustained strong growth outlook for the economy. However, from April onwards, the

1 Rodney Gerard D'Cruz is a partner at Adnan Sundra & Low.

2 BNM's Annual Report 2018 (Executive Summary) (http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_ar&ac=42&en).

3 Gross Domestic Product Third Quarter 2018, Department of Statistics Malaysia: https://www.dosm.gov.my/v1/index.php?r=column/cthemeByCat&cat=100&bul_id=NUtDV2RPTktsZXRjMlcxWXpHS0RYZz09&menu_id=TE5CRUZCblh4ZTZMODZIbmk2aWRRQT09.

4 The Ministry of Finance's Economic Report 2018/19 – Chapter 3 Macroeconomic Outlook: http://www1.treasury.gov.my/eo_2019.html.

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expectation of a faster pace of monetary policy normalisation in the US and the strengthening of the US dollar led to non-resident portfolio outflows from regional economies, including Malaysia. As at the end of August 2018, the ringgit depreciated against US dollar as external uncertainties continue to drive non-resident portfolio outflows and a strengthening US dollar.[5] The ringgit appreciated marginally against the US dollar during the fourth quarter of 2018, despite non-resident portfolio outflows from the domestic bond and equity markets.[6]

The total size of the Malaysian capital market amounted to 3.1 trillion ringgit in 2018 compared with 3.2 trillion ringgit in 2017 and 2.84 trillion ringgit in 2016; equity market capitalisation contracted, by 10.8 per cent, to 1.7 trillion ringgit, compared to 1.9 trillion ringgit in 2017. Overall, the bond market totalled 1.4 trillion ringgit as at 31 December 2018, which is an increase of 8.8 per cent from the 1.3 trillion ringgit recorded at the end of 2017. Malaysia continued to maintain its position as the third-largest local currency bond market as a percentage of gross domestic product in Asia, after Japan and South Korea, and continued to lead the world *sukuk* market in 2018, accounting for 1.9 trillion ringgit. Malaysian corporate bonds and the *sukuk* market reported a combined total issuance of 105.45 billion ringgit in 2018, a decrease of 15.56 per cent from the 124.88 billion ringgit in 2017.[7]

Malaysia's financial services industry has traditionally been a key driver of its economic development, and is the foundation of the Financial Sector Blueprint (FSB), the 10-year master plan implemented by the Bank Negara Malaysia (BNM) for managing Malaysia's transition towards becoming a high-value-added, high-income economy.[8] However, exactly how the new government will continue the objectives of the FSB has yet to be confirmed, as the inaugural months of the Pakatan Harapan administration opened with an increased focus on good governance and curtailing corruption while reviewing and streamlining infrastructure investment.

The number of licensed banking institutions in Malaysia on the BNM website currently stands at 57, comprising 32 domestic banking institutions and 25 foreign-owned banking institutions.[9] There are also 16 Islamic banks, 11 of which are domestically owned, and 11 investment banks, all of which are domestically owned.[10]

The five main local banking groups are:

a Malayan Banking (Maybank);
b Public Bank;
c CIMB Bank;
d RHB Bank; and
e Maybank Islamic.

5 The Ministry of Finance's Economic Report 2018/19 – Chapter 4 Monetary and Financial Developments: http://www1.treasury.gov.my/eo_2019.html.

6 BNM's Fourth Quarterly Bulletin 2018 http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_qb&ac=180&en&year=2018.

7 Securities Commission Malaysia, Annual Report 2018: https://www.sc.com.my/api/documentms/download.ashx?id=35ed16aa-24a2-4846-a404-0653fadcdb44.

8 Economic Transformation Programme: https://policy.asiapacificenergy.org/sites/default/files/ETP.pdf, BNM website: http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_fsmp&ac=8&en.

9 www.bnm.gov.my/index.php?ch=fs&pg=fs_mfs_list&ac=118&lang=enhttp://.

10 Ibid.

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All (other than Maybank Islamic) have widespread branch networks, affording them access to inexpensive funding sourced from retail deposits. All (other than Maybank Islamic) have affiliated Islamic and investment-bank subsidiaries.

Top 10 banks in Malaysia by asset size (ringgit) as at the end of 2018	
Institution	**Asset size (million ringgit)**
Malayan Banking	806,992
CIMB Bank	534,089
Public Bank	419,693
RHB Bank	243,166
Maybank Islamic	225,215
Hong Leong Bank	195,530
AmBank	137,881
United Overseas Bank (Malaysia)*	112,975
OCBC Bank (Malaysia)*	94,518
HSBC Bank Malaysia	83,922
Data sourced from 2018 annual reports or financial statements (unless otherwise stated) * As at 30 September 2018	

II THE REGULATORY REGIME APPLICABLE TO BANKS

In line with the FSB, the regulatory and supervisory framework of Malaysia in respect of the banking and finance sector was recently consolidated and updated under the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA) (collectively, Acts), both of which came into force on 30 June 2013, simultaneously consolidating and repealing the Banking and Financial Institutions Act 1989 (BAFIA), the Islamic Banking Act 1983, the Insurance Act 1996, the Payment Systems Act 2003 and the Exchange Control Act 1953. The Acts aim to provide a regulatory framework for both the conventional financial and *shariah*-compliant sectors, and endow the BNM with greater powers to counter future risks to stability in the financial sector, increase consumer protection and promote competition in the financial services sector. The Acts also contain provisions that preserve every guideline, direction, circular or notice previously issued under any repealed legislation in relation to any provision of the Acts prior to their coming into force.

Malaysia has also established its own mid-shore jurisdiction on the island of Labuan, off the coast of Borneo, which was declared an international offshore financial centre in October 1990 to complement the activities of the domestic financial market in Kuala Lumpur. Labuan is regulated and administered by the Labuan Financial Services Authority (Labuan FSA) pursuant to the Labuan Financial Services Authority Act 1996 (Labuan FSA Act). In 2008, the jurisdiction was renamed the Labuan International Business and Financial Centre (Labuan IBFC), and an entity called Labuan IBFC Incorporated was established as the jurisdiction's marketing arm in 2008. The Labuan FSA and the Labuan IBFC work together to promote Labuan IBFC's reputation as the premier mid-shore international business and financial centre in the Asia region. Entities operating in the Labuan IBFC are subject to federal laws that are specific to the Labuan IBFC. Labuan banks are subject to the Labuan Financial Services and Securities Act 2010 (LFSSA) and Labuan Islamic banks are regulated under the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA).

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i The BNM

The BNM is a statutory body wholly owned by the government that was established under the Central Bank of Malaysia Act 1958 and continues to operate under the Central Bank of Malaysia Act 2009 (CBA), which became effective on 25 November 2009. The BNM reports to the Minister of Finance (Minister) and keeps the Minister informed of policies governing the monetary and financial sector.

The BNM is empowered to act as the regulator of banking institutions under the Acts and the CBA. The CBA confers the necessary powers and instruments on the BNM to achieve its mandates effectively, and legitimises the duality of both the conventional and the Islamic financial systems in Malaysia, and in doing so establishes the legal foundation for the development of an Islamic financial system within the Malaysian financial system.

The BNM's primary objectives include the prudent conduct of monetary policy, financial system stability, and the development of a sound and progressive financial sector. In carrying out the aforementioned, the BNM is responsible for advising the government on macroeconomic policies and the management of public debt. It is also the sole authority for issuing currency and managing the international currency reserves of the country. Other functions of the BNM include the regulation and supervision of financial institutions as described below, and the monitoring and supervision of payment systems, money markets and foreign exchange markets.

From a supervisory perspective, the BNM is empowered by the Acts to regulate banking institutions, and does so by way of a risk-based supervisory (RBS) approach that monitors and reviews the manner in which all financial institutions identify, control and deal with their respective business risks.

ii Securities Commission

In addition to the foregoing, financial institutions and investment banks that provide capital markets services are regulated by the Securities Commission (SC), a statutory body with investigative and enforcement powers established under the Securities Commission Act 1993 (SCA).

The SC is the regulatory body mandated to regulate the Malaysian capital market, and is directly responsible for the regulation, supervision and monitoring of all persons licensed under the Capital Markets and Services Act 2007 (CMSA) with the core objective of investor protection. The SC is also primarily responsible under the CMSA for encouraging and promoting the development of the securities and derivatives markets, and for the monitoring and supervision of public-listed companies to ensure compliance with securities laws.

The CMSA constitutes a single framework regulating the offering and licensing of capital market services, market conduct, issuances of securities, and the conduct of takeovers and mergers. Debt issuances (bond and *sukuk*) in Malaysia require the approval of the SC, and are further governed by various guidelines and practice notes issued by the SC under the CMSA.

iii Companies Commission of Malaysia

Banks in Malaysia fall under the general supervision of the Companies Commission of Malaysia (CCM), as the FSA and the IFSA require incorporation under the Companies Act 2016 (CA) for the undertaking of banking business. However, the IFSA provides for

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international Islamic banks to do business through either a locally incorporated company or a branch registered with the CCM, whereas banks in Labuan are required to be incorporated or registered under the Labuan Companies Act 1990.[11]

iv Labuan FSA

The Labuan FSA is the sole statutory body responsible for the regulation, supervision and development of the Labuan IBFC under the Labuan FSA Act. According to the Labuan FSA website, the objectives of the Labuan FSA include promoting and developing Labuan as an international centre for business and financial services; implementing national objectives, policies and priorities for the development and administration of international business and financial services in Labuan; and acting as the central regulatory, supervisory and enforcement authority of the international business and financial services industry in Labuan.

The foregoing includes the licensing and regulation of licensed entities operating within the Labuan IBFC, and supervision over those entities to ensure their compliance with the applicable domestic and international standards and best practices.

The Labuan FSA is also responsible for the development of policies for the conduct of business and financial services in the Labuan IBFC, and administration of several crucial pieces of legislation, including the LFSSA and the LIFSSA, subject to the general directions and control of the Minister.[12]

v Development Financial Institutions Act 2002

The Development Financial Institutions Act 2002 (DFIA) provides for the BNM to be responsible for the regulation and supervision of specialised financial institutions known as development financial institutions (DFIs), established by the government to specifically develop and promote national strategically important socioeconomic sectors such as agriculture, small and medium-sized enterprises, infrastructure, maritime, export-oriented sectors, capital-intensive and high-technology industries.

The provisions of the DFIA empower the BNM to monitor the activities and financial performance of these institutions and their main objective, which is to provide specific financial products and services to cater to their respective focus areas; and to ensure that DFIs are resilient, efficient and able to fulfil their respective mandates in a financially sustainable manner, while contributing to the overall stability of the financial system.

In January 2016, further amendments were made to strengthen the regulatory framework of the DFIA in line with the evolving role of DFIs in supporting Malaysia's socioeconomic development. The new amendments enhance provisions in the DFIA on corporate governance, business activities and the scope of the BNM's regulatory oversight to ensure sound financial management and an improvement in the operational efficiency and resilience of DFIs. Other amendments incorporate new provisions for the regulation of *shariah* governance and consumer protection, with enforcement tools to ensure compliance.

11 FSA; IFSA, Section 12.

12 Labuan IBFC website: www.labuanibtc.com.

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In 2018, BNM collaborated with the World Bank and DFIs to develop an enhanced performance measurement framework for DFIs. BNM is also engaging with the government to review the DFI landscape to take into account developments in the financial system and changes in Malaysia's economic structure and priorities.[13]

At present, there are six DFIs prescribed under the DFIA: Bank Pembangunan Malaysia Berhad, Bank Perusahaan Kecil & Sederhana Malaysia Berhad, Export-Import Bank of Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional and Bank Pertanian Malaysia Berhad (Agrobank).[14]

Licensing

Under the Acts, all persons undertaking banking business, investment banking or insurance business are required to hold a valid licence granted by the Minister. These businesses continue to fall within the oversight of the Ministry of Finance and the BNM. The Minister is the authority for the issuance or revocation of licences to carry on banking business, insurance business and investment banking business, or the imposition of conditions on those licences, and has the power to carry out investigations in certain circumstances. Specifically, licences for commercial and investment banks are issued under the FSA, whereas licences for Islamic banks and international Islamic banks are issued under the IFSA.

The CMSA provides that any person wishing to carry out capital market activities (save for registered persons) is required to be licensed by the SC, the sole authority that issues and approves licences for capital market intermediaries engaging in the regulated activities prescribed under the CMSA. Under the CMSA single licensing regime, capital market intermediaries that are fit and proper are issued with a licence that will enable them to carry on one or more regulated activities.

The two main types of licences are new capital markets services licences, which are granted to principals, and new capital markets services representatives' licences, which are granted to representatives of a principal, enabling licensed representatives to carry out one or more regulated activities on that principal's behalf.[15]

In Labuan, the LFSSA empowers the Labuan FSA to grant licences for the conduct of Labuan banking business, which means the following:

a the business of receiving deposits on current accounts, deposit accounts, savings accounts or any other accounts as may be specified by the Labuan FSA;
b Labuan investment banking business;
c Labuan financial business;
d Labuan Islamic banking business; and
e such other business as the Labuan FSA, with the approval of the Minister, may specify, in any currency (including the ringgit where permitted by the Acts or such other relevant law in force).

The LIFSSA also empowers the Labuan FSA to grant licences for the conduct of Labuan Islamic banking business (i.e., the carrying on of Labuan banking business in compliance with *shariah* principles.

13 BNM Financial Stability and Payment Systems Report 2018: http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_fspr&ac=27&en.

14 Ibid.

15 SC website: www.sc.com.my/the-licensing--process. See also Section 58, CMSA.

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III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

From a corporate governance perspective, the Acts codify the duties of the directors of financial institutions, and place stringent requirements for transparency on the directors of financial institutions and their holding companies. Directors are required to disclose to the board of directors the nature and extent of any direct or indirect interest in a material transaction or material arrangement with the financial institution where they hold office. Further, under the Acts, the approval of the BNM is required for the appointment, election, reappointment and reelection of the chairperson, directors and chief executive officer of a financial institution.

In addition, the Acts provide that the BNM has the power to specify fit and proper requirements to be complied with by the chairperson, directors, chief executive officer and senior officers of a financial institution and, in the case of Islamic financial institutions, members of the *shariah* committee. The requirements may include minimum criteria relating to probity, personal integrity and reputation; competency and capability; and financial integrity. The BNM has complete discretion in determining whether the fit and proper requirements specified have been complied with.[16]

The aforementioned RBS approach[17] is primarily implemented by the BNM through the adoption of risk profiles, best practices, sound governance and proper risk management systems within the internal oversight process of each institution with the objective of anticipating and managing future risks; and identifying and resolving weaknesses within the processes of each institution. The BNM further facilitates the RBS approach by ensuring the quality of the membership of directors and senior management of financial institutions, inculcating a culture of workforce risk management and ethics, and reliance on the opinion of independent audit and actuarial professionals appointed by financial institutions.

To further ensure the proper division and coordination of their respective legislative responsibilities in respect of investment banks in particular, the BNM and the SC jointly issued the Guidelines of Investment Banks pursuant to Section 126 of the BAFIA (now repealed) and Section 158 of the SCA. The Guidelines specifically provide that the BNM will be responsible for the prudential regulation of investment banks to ensure safety and soundness in the interests of depositors, and that the SC will be responsible for the business and market conduct of investment banks to promote market integrity and investor protection in the capital market.[18]

The BNM also has stringent fit and proper tests, which are set out in further guidelines contained in the Fit and Proper Criteria of June 2013[19] issued under the FSA, which should be read together with the Corporate Governance guidelines issued in August 2016 (CG Guidelines.[20] The BNM also issued Fit and Proper Criteria in June 2017 for the DFIs, as prescribed under the DFIA.

The CG Guidelines are applicable to, inter alia, banks, investment banks, Islamic banks and financial holding companies (i.e., companies approved by the BNM to hold more

16 Section 55, FSA; Section 69, IFSA.

17 See Section II.i.

18 SC website: www.sc.com.my.

19 Guidelines on Fit and Proper Criteria dated 28 June 2013: http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/Ft_Proper_Criteria_280613.pdf .

20 Guidelines on Corporate Governance: http://www.bnm.gov.my/index.php?ch=57&pg=140&ac=512&bb=file.

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than 50 per cent of the shares of a licensed financial institution), and set out the minimum standards of corporate governance that the BNM expects local financial institutions to adopt, which are consistent with the long-term viability of the aforesaid institutions.

Based on the fundamental concepts of responsibility, accountability and transparency, the CG Guidelines contain provisions that set out management and audit oversight, accountability and transparency together with key responsibilities of the board of directors and senior management of financial institutions. Overall, the CG Guidelines seek to encourage a corporate culture that reinforces ethical, prudent and professional behaviour, beginning with the example to be set by the board and senior management of the core values of a financial institution. Similar guidelines have been issued that are applicable to DFIs.[21]

ii Management of banks

Further to the foregoing, the CG Guidelines require boards of directors of banking institutions to establish specialised board committees to oversee critical or major functional areas, to address matters requiring detailed review or in-depth consideration, and to be responsible for the decisions of those committees. These specialised committees help to discharge the functions of the board and comprise the following, as set out in the CG Guidelines:

a a nominations committee responsible for the following matters concerning the board of directors, senior management and company secretaries:
- board appointments and removals;
- the overall composition of each group;
- measures for evaluation of the performance and development of directors, senior managers and company secretaries; and
- fit and proper assessments and evaluations;

b a remuneration committee responsible for reviewing the remuneration of directors, and actively overseeing the design and operation of remuneration systems of financial institutions;

c a risk management committee responsible for formulating risk management strategies that include identification of the nature of and exposure to risks involved in banking, and methods used to identify, monitor, manage and control each risk, and the nature and frequency of evaluation procedures of risk management systems;

d an audit committee to provide independent oversight of the internal and external audit functions and internal controls, and ensuring checks and balances within the financial institution; and

e in the case of Islamic financial institutions, a *shariah* committee to provide oversight on *shariah* compliance.

In addition, the aim of the CG Guidelines is to ensure that risk-taking activities and business prudence are appropriately balanced so as to maximise shareholders' returns and protect the interests of all stakeholders, and they contain principles dealing with board matters, management oversight, accountability and audit and transparency.

21 Ibid.

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The CG Guidelines should be read together with the Acts, the CA and other relevant regulations, guidelines and circulars relating to corporate governance that the BNM may issue from time to time.[22]

iii Regulatory capital and liquidity

The Acts provide that the BNM has the power to prescribe standards on prudential matters (including liquidity and capital adequacy) to be complied with by financial institutions to promote the sound financial position of an institution, and the integrity, professionalism and expertise in the conduct of the business, affairs and activities of an institution. Pursuant to such powers, the BNM issued the liquidity coverage ratio (LCR) framework in August 2016 as per Basel III requirements (see below), which provides that banking institutions must maintain sufficient stock of high-quality liquid assets (HQLA) to withstand an acute liquidity stress scenario for a 30-day horizon at both the entity and consolidated levels. The LCR framework, which took effect on 25 August 2016, supersedes the LCR guidelines issued on 31 March 2015 and the Liquidity Framework and Liquidity Framework issued in July 1998, and provides that banking institutions shall hold, at all times, an adequate stock of HQLA such that it maintains a minimum LCR of 70 per cent, achieved by January 2016, rising to 100 per cent by January 2019 and thereafter. In addition, banking institutions are required to comply with the framework at (1) their respective entity and global operational level on a stand-alone basis; and (2) a consolidated level, which includes both (1) aforementioned and the consolidation of all subsidiaries, save for insurance and *takaful* subsidiaries.[23] As at January 2019, all banking institutions reported LCR levels of above the 100 per cent minimum ratio.[24]

In addition to the Acts, the CBA provides that for the purpose of conducting monetary operations, the BNM may require financial institutions to deposit a reserve with it, and prescribe the principles and method for the determination of that reserve. Pursuant thereto, in January 2016, the BNM issued the Statutory Reserve Requirement Guidelines,[25] which came into effect in February 2016 for the purpose of liquidity management, whereby financial institutions (conventional and Islamic) are required to maintain a statutory reserve requirement (SRR) balance in their statutory reserve accounts equivalent to a certain proportion of their eligible liabilities, this proportion being the SRR rate (currently 3.5 per cent.[26] In this case, eligible liabilities comprise ringgit-denominated deposits and non-deposit liabilities, net of interbank assets and placements with the BNM, subject to the adjustments, exclusions and deductions prescribed under the SRR rules. In the past, and in addition to the SRR, Malaysian financial institutions were required to set aside a percentage of their profits as buffers under the repealed Banking and Financial Institutions Act 1989. The BNM announced in May 2017 that these buffers were no longer needed with the phasing-in of the

22 Guidelines on Corporate Governance 2016: http://www.bnm.gov.my/index.php?ch=57&pg=140&ac=512&bb=file.

23 BNM Liquidity Coverage Ratio Framework, 25 August 2016: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=285&bb=file.

24 BNM Financial Stability and Payment Systems Report 2018: http://www.bnm.gov.my/files/publication/fsps/en/2018/fs2018_book.pdf).

25 Statutory Reserve Requirement Guidelines dated 26 January 2016: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=30&bb=file.

26 CBA Section 26; BNM Statutory Reserve Guidelines 2016: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=30&bb=file.

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Basel capital conservation buffer. Instead, financial institutions must maintain a set minimum amount of capital funds at all times.[27] It is now possible for the existing reserve funds to be distributed as dividends, which was not possible previously.[28]

The Acts also provide that a financial institution may only be licensed if its capital funds are equal to or exceed the minimum amount prescribed by the Minister. Pursuant thereto, the BNM issued the Guidelines on Capital Funds and the Guidelines on Capital Funds for Islamic Banks in 2013 (updated in 2017) to ensure that financial institutions maintain a minimum amount of capital to operate and perform their functions.

The Guidelines on Capital Funds provide that the minimum capital funds that must be maintained by commercial banks and investment banks are as follows: for a domestic bank (by itself or in aggregation with its related corporation that is a licensed investment bank), 2 billion ringgit; for a locally incorporated foreign bank, 300 million ringgit; and for a stand-alone investment bank, 500 million ringgit.[29] Under the Guidelines on Capital Funds for Islamic Banks, banking entities are required to maintain 300 million ringgit as a minimum capital fund.[30]

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) finalised a package of measures to strengthen global capital and liquidity rules with the goal of strengthening the resilience of the global banking system. The rules are detailed in the documents Basel III: A global regulatory framework for more resilient banks and banking systems (revised) and Basel III: International framework for liquidity risk measurement, standards and monitoring (collectively, Basel III).

The BNM issued a circular implementing Basel III in 2010 that set out its approach to incorporating elements of each reform into Malaysia's domestic regulatory and supervisory framework, with the regulator's expectations of banking institutions in managing the transition to the new regime. The circular provides that the BNM supports the implementation of these reforms, and will strengthen the existing capital and liquidity standards for banking institutions in Malaysia to be in line with Basel III, and that the BNM aims to implement Basel III reforms in Malaysia in accordance with globally agreed levels and is working on an implementation timeline for the gradual phasing-in of the reforms between 2013 and 2019.[31]

In addition to the foregoing, and to facilitate the monitoring of Basel III reform implementation, identification of transitioning issues and assessment of potential impact on the financial system, the following requirements were imposed on financial institutions by the BNM:

a minimum regulatory capital requirements imposed under the Capital Adequacy Framework (Capital Components) and the Capital Adequacy Framework for Islamic Banks (Capital Components) issued by the BNM, which basically fulfil Basel III capital

27 Removal of reserve fund requirement in the policy document on Capital Funds: www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=534&lang=en.

28 http://www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=534&lang=en. Removal of reserve fund rule mildly positive for banks: http://www.theedgemarkets.com/article/removal-reserve-fund-rule-mildly-positive-banks.

29 BNM's Capital Funds Guidelines 2017: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=590&bb=file.

30 BNM's Capital Funds for Islamic Banks Guidelines 2017: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=591&bb=file)

31 Implementation of Basel III (2010): http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=26&bb=file.

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adequacy requirements. The guidelines require banking institutions to maintain a minimum risk-weighted total capital ratio of 8 per cent at all times at entity, global and consolidated levels; and

b reporting requirements on financial institutions with regard to their Basel III leverage and liquidity prior to formal implementation of the new standards.[32]

In November 2012, the BNM issued its regulatory capital adequacy framework (Capital Adequacy Framework (Capital Components) (2012 Framework)), implementing the Basel III reforms. The capital requirements promulgated by the BNM provided that banking institutions were required to maintain the following minimum capital ratios for the calendar years stated: a Common Equity Tier 1 (CET1) capital ratio of 3.5 per cent in 2013, 4 per cent in 2014 and 4.5 per cent in 2015; a Tier 1 capital ratio of 4.5 per cent in 2013, 5.5 per cent in 2014 and 6 per cent in 2015; and a total capital ratio of 8 per cent from 1 January 2013 onwards. The 2012 Framework provided that these capital requirements would be supplemented by a leverage ratio, an LCR and a net stable funding ratio (NSFR). Further, banking institutions were required to maintain additional capital buffers above the minimum CET1, Tier 1 and total capital ratios set out above in the form of a capital conservation buffer and a countercyclical capital buffer based on a percentage of total risk-weighted assets.

The BNM then issued its guidelines on the Capital Adequacy Framework (Capital Components) in October 2015 (2015 Framework) for banking and financial institutions, which superseded the 2012 Framework. The provisions of the 2015 Framework do not differ greatly from the 2012 Framework, but seek to enhance it so that Malaysian regulations can better conform with Basel III. The 2015 Framework provides detailed formulae for calculating the capital conservation buffers and countercyclical buffers, determined from an operational perspective, and provides that banking institutions and their holding companies are required to comply with the provisions of the 2015 Framework both at the entity and consolidated levels.[33]

The BNM subsequently issued its guidelines on the Capital Adequacy Framework (Capital Components) in August 2017 (2017 Framework) for banking and financial institutions. The aim of the 2017 Framework is to incorporate loss absorption mechanisms via write-off for Additional Tier 1 and Tier 2 Islamic capital instruments that are structured using equity-based *shariah* contracts such as *wakalah*, *musyarakah* or *mudarabah*.[34] The BNM issued fresh guidelines on the Capital Adequacy Framework (Capital Components) in February 2018 (2018 Framework) for banking institutions, to be read together with the Capital Adequacy Framework (Basel II – Risk-Weighted Assets) Guidelines. The 2018 Framework supersedes the 2017 Framework.[35]

32 Basel III Observation Period Reporting (Capital Adequacy Ratios, Liquidity Coverage Ratio, and Leverage Ratio) 2017: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=656&bb=file.

33 Capital Adequacy Framework (Capital Components) 2012 and 2015: http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/gl_11_capital_adequacy_framework.pdf): http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/Capital_Adequacy_Framework_Capital%20Components_Oct2015.pdf.

34 Reissuance of the Capital Adequacy Framework (Capital Components) 2017(http://www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=567&lang=en.

35 Capital Adequacy Framework (Capital Components) 2018: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=447&bb=file.

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The implementation of Basel III standards remained a key focus of banks' regulatory and supervisory activities in 2018. The leverage ratio requirement took effect on 1 January 2018 with a minimum ratio of 3 per cent, and the BNM announced in October 2018 the extension of the net stable funding ratio (NSFR) observation period to 31 December 2019. The NSFR requires banks to maintain sufficient stable funding in relation to their asset profile and off-balance sheet obligations over a one-year horizon. While most banking institutions are expected to be well-positioned to meet the NSFR minimum requirement of 100 per cent, the BNM is conducting further work on the liquidity risk management practices of banking institutions as additional input to the finalisation of the NSFR requirements. Although progress in the implementation of NSFR globally remains uneven, the Bank remains committed to its implementation in Malaysia and aims to finalise the NSFR requirements in the first half of 2019.

In the first half of 2019, BNM will issue proposals on enhanced regulatory requirements and policy measures for domestic systemically important banking institutions (D-SIBs) to reduce the probability and impact of their distress or disorderly failure on the financial system and the economy. This will include requiring D-SIBs to hold additional capital buffers in the form of Common Equity Tier 1. In light of the increasing size, complexity and regional footprint of some domestic banking groups, it is crucial to hold these banking groups to higher prudential standards to ensure their continued resilience and reduce the moral hazard associated with expectations of publicly funded bail-outs. The Bank also completed a review of technology risk management standards to ensure that new and emerging dimensions of risk are managed appropriately, in particular from increased exposures to cyber threats and compromised access to confidential data.[36]

iv Recovery and resolution

The CA was introduced in early 2017, repealing and superseding the Companies Act 1965 for the most part. As with corporations, financial institutions are subject to general legislation for corporate insolvency, now contained within Part IV of the CA. The modes of winding-up proceedings under the CA include compulsory and voluntary winding up and the appointment of receivers and managers over a corporation. The Act also contains provisions relating to corporate voluntary arrangements and judicial management in Part VIII (corporate rescue mechanisms), which came into force on 1 March 2018, together with the Companies (Corporate Rescue Mechanism) Rules 2018. However, specialised frameworks for addressing the failure of financial institutions to pay their debts as they fall due exist separately under the Acts and the Malaysia Deposit Insurance Corporation Act 2011 (MDICA).

Consumers who make deposits into financial institutions in Malaysia are protected by an insurance scheme known as the Perbadanan Insurans Deposit Malaysia (PIDM) (or the Malaysia Deposit Insurance Corporation (Corporation)) pursuant to the provisions of the MDICA. As a measure that promotes financial stability within the financial system, the PIDM ensures that depositors are insured against the loss of their deposits (subject to a threshold of 250,000 ringgit per depositor per financial institution) in the event of loss caused by the failure of a financial institution holding their deposits.

36 BNM Financial Stability and Payment Systems Report 2017: www.bnm.gov.my/files/publication/fsps/en/2017/fs2017_book.pdf.

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The provisions of the MDICA empower the Corporation to assume control of a non-viable financial institution, and to acquire and take control of non-performing loans that are outstanding between financial institutions, borrowers and security providers through the appointment of a conservator.

The MDICA further provides that upon the appointment of a conservator, a moratorium shall take effect during which, inter alia, no action, suit or proceeding may be commenced or continued against the Corporation, the conservator or the financial institution, any petition for the winding up of the financial institution shall be dismissed, no receiver, receiver manager or liquidator may be appointed over the financial institution, and no steps may be taken to enforce any security over the assets of the financial institution.[37]

The MDICA also provides that the BNM may provide written notice to the Corporation if the BNM is of the opinion that a financial institution has ceased to be viable or is likely to cease to be viable, whereupon the Corporation is empowered to, inter alia:

a require the financial institution to take any step or action or refrain from any act or thing, in relation to itself, its businesses or its officers, to cease soliciting, taking or repaying deposits, or carry on its business or such part of its business as the Corporation may direct, or to restructure the whole or part of its business as may be specified by the Corporation;

b acquire or subscribe to the shares of the financial institution;

c assume control over the member institution, carry on the whole or part of its businesses, and manage the whole or part of its assets, liabilities and affairs, including disposal of its assets or businesses or any part thereof, or appoint any person to do so on behalf of the Corporation;

d apply for the appointment of a receiver, a manager or a receiver manager, to manage the whole or part of the assets, liabilities, businesses and affairs of the financial institution;

e subject to the approval of the Minister, present a petition for the winding up of the financial institution;

f with the approval of the Minister, designate one of its subsidiaries as a bridge institution; or

g transfer such assets and liabilities of the non-viable financial institution to the bridge institution on terms as the Corporation shall determine.[38]

The Acts themselves provide measures for addressing the insolvency of financial institutions that distinguish between conventional and Islamic banks whereby the BNM itself acts as a resolution authority, and with the prior approval of the Minister by an order in writing, is empowered to assume control of the whole or part of the business, affairs or property of a financial institution, manage the same, or appoint any person to do so on behalf of the BNM in the event that the BNM is of the opinion that certain circumstances exist in relation to the financial institution concerned, including the following:

a the assets of the institution are not sufficient to give adequate protection to its depositors, policy owners, participants, users or creditors, as the case may be;

b the capital of the institution has reached a detrimental level or is eroding in a manner that may detrimentally affect its depositors, policy owners, participants, users, creditors or the public generally; and

37 Sections 161 and 179, MDICA.

38 Sections 98 and 99, MDICA.

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c the financial institution has become or is likely to become insolvent, or is likely to become unable to meet all or any of its obligations.[39]

The Acts provide the BNM with further powers in the event of insolvency whereby it may:

a make an application to appoint a receiver and manager over the whole or part of the business, affairs or property of the financial institution;[40]

b with the prior approval of the Minister, by an order in writing, vest in a bridge institution or any other person the whole or part of the business, assets or liabilities of the financial institution;[41]

c with the prior approval of the Minister, provide financial assistance to another institution or any other person to purchase any shares, or the whole or any part of the business, assets or liabilities, of the financial institution;[42] and

d recommend to the Minister, and the Minister may, upon such recommendation, authorise the BNM to file an application for the winding up of a financial institution.[43]

The Acts generally provide that the provisions of the CA shall apply to the winding up of an institution, unless specifically provided otherwise. However, no application for the winding up of a financial institution may be presented by any person without the prior written approval of the BNM.[44]

In conclusion, the Acts provide that in the winding up of investment banks and Islamic banks, the assets of a banking institution shall be available to meet all liabilities of that licensed investment bank in respect of all deposits in Malaysia as a priority over all other unsecured liabilities of those banking institutions in Malaysia, other than preferential debts set out in the CA and debts due and claims owing to the government under the Government Proceedings Act 1956.[45]

IV CONDUCT OF BUSINESS

Under the Malaysia Deposit Insurance Corporation Act 2011, conduct of, inter alia, the following activities would require licensing under the provisions thereof:

a banking business, which means the business of accepting deposits on current accounts, deposit accounts, savings accounts or other similar accounts; paying or collecting cheques drawn by or paid in by customers; and provision of finance;

b investment banking business, which means the business of accepting deposits on deposit accounts, and the provision of finance; and any regulated activity carried on pursuant to a capital markets services licence under the CMSA; and

c such other activities as the BNM, with the approval of the Minister, may prescribe.

39 Sections 165 and 167, FSA; Sections 177 and 179, IFSA.

40 Section 172, FSA.

41 Section 176, FSA.

42 Section 188, FSA.

43 Section 193, FSA.

44 Sections 204, 205, 207, IFSA.

45 Section 205, FSA; Section 216, IFSA.

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Under the IFSA, conduct of, inter alia, the following activities would require licensing under the provisions thereof:

a Islamic banking business, which means the business of accepting Islamic deposits on current accounts, deposit accounts, savings accounts or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers, accepting money under an investment account, or the provision of finance;

b international Islamic banking business, which means Islamic banking business in currencies other than the ringgit or such other business in point (c) below; and

c such other activities as the BNM, with the approval of the Minister, may prescribe.

International Islamic banks carry on Islamic banking business in currencies other than the Malaysian ringgit. The Guidelines on International Islamic Banks issued by the BNM in 2008 provide that Islamic banking business in international currencies includes the following: commercial banking business, investment banking business, and other banking businesses in Malaysia, as may be specified by the BNM.[46]

The LFSSA and the LIFSSA provide that the Labuan FSA may grant a Labuan banking licence, a Labuan investment banking licence, a Labuan Islamic banking licence, a Labuan Islamic investment banking licence or such business licence as the Labuan FSA, with the approval of the Minister, may specify. Labuan banks holding any of the aforementioned licences would only be allowed to undertake business activities in currencies other than the Malaysian ringgit in, from or through the Labuan IBFC, subject always to the relevant exchange control restrictions imposed under the Acts.

The Rules on Prohibited Business Conduct were issued by the BNM in 2016 pursuant to the provisions of the Acts, which prohibit financial services providers from engaging in conduct deemed inherently unfair to financial consumers. These rules reinforce existing standards of business conduct and consumer protection issued by the BNM by way of the following:

a ensuring consumers are not provided with misleading or deceptive information in connection with a financial service or product;

b preventing unreasonable business practices that intimidate or exploit financial consumers;

c preventing business practices that restrict the freedom of financial consumers to choose between financial services or products available to them; and

d preventing collusive business practices that may result in unfavourable outcomes to financial consumers.

In addition to the foregoing, the Financial Services (Financial Ombudsman Scheme) Regulations 2015 and Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015 (Regulations) were issued in September 2015. The Regulations established the Financial Ombudsman Scheme (FOS) as contemplated under the FSB to ensure the effective and fair handling of complaints and the resolution of disputes against member banking institutions for direct financial loss, within prescribed monetary limits, which

46 Guidelines on International Islamic Banks 2008: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=54&bb=file.

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include 250,000 ringgit in respect of disputes relating to financial service, and 25,000 ringgit for disputes on unauthorised transactions involving payment instruments, payment channels or cheques.

The FOS commenced operations in 2016.[47] Its operations are funded by its banking institutions' members and governed by a board of directors made up of independent individuals who are not in active employment, nor have a significant interest in any banking institution. To avoid duplicity and inconsistency, the Acts further provide that a dispute referred to the FOS may not be further referred to the Tribunal for Consumer Claims under the Consumer Protection Act 1999. However, the service does not constitute a replacement for the Malaysian courts.[48]

As the responsible authority under the Malaysian Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001, the BNM is tasked with disseminating financial intelligence received from reporting entities to the law enforcement agencies tasked to investigate money laundering and terrorism financing activities. The Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) – Banking and Deposit-Taking Institutions (Sector 1) Guidelines also state the obligations of reporting institutions and common red flags with respect to the banking sector.

The BNM has continuously sought to strengthen money laundering and terrorism financing controls and practices among banking institutions. This is reflected in the increased resources allocated to, and investments in, screening and transaction monitoring systems, and improved practices in the conduct of customer due diligence. Further enhancements in governance and control measures were put in place to improve processes for identifying transactions designed to evade tax and for assessing risks associated with politically exposed persons.

In 2018, the legal and regulatory framework continued to be strengthened to counter money laundering and terrorism financing risks, which constitutes one of the main objectives for the BNM in 2019. The Companies Act was revised to improve transparency in the ownership of legal persons registered in Malaysia. Owing to the recent proliferation of digital currencies, the BNM has also taken the steps to extend the AML/CFT obligations to digital currency exchangers by issuing the Anti-Money Laundering and Counter Financing of Terrorism Policy for Digital Currencies (Sector 6) to ensure that effective measures are in place against money laundering and terrorism financing risks associated with the use of digital currencies and to increase the transparency of digital currency activities in Malaysia.[49]

In 2018, Malaysia's effort to preserve the integrity of the financial system and combat money laundering and terrorism financing risks have resulted in the Financial Action Task Force (FATF) Plenary upgrading Malaysia's technical compliance ratings of its AML/CFT framework. This places Malaysia among jurisdictions that are highly rated for their technical compliance with FATF Recommendations. The National Coordination Committee to Counter Money Laundering (NCC) has also endorsed the results of the National Risk

47 BNM Financial Stability and Payment Systems Report 2016: www.bnm.gov.my/files/publication/fsps/en/2016/fs2016_book.pdf.

48 Financial Services (Financial Ombudsman Scheme) Regulations 2015 and Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=443&bb=file): http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=444&bb=file.

49 BNM Financial Stability and Payment Systems Report 2017: www.bnm.gov.my/files/publication/fsps/en/2017/fs2017_book.pdf.

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Assessment (NRA), which will provide important inputs for the NCC to review the National AML/CFT Strategic Plan in 2019 to further enhance the identification of, and safeguards against, money laundering and terrorist financing threats and vulnerabilities at the national level.

The SC has also been active in undertaking regulatory reform, and introduced the Lodge and Launch (LOLA) Framework for wholesale offerings of unlisted capital market products in June 2015, which constituted a major revision of its capital markets product authorisation rules. The LOLA provides an avenue for unlisted capital market products offered to sophisticated investors (comprising accredited investors, high-net-worth entities and high-net-worth individuals) to be made available to such investors once specific information has been lodged with the SC via an online submission system, which significantly reduces the time to market.

The Netting of Financial Agreements Act 2015 (NFAA), which came into force in March 2015, contains provisions for the enforceability of close-out netting for financial transactions in Malaysia. Close-out netting is an important risk-management mechanism used by financial institutions and other financial market participants in financial derivative transactions and repurchase transactions. The enforceability of close-out netting provides credit risk reduction and mitigation benefits by allowing counterparties to net off credit risk exposures instead of having gross exposures, thus improving operational efficiency and reducing systemic risk of the financial system.

It is also anticipated that the NFAA will enhance the efficiency of the financial markets in Malaysia, as banking institutions would be able to deal more competitively with foreign counterparties globally, develop new hedging instruments and innovative financial products, and facilitate the further development of a vibrant and competitive financial market.[50]

In 2016, the BNM introduced the Financial Technology Regulatory Sandbox Framework (Framework) to enable the deployment and testing of innovations and advances in financial technology (fintech) in live environments within specified parameters and time frames. The Framework sets out a conducive regulatory environment that harnesses the potential of fintech to modernise, deepen and inject competition in the domestic financial and funding markets. Through the Framework, the BNM aims to facilitate the growth and development of Malaysia's financial sector by encouraging innovation in financial services and the introduction of new business models, solutions and enhancements in customer value and experience; and improvements in the efficiency and risk management of financial institutions.[51] The Financial Technology Enabler Group was established by the BNM in June 2016. It is responsible for formulating and enhancing regulatory policies to facilitate the adoption of technological innovations in the Malaysian financial services industry.

In 2017, the BNM spearheaded a tripartite effort between the Malaysian Anti-Corruption Commission and the Inland Revenue Board of Malaysia for strategic cooperation in combating financial crimes, tax evasion and corruption. This joint strategic cooperation aims to combine the powers and resources of each agency to restrain financial

50 Malaysia Ministry of Finance press release dated 30 March 2015: http://www.treasury.gov.my/images/ucapan/2015/Coming_Into_Force_Of_The_Netting_Of_Financial_Agreements_Act_2015.pdf.

51 Financial Technology Regulatory Sandbox Framework: www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4273&lang=en.

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crimes, especially those involving corruption and tax evasion. It is hoped that this joint effort will strengthen the country's financial system, increase national revenue, and build a nation free from corruption and abuse of power.

V FUNDING

The primary sources of funding for banks in Malaysia are deposits (fixed, demand, savings, investment deposits, etc.), which include negotiable instruments of deposits and repurchase agreements. The money and foreign exchange markets are also integral to the funding of the banking system. These are governed by the Code of Conduct for Malaysia Wholesale Financial Markets, which came into effect on 2 May 2017. This Code and the Guidelines on Repurchase Agreement Transactions, issued by the BNM in 2015, set out the principles and standards to be observed by market participants in wholesale financial markets. The Code of Conduct for Malaysia Wholesale Financial Markets sets out the eligibility requirements for dealers and brokers, market conduct and internal control requirements to safeguard the professionalism and integrity of the wholesale financial markets and the role of industry associations in preserving market integrity, while the Guidelines on Repurchase Agreement Transactions set out the scope of the repurchase agreement that can be conducted by licensed banks and licensed investment banks to promote sound risk management practices.[52]

Throughout 2015, the Islamic banking sector completed an industry-wide exercise to migrate customers' Islamic deposit accounts into Islamic deposits or investment accounts according to the requirements of the IFSA. During the exercise, which was carried out over the subsequent two years, customers, depending on their risk appetite, could choose to convert their deposits into investment accounts that offered different rates of return but were not principal-guaranteed. By the end of 2018, investment intermediation activities had continued to grow, whereby total investment accounts managed by Islamic banks amounted to 82.6 billion ringgit, compared to 2017, when investment accounts amounted to 79 billion ringgit.[53]

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Reporting requirements

The Acts provide that financial institutions carrying on banking business under the FSA and Islamic banking business under the IFSA must be public companies incorporated under the CA. Consequently, the reporting obligations for substantial shareholders under the CA apply to substantial shareholders of Malaysian financial institutions. A substantial shareholder is a person who has an interest of at least 5 per cent of the interests in the voting shares of a company. Notice in writing of the acquisition of a substantial shareholding must be given to the company and the SC within three days for a company whose shares are quoted on a stock exchange, and five days for any other case, from the date a person becomes a substantial shareholder. A substantial shareholder is also required to file a notice of change in their interests or notice of cessation of a substantial shareholding within three days for a company

52 Repurchase Agreement Transactions: www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=436&lang=en.

53 BNM Financial Stability and Payment Systems Report 2018 ((http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_fspr&ac=27&en).

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whose shares are quoted on a stock exchange, and five days for any other case, from the date of a change or date of cessation, as the case may be. The changes made in the CA regarding substantial shareholders provide for good governance practices by enhancing and refining the relevant provisions pertaining to transactions involving directors and substantial shareholders by way of rules relating to substantial property transactions and persons connected with directors or substantial shareholders; and disclosure principles to avoid conflicts of interest.[54]

ii Share transactions

The Acts provide that all approvals are required on two levels: first, prior to the commencement of negotiations, and subsequently, prior to the execution of the relevant transaction agreements. Approval is required for direct and indirect acquisitions of shares in a financial institution.

iii Acquisition

The Acts require the approval of the BNM or the Minister for the acquisition of interest in shares that exceed prescribed percentages, or result in a change in control, of a financial institution. An interest in shares is defined under Schedule 3 of the Acts, and includes both legal and beneficial interest in shares. Such an interest arises when a person enters into a contract to acquire shares or has a right to have a share transferred to them. A person is deemed to have an interest in shares if he or she holds shares jointly with another person. This does not apply in certain instances, such as when the interest is held by a person as security or as bare trustee.

Consequently, the Acts require a person to obtain the prior approval of the BNM for:

a entering into an agreement to acquire an interest in shares that would result in him or her holding an aggregate interest of 5 per cent or more of shares in a licensed person;

b entering into an agreement to acquire an interest in shares that would result in the acquirer holding an aggregate interest in shares of a financial institution of, or exceeding, any multiple of 5 per cent or the percentage holding triggering a mandatory offer under the Malaysian Code on Take-Overs and Mergers 2016; and

c entering into any agreement that will result in him or her holding an aggregate of more than 50 per cent of the interest in shares of a financial institution.

A person's interests are aggregated with shares held by his or her spouse, children, family corporation and persons acting in concert with him or her for the purposes of determining interests held, or to be held, by a person in a financial institution.

iv Control

The Acts require a person to obtain the prior approval of the Minister if he or she takes control of a financial institution. In this case, control means the acquirer has an interest of more than 50 per cent of the shares in a financial institution; or, unless proven otherwise, has the power to, inter alia, appoint the majority of the directors of a financial institution, or to

54 FAQs of the Companies Act 2016 (Act 777): http://www.ssm.com.my/Pages/Legal_Framework/FAQS-ON-COMPANIES-ACT-2016-AND-TRANSITIONAL-ISSUES/companies_act_2016_-_policies.pdf.

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make and implement business and administration decisions of a financial institution, or is a person in accordance with whose directions, instructions or wishes the directors or senior officers of a financial institution are accustomed or under an obligation to so act.

v Disposal

The Acts also require a person who has an aggregate interest in shares of a financial institution of more than 50 per cent, or 50 per cent or less but with control over the financial institution, to obtain the approval of the Minister before entering into an agreement that would result in that person holding less than a 50 per cent interest in shares in, or ceasing to have control over, the licensed person.

vi Sharing threshold for individuals

The Acts stipulate that an individual may own a maximum interest of 10 per cent of the shares in a financial institution. However, solely in the case of the IFSA, this threshold may be waived by the BNM if it is satisfied that an individual will not exercise control over the financial institution and has given a written undertaking not to exercise control over the financial institution. No such provision for waiver is provided for under the FSA.

vii Reconstruction, amalgamation and transfers

The Acts require the prior approval of the Minister, upon recommendation by the BNM, for any agreement or arrangement for the reconstruction or amalgamation of a financial institution. The Acts also require the prior written approval of the BNM for any agreement or arrangement to transfer the whole or part of the business of a financial institution. Consequently, the prior approval of the Minister or the BNM (as the case may be) would have to be applied for and obtained if the acquisition of a financial institution is to take place through the acquisition of business and assets.

viii Foreign ownership of financial institutions

The current position was established by a statement made by the then Prime Minister on 27 April 2009 and as announced by the BNM in April 2009 with regard to the liberalisation of the financial sector as contemplated under the FSB, whereby flexibility is allowed for the following thresholds for foreign equity ownership in banking and financial institutions in Malaysia: up to 70 per cent in investment banks, insurance companies and Islamic banks, subject to domestic Islamic banks maintaining a paid-up capital of at least US$1 billion; and up to 30 per cent in conventional commercial banks.

Priority will be accorded to investors who have the capacity to contribute in areas of Malaysia's financial sector where growth is required and in new areas of growth, or in areas that will reinforce Malaysia's position as an international Islamic financial hub.

VII THE YEAR IN REVIEW

As has already been mentioned, 2018 was a year in which economic growth began to moderate while remaining resilient, despite the country experiencing a change of government for the first time in the country's history. The economy was also confronted with several external and domestic challenges. Overall, the strong fundamentals and highly diversified structure of the Malaysian economy have accorded Malaysia the ability to weather challenges posed

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by global volatility. With the benefit of flexible and pre-emptive domestic policies ensuring the minimisation of risks while its external position remained healthy, with a current account surplus, adequate international reserves and manageable external debt exposure, the Malaysian economy remains resilient, and is widely expected to sustain its growth momentum in 2019.[55]

VIII OUTLOOK AND CONCLUSIONS

In mid-2017, Malaysia pioneered the issuance of green *sukuk*. On 27 July 2017, the SC announced the debut of the world's first green *sukuk* under the Sustainable and Responsible Investment (SRI) Sukuk Framework launched in 2014.[56] This issuance was the result of high-level collaboration between the SC, the BNM and the World Bank Group to 'to develop an ecosystem to facilitate the growth of green sukuk and to introduce innovative financial instruments to accommodate global infrastructure needs and green financing'.[57] In 2018, the SC continued to lead initiatives to establish Malaysia as a regional leader for sustainable and responsible investment (SRI) in 2018 by establishing a 6 million ringgit green SRI *sukuk* grant scheme in 2018 to incentivise issuances of green SRI *sukuk* by defraying up to 90 per cent of external review costs in relation to obtaining green certification.[58]

In the ASEAN region, Malaysia is also one of the ASEAN countries that observes the ASEAN Green Bond Standards, introduced by the ASEAN Capital Markets Forum in 2017 and ASEAN Social Bond Standards and ASEAN Sustainability Bond Standards, both introduced by the ASEAN Capital Markets Forum in October 2018. The region now has a complete suite of standards to accelerate the development of sustainable finance in the region.[59] In addition, going forward the government has emphasised in the Mid-Term Review of the Eleventh Malaysia Plan 2016–2020: New Priorities and Emphases its determination to support development of green projects, green technologies and green industries through financing mechanisms such as green *sukuk* financing to fund development of green projects. The Green Technology Financing Scheme 2.0[60] will be continued to provide financing for development of green technologies and green industries.[61]

In line with its commitment to further strengthen corporate governance, the BNM issued enhanced standards in August 2016 to raise the corporate governance bar to strengthen the conditions for strong and effective boards, with greater emphasis on a sound risk culture and remuneration system in promoting prudent risk-taking. The key changes introduced in

55 BNM's Annual Report 2018 (Executive Summary) (http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_ar&ac=42&en).

56 https://www.sc.com.my/post_archive/sc-introduces-sustainable-and-responsible-investment-sukuk-framework/.

57 https://www.nst.com.my/opinion/columnists/2018/03/346085/malaysias-green-sukuk and www.mifc.com/index.php?ch=28&pg=72&ac=187&bb=uploadpdf.

58 61 https://www.sc.com.my/post_archive/sc-introduces-sustainable-and-responsible-investment-sukuk-framework/.

59 https://issuance.sc.com.my/post_archive/asean-capital-market-regulators-launch-professional-mobility-framework-social-and-sustainability-bond-standards/.

60 https://www.gtfs.my/page/gtfs-guideline.

61 Mid-Term Review of the Eleventh Malaysia Plan 2016-2020: New Priorities and Emphases (18 October 2018): http://epu.gov.my/en/rmk/mid-term-review-eleventh-malaysia-plan-2016-2020.

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the standards include addressing issues arising from more complex organisational structures and business models of financial institutions that have expanded in size and across borders, namely:

a strengthened requirements on board composition, including that the majority of the directors should be independent;

b enhanced expectations for boards and their committees, including a requirement to approve and maintain credible recovery and resolution plans under conditions of stress;

c an expectation for boards to set a tenure limit for independent directors that should not generally exceed nine years;

d requirements for financial institutions to adopt a code of ethics that promotes ethical, prudent and professional behaviour supported by a transparent whistle-blowing policy;

e expanded requirements on remuneration arrangements that promote a sound risk culture and are aligned with prudent risk-taking; and

f strengthened expectations for effective group-wide governance arrangements.[62]

The Securities Commission also issued the Malaysian Code on Corporate Governance (Code) in 2017, which places more emphasis on internalisation of corporate governance culture, not just among listed companies, but also encourages non-listed entities – including state-owned enterprises, small and medium-sized enterprises and licensed intermediaries – to embrace the Code.[63]

In December 2016, the BNM introduced a Supplementary Notice[64] to its existing Foreign Exchange Administration Rules (issued on 30 June 2013) to enhance the foreign exchange market through the following measures:

a allowing residents to freely and actively hedge their foreign currency exposure with a licensed onshore bank up to a limit of 6 million ringgit per client per bank, subject to a declaration of non-participation in speculative activities;

b allowing residents with domestic ringgit borrowing to invest in foreign currency assets both onshore and abroad up to a limit of 50 million ringgit;

c allowing resident and non-resident fund managers to manage their foreign exchange exposure up to 25 per cent of their invested assets, subject to registration with the BNM;

d allowing offshore non-resident financial institutions to participate in the Appointed Overseas Office Framework (AOO Framework);[65]

e expanding the AOO Framework to include non-resident financial institutions; and

f requiring exporters to convert 75 per cent of their proceeds into ringgit.

In 2017, the BNM issued Supplementary Notice No. 2, which sets out additional hedging flexibilities to further facilitate foreign exchange risk management. For example, the hedging

62 Corporate Governance 2016: http://www.bnm.gov.my/index.php?ch=57&pg=140&ac=512&bb=file.

63 SC Releases New Malaysian Code on Corporate Governance to Strengthen Corporate Culture: https://www.sc.com.my/news/media-releases-and-announcements/sc-releases-new-malaysian-code-on-corporate-governance-to-strengthen-corporate-culture.

64 Supplementary Notice on Foreign Exchange Administration Rules – Measures to Promote The Development of Malaysian Financial Market: www.bnm.gov.my/documents/2016/Supplementary_Notice_on_Foreign_Exchange_Administration_Rules.pdf.

65 BNM press release dated 6 December 2016: www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4318.

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framework is expanded to include other major currency pairs. Again in 2017, it issued Supplementary Notice No. 3, which lays down additional hedging flexibility.[66] In 2018, the BNM issued Supplementary Notice No. 4, which introduces greater flexibility in the management of export proceeds, flexible hedging of foreign currency obligations and wider access for non-residents to the onshore market financial market.[67]

On 18 February 2018, the BNM issued the Anti-Money Laundering and Counter Financing of Terrorism Policy for Digital Currencies (Sector 6) (Policy Document) to ensure that effective measures are in place against money laundering and terrorism financing risks associated with the use of digital currencies and to increase the transparency of digital currency activities in Malaysia.[68] Recently the Capital Markets and Services (Prescription of Securities) (Digital Currency and Digital Token) Order 2019[69] came into force on 15 January 2019, and it allows the SC to regulate digital assets as prescribed securities. The offering of prescribed securities, as well as its associated activities, will require authorisation from the SC and need to comply with the relevant securities laws and regulations.[70] The SC will put in place guidelines to regulate the offering and trading of digital assets. To implement the regulatory framework on digital assets, the SC and the BNM will enter into coordination arrangements to ensure compliance with laws and regulations under the purview of both regulations. This regulatory framework is expected to be launched by the end of the first quarter in 2019.[71]

Further to the foregoing, the BNM established the Financial Markets Committee (FMC) in May 2016,[72] which was entrusted with formulating strategies to further develop the domestic financial market and provide an effective engagement platform to discuss potential issues and risks related to the development of the financial market. Since its inception, proactive measures have been introduced to develop the onshore foreign exchange market, mitigate speculative activities and correct imbalances that existed within the onshore foreign exchange market. The FMC issued 'Updates on Malaysian Financial Market' on 21 December 2017 outlining the results of the FMC's various initiatives.

In conclusion, Malaysia has a strong financial system that is the result of many decades of good work and systematic development. The strength of the BNM's institutional arrangements has been tested, and has always been proven in times of change and uncertainty. Although fundamental shifts in political and social dynamics have made the regulatory

66 Supplementary Notice (No. 2) on Foreign Exchange Administration Rules and Amendment to the Definitions of the Notices on Foreign Exchange Administration Rules – Measures to Promote Development of Malaysian Financial Market: www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=533&lang=en.

67 http://www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4726&lang=en.

68 Bank Negara Malaysia issues policy document for digital currencies (see also footnote 45): www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4628&lang=en.

69 http://www.federalgazette.agc.gov.my/outputp/pua_20190114_PUA12.pdf?fbclid=IwAR3RG1vaiM3MSd_lONZl4jyuVeAUt_anYTJmI08GhVB0kb8IAWKhhTaV1rQ.

70 https://www.nst.com.my/news/nation/2019/01/450532/order-prescribe-digital-assets-securities-comes-force-tomorrow.

71 https://www.sc.com.my/news/media-releases-and-announcements/sc-to-regulate-offering-and-trading-of-digital-assets.

72 Establishment of the Financial Markets Committee (see also footnote 6): www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4178&lang=en.

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and policymaking environment increasingly challenging, we firmly believe that Malaysia will maintain its role at the forefront of banking and financial regulation, and continue its outstanding work towards a better future for all Malaysians.

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Chapter 23

MEXICO

Federico De Noriega Olea and Juan Enrique Lizardi Becerra[1]

I INTRODUCTION

The banking system is regulated by four main governmental agencies: the Bank of Mexico (Banxico) as the Mexican central bank, the Ministry of Finance and Public Credit (SHCP) as the ministry within the executive branch in charge of regulating financial institutions, the National Banking and Securities Commission (CNBV) as an agency that directly depends on the SHCP, and the Financial Consumer Protection Commission (Condusef).

As at January 2019, the Mexican banking market is composed of 51 retail banking institutions, plus two more that are waiting to commence operations, six development banks and 23 financial groups.[2] The five largest retail banking institutions in the market – based on the amount of assets, resources collected from the public at large and participation in loan portfolios – are BBVA Bancomer, Santander, Citibanamex, Banorte and HSBC, respectively.[3]

In November 2018, an initiative by the Morena parliamentary group (the political party to which the current President of Mexico belongs to and that has a majority in Congress) was filed before the senate to try to reduce bank fees and commissions. The announcement of the initiative had an adverse effect in the Mexican capital markets, after which the Morena parliamentary group decided not to prioritise it, and wait for the markets to cool down.

Notwithstanding, the house of representatives majority leader recently said, during an interview with *Bloomberg*, that the initiative on reducing and cutting bank fees and commissions would sooner or later be approved.[4]

The President has also spoken about reforming the mandate of development banks and restructuring their operations. There have been some declarations about a possible merger of development banks, but there is still no concrete plan regarding this.

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1 Federico De Noriega Olea is a partner and Juan Enrique Lizardi Becerra is an attorney at Hogan Lovells BSTL, SC.

2 https://www.gob.mx/cnbv/acciones-y-programas/sectores-supervisados.

3 Statistics Bulletin for Retail Banking as of 31 December 2019, available at http://portafolioinfo.cnbv.gob.mx/Paginas/Contenidos.aspx?ID=40&Contenido=Boletines&Titulo=Banca%20M%C3%BAltiple.

4 Interview available at https://www.bloomberg.com/news/articles/2019-01-02/mexico-needs-law-to-cut-bank-fees-majority-whip-clouthier-says.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

Banxico is the central bank of the government, governed by the Bank of Mexico Law. The primary activities of Banxico consist of:

a directing monetary policy and controlling inflation;
b financing the federal government;
c minting coins and issuing bills; and
d regulating intermediation and financial services.

Banxico accomplishes these tasks in part by establishing the required characteristics for financial transactions (e.g., mandatory rates, terms and interest).

Banxico issues general provisions and regulations that are applicable to financial institutions, issuers of securities, intermediaries and the public at large. Banxico also has the authority to sanction entities and individuals that do not comply with those regulations. It regulates certain aspects of banks as they relate to payment systems and derivatives, among others.

The SHCP is a ministry of the Federal Public Administration. It evaluates, surveys, promotes and organises financial services rendered by banking and non-banking agents. Through its separate agencies, including the CNBV and the Insurance and Bonds National Commission, the SHCP evaluates and surveys banks, bonding and insurance companies, brokerage houses and all other entities within the financial system.

The SHCP has the authority to issue rules to develop the provisions of the Credit Institutions Law (LIC), which is the main body of law governing banks and their transactions. One of the main functions of the SHCP is to issue money laundering rules.

The CNBV is in charge of granting authorisations, and inspecting and surveying all financial activities, transactions and entities; it also acts as an enforcement body for those entities under its surveillance. All financial activities, which nowadays also include fintechs, are mainly coordinated and regulated by the CNBV; as such, it can be considered the most important government agency for such matters.

Authorisations to undertake banking and other regulated financial activities will commonly have to be filed with, inter alia, the SHCP, Banxico and the CNBV, but the authorisation is ultimately issued by the CNBV.

Besides the LIC as the main body of banking law, there are two additional regulations that are of importance for banking institutions: the general rules applicable to banks issued by the CNBV[5] and Circular 3/2012 issued by Banxico (provisions applicable to transactions of credit institutions and rural financial institutions).

Condusef is another regulatory agency in charge of the surveillance and regulation of banks, but from a consumer-protection standpoint. Condusef is in charge of regulating the marketing and offering of services by financial institutions to the public at large. It also serves as a mediator of disputes between financial consumers and financial institutions.

Retail banking institutions must be incorporated as corporations under Mexican law,[6] their by-laws must be approved beforehand by the CNBV and the authorisation for their incorporation must be published in the Federal Official Gazette. Mexican law provides the

5 Known as the Circular Única de Bancos.

6 As *sociedades anónimas*.

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opportunity to incorporate fully fledged retail banks or niche retail banks, depending on the activities that they intend to perform; hence, the minimum capital stock requirement varies according to the kind of bank.

The capital structure of banks also varies based on whether a foreign financial institution owns 51 per cent or more of the capital stock. A bank whose capital stock is owned by a foreign financial institution is called an affiliate banking institution. To form one of these entities, a bilateral international treaty must exist between Mexico and the country where the holding entity resides.

Affiliate banking institutions' capital stock is composed of Series F and Series B shares. The former may be acquired only by a foreign bank or a specialised government agency as a deposit insurance institution (IPAB), which secures personal bank accounts up to a maximum of 400,000 investment units (UDIs)[7]), and shall not be lower than 51 per cent. Series B shares may be freely subscribed and grant limited voting rights.

The capital stock of retail banks that are not affiliate banking institutions is composed of Series O and Series L shares: Series O shares are common shares and may be freely subscribed; Series L shares, which may represent up to 40 per cent of the issued shares, may also be freely subscribed and have limited voting rights.

Finally, development banks are decentralised agencies of the federal government known as national credit companies, which may perform credit operations in the same way as retail banks. However, their purpose is to render services for the development of specific segments of the national economy, promoting, for instance, foreign commerce or the development of public works, and to offer financial services to promote innovation, boost environmental sustainability and promote the financial inclusion of micro, small and medium-sized enterprises and small rural producers.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The CNBV may be considered as the Mexican equivalent to the Financial Services Authority of the United Kingdom, and a mixture of the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the state banking commissions from the federal reserve banks and the Securities and Exchange Commission of the United States. The CNBV is the regulator in charge of oversight, and the control body of the banking, financial and securities systems in Mexico, and is considered the main prudential regulator.

The SHCP is also one of the main regulators in the banking system. Its main authorities are:

a the issuance of general rules;
b control of financial policies;
c budget control;
d administrative control; and
e granting authorisations for specific activities.

Regarding the control of financial policies, the SHCP is entitled to plan, coordinate, evaluate and oversee the country's banking system, including Banxico, retail banks, development

7 As at 8 March 2019, 1 UDI is equivalent to 6.268665 Mexican pesos.

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banks, financial groups, and any other institution that performs credit and banking activities. This control over financial policies includes insurance, securities, surety bonds and credit ancillary activities.

Banxico's main activities are those of a regular central bank, namely:

a maintaining the stability and supply of the currency;
b the control and prudential regulation of the financial system;
c acting as lender of last resort;
d modulation of the public debt; and
e coordination of the payment systems.

Additionally, with the CNBV and the SHCP, Banxico has the authority to issue general rules. Among all the authorities granted to Banxico, we highlight the strengthening and development of the financial system, which include:

a operating with credit institutions as reserve bank and lender of last resort;
b granting loans to credit institutions and the federal government;
c determining the characteristics of lending, deposit and services activities by credit institutions as well as securities and derivatives transactions;
d setting limits on lending and deposit transactions to control the risk of banking institutions;
e requesting periodic reports and information regarding financial entities' activities and results; and
f issuing an opinion regarding:
- any application for an authorisation to act as a retail banking institution;
- acquisitions of more than 5 per cent of ordinary shares from retail banking institutions, including subsidiary institutions from foreign entities;
- mergers or spin-offs of retail banks;
- the establishment of foreign financial entities' subsidiaries as retail banks;
- financial entities' capitalisation thresholds;
- ratings of credit portfolios;
- support documentation for lending, services and deposit transactions; and
- the integration of reserve funds corresponding to credit ratings for prudential, solvency and stability purposes.

Banxico is also able to impose sanctions on financial entities and request the performance of audits and inspection visits to such entities.

ii Management of banks

Management of banks is entrusted to three main bodies. The first is the board of directors, followed by the chief executive officer (CEO), and lastly an audit committee that is directly accountable to the board of directors. The board of directors is composed of five to 15 members, who are elected by the shareholders, of which 25 per cent must be independent members and the majority must reside in Mexico. It shall hold meetings at least quarterly. These will be valid when 51 per cent of the members of the board are present: of those members, at least one must be an independent member. The members of the board must fulfil certain requirements regarding experience, reputation, ethics and knowledge.

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The board of directors is the body in charge of performing and approving all actions required to fulfil the bank's purpose (with the sole exception of those expressly reserved for the shareholders' meeting); it has all the necessary powers and authority to represent the bank and lead its business.

A statutory audit committee is also required, which shall be composed of at least two statutory auditors, one appointed by the ordinary series of shares (Series O and Series F) and the other by the limited series of shares (Series L and Series B). This committee is in charge of:

a requesting monthly reports from the board of directors, including a financial situation statement and a results statement;

b examining the operations, documentation, registry and any other evidence to the extent necessary to oversee the operations; and

c filing an annual report to the shareholders' meeting regarding the truthfulness, sufficiency and rationale of the information delivered by the board to the shareholders' meeting, in which the opinions of the members of this committee regarding accounting and information policies and the sufficiency and adequacy of certain criteria are included.

The CEO must be an individual who resides in Mexico for tax purposes, with a recognised moral reputation and at least five years' experience in senior decision-making positions. The CNBV has the authority to remove any officer in the event that he or she does not comply with these requirements or ceases to comply with them. The CEO is in charge of the elaboration and presentation of policies for the correct application and utilisation of the human and material resources of the entity, including the consideration of their efficient use, restrictions on misuse, oversight and control mechanisms.

The audit committee is the body entitled to follow up on the internal and external audit processes of the institution, as well as with the internal comptroller. It ensures that accounting and financial information is generated in accordance with the applicable requirements and accounting principles.

The members of this committee are selected for their aptitude and professional reputation. The committee shall be composed of at least three and no more than five members, one of whom must be an independent member and shall act as chair. Mexican law also requires there to be a secretary, who may or may not be a member of the committee, and who will be entitled to keep all minutes and records. Meetings shall take place at least four times a year, and their resolutions will be validly adopted if approved by the majority, provided that the chair, or his or her deputy, attends the meeting. Employees and officers of banking institutions are not allowed to be part of this committee.

The committee's main activities consist of proposing to the board an internal control system for the operations of the institution, and its supervision. The control system shall include:

a policies concerning the organisational structure of the bank;

b communication channels and information flow mechanisms;

c general operating policies;

d a business continuity plan; and

e control measures for the correct approval, processing and registration of the bank's transactions.

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In addition to the aforementioned managerial and vigilance bodies, banking institutions shall incorporate other types of subcommittees, such as a corporate banking credit committee, internal credit committee, risks committee, human resources and institutional development committee, and compensation committee.

Mexican banking law contemplates two types of compensation for officers and employees: ordinary and extraordinary. Ordinary compensation is salary, benefits and fixed remunerations, and extraordinary compensation covers all types of variable compensations based on results. The compensation committee is the body in charge of overseeing the compliance of these compensations with Mexican law by means of a compensation system that must be implemented and cover all policies and proceedings determined by the bank to comply with the CNBV's general rules with respect to risk management. Mexican laws and regulations do not limit the compensation of banking officers and employees.

iii Regulatory capital and liquidity

Regulatory capital for full-fledged retail banks is 90 million UDIs (currently this is around 562 million Mexican pesos) and for the smallest niche retail banks 36 million UDIs (currently around 225 million Mexican pesos). The regulatory minimum capitalisation index for Mexican banks is, as per Basel III, currently 8 per cent. Each of the 51 retail banking institutions in Mexico has a capitalisation index higher than the minimum required; thus all banks are qualified by the CNBV under the highest category. For example, as of November 2018, HSBC, one of the retail banking institutions with a lower capitalisation index percentage, has 12.13 per cent; Bancomer BBVA, which is the biggest bank in Mexico, has reached 15.09 per cent; conversely, Bank of China has 155.46 per cent and Pagatodo, a local bank, has 213.17 per cent.[8]

Retail banks' capital, as in most of the world, is divided into Tier 1 and Tier 2 capital, each with their particularities:

a Tier 1 capital, or basic capital, includes capital stock, capital reserves and undistributed profits. It is divided into core Tier 1 capital or basic capital 1, which is paid capital plus earned capital and includes profits, reserves and valuations, and has a minimum capitalisation index at 4.5 per cent; and Tier 1 or basic capital 2, which is composed of regular capital stock plus capital increases that have not been formalised, plus all capitalisation instruments less subordinated debt, share investments, pending reserves and others, and has a minimum capitalisation index at 6 per cent;

b Tier 2 capital, or supplementary capital, is the monies that finance the bank's activities. It is composed of capitalisation instruments that exceed the basic capital, such as preferred and convertible shares, subordinated debt, debt convertible into shares and a part of the reserves for non-recoverable credits;

c net capital: the addition of Tier 1 and Tier 2; and

d capital supplements, the additional margin that each bank shall contribute to operate with a positive margin promoted by the regulators.

As a consequence of Basel III, Mexico has implemented requirements regarding capital instruments (subordinated debentures). The first requirement is that either the issuer or

8 https://www.cnbv.gob.mx/SECTORES-SUPERVISADOS/BANCA-MULTIPLE/Prensa%20%20Sector%20Bancario/Comunicado%20de%20Prensa%20004%20Alertas%20Tempranas%20BM%20nov18.pdf.

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the controlling entity of the corporate group be listed in the Mexican Stock Exchange. The second is that these instruments shall have one of the following features: convertibility of the principal amount of the subordinated debentures into equity or a reduction in the principal value of the debentures. The convertibility or reduction in the debentures value shall be triggered, regarding the instruments corresponding to basic capital 2, when the ratio of basic capital 1 reaches a value of 5.125 per cent with respect to the assets subject to the risk. For debentures subject to the supplementary capital, these shall be converted when they reach a value of 4.5 per cent of basic capital 1 with respect to the assets subject to the risk. Hence, the banks may timely absorb any losses, improving solvency in difficult scenarios and before governmental intervention.

Financial groups are regulated under Mexican law by a specific law, the Law Regulating Financial Groups, and specific general rules issued by the CNBV. The regulating groups are supervised by the same governmental agencies as regular retail banking institutions; holding companies of financial groups have a specific treatment that differs from their subsidiaries; and these groups may be composed of different types of financial entities, including non-bank financial institutions or even real estate managing corporations.

iv Recovery and resolution

Mexican law establishes two types of early warnings for banking institutions facing solvency or capital problems: minimum measures, and additional measures applied discretionally by the CNBV.

Banking institutions may be classified into five groups, according to their capitalisation index:

a level I: institutions whose capitalisation index is higher than 10.5 per cent;
b level II: institutions that have a capitalisation index equal to or higher than 8 per cent;
c level III: banks that have a capitalisation index equal to or higher than 7 per cent;
d level IV: institutions with a capitalisation index equal to or higher than 4.5 per cent; and
e level V: institutions with a capitalisation below 4.5 per cent.

Minimum measures have three levels:

a the first is triggered when a banking institution is downgraded to level II as per its capitalisation index. In that event, the institution would have to:
- deliver a detailed evaluation report of the reasons for its financial situation;
- not engage in any transaction that may put its capitalisation index below the minimum requirement;
- file a capital conservation plan with the regulator;
- partly restrict dividend payments, compensation and extraordinary bonus; and
- refrain from increasing financing to relevant related persons;

b at the second level, if downgraded further to level III, the bank would have to:
- deliver a capital restoration plan;
- suspend dividend payments;
- suspend any repurchase programmes for its own shares;
- defer interest and principal payment of subordinated debentures or convert them early into shares; and
- suspend the payment of compensation and extraordinary bonus; and

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c at the last level, when it reaches level IV or V, the entity will not be allowed to make new investments in non-financial assets, open branches or engage in any new activity distinct from its regular transactions.

Additional measures also have three different levels, based on the capitalisation index groups:

a for capitalisation level II:
- the banking institution must deliver a detailed report regarding the manner and terms under which it will manage the assets subject to total risks and the strategy to follow to strengthen its capitalisation index;
- for retail banking entities controlled by foreign financial institutions, the above-mentioned report must be delivered to the highest ranking officer of such area in the foreign financial institution;
- the institution must retain specialised external auditors for special audits; and
- it must minimise the effects of transactions entered into with entities of the same corporate group that carry a monetary benefit transfer;

b for level III, the banking institution must:
- not increase salaries or benefits to any employee (including officers);
- limit the execution of new transactions that may affect its capitalisation index; and
- not execute transactions with entities of the same corporate group; and

c for levels IV and V, the banking institution must:
- substitute officers, members of the board, statutory auditors or external auditors;
- reduce its risk exposure; and
- modify policies regarding interest rates paid over deposits that are over the regular risk level assumed by the entity.

The law also contemplates a management intervention, which is triggered as a consequence of:

a downgrades of a banking institution's index capitalisation level within one month, and not remedying it within one business day;

b the institution putting itself in a situation that is cause for revocation of its banking authorisation; or

c the institution defaulting on any of its primary payment obligations, and the banking stability committee of the federal government determining that this is the case.

If a management intervention is declared by the CNBV, the IPAB will:

a appoint a precautionary manager (with full authority as if that individual acted as sole director of the entity, substituting the board of directors and the shareholders' meeting);

b prepare a report regarding the status of the institution; and

c engage in all activities and transactions required to safeguard the interests of the public at large.

For the fulfilment of his or her duties, the precautionary manager may be assisted by a consultation committee appointed by the IPAB. This managerial intervention may only terminate if the bank has begun its dissolution, the IPAB sells all the bank's capital stock, or the irregular or illegal transactions have been corrected.

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If, after the intervention made by the precautionary manager to the banking institution, it is determined by the government's banking stability committee that the institution's recovery is unfeasible, the CNBV revokes the bank's concession, and the IPAB will intervene as the institutional liquidator, starting by paying all the amounts corresponding to secured transactions, and followed by the transfer of the bank's assets to a stable banking institution able to maintain them to preserve the continuity of the banking operations, or to a new banking institution created by the IPAB for that sole purpose; or, in the event that there are only liquid assets, the sale of those assets in favour of any capable third party.

In the event that the assets of the banking institution are not enough to pay its debt, a regulated mechanism to liquidate the defaulting institution's capital stock to cover as much of its debt as possible shall apply. At this moment, the bank is formally declared bankrupt.

IV CONDUCT OF BUSINESS

The conduct of business of Mexican banking institutions is regulated by Banxico and CNBV general rules, mainly the general rules applicable to credit institutions issued by the CNBV and Circular 3/2012 issued by Banxico.

The CNBV rules are aimed at prudential regulation, capitalisation, reserves, evaluation, risk management, the internal corporate structure of entities, financial information, its disclosure, external auditors, regulatory reports, early warnings and corrective measures.

On the other hand, Circular 3/2012 regulates transactions, deposits, debt certificates, subordinated debentures, bankers' acceptance, structured banking notes, credit transactions referenced to investment units or currency, banking cards (debit and credit), direct debiting, funds transfers, trusts, commissions, mandates, appraisals, ATMs, non-banking cards, currency exchange, securities transactions, precious metals and transactions with derivative instruments.

V FUNDING

In the Mexican market, funding is normally made to small banks by development banks for the former to lower interest rates and compete with larger banks that have a sound capital structure and reserves and therefore do not require government funding.

Interbank funding is common. It is usually performed through three different types of negotiable instruments: banknotes, bankers' acceptance and deposit certificates. These may be exchanged by direct or repurchase transactions. Banxico has established a formula that generates an average interbank funding rate, which is based on the amounts marketed by banking intuitions for banknotes on a given date, the interest rate, amounts marketed by banking intuitions for bankers' acceptances on a given date, the interest rate, and amounts marketed by banking intuitions for deposit certificates on a given date and the interest rate. This rate is published daily by Banxico to enable the public to evaluate funding transactions between banks and brokerage houses.

Bigger banks fund themselves through retail deposits, bank bonds and interbank loans.

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VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The LIC regulates any transfer of shares of a banking institution over 2 per cent; in this event, the persons or entities either selling or acquiring the shares must notify the CNBV within three business days of the date on which the transaction takes place.

If more than 5 per cent of a banking institution's capital stock is intended to be acquired by a person or group of persons directly or indirectly, prior approval from the CNBV must be secured. To obtain this authorisation, the intended purchaser must comply with certain requirements and provide the information requested by the CNBV.

Prior authorisation is also required if a person or group of persons, whether or not they are current shareholders, intend to acquire 20 per cent or more or to secure control of the entity. The requirements to secure this authorisation are broader, and are similar to those required for the incorporation of the institution: a complete set of information regarding the acquiring party and its shareholders, their information, good reputation and moral qualifications, a list of the intended new board members and high-ranking officers as well as their qualifications, a general operating plan for the bank, and a strategic programme for the organisation, management and internal controls of the institution. The CNBV may also request any additional information.

If the requirements imposed by the CNBV for the acquisition of the shares are not complied with, the bank shall refrain from registering new shareholders as such, and report the matter to the CNBV within five business days.

ii Transfers of banking business

Mexican civil law states, as a general rule, that the assignment of credits or account receivables may be effective after notifying the debtor and registering the assignment with the Single Registry of Security Interests. For the assignment of debts, the debtor must secure consent from the creditor.

Nonetheless, the LIC provides a special rule that the assignment or discount of credit portfolios may be performed by banks without any restriction, provided that the assignment is made to:

a Banxico;
b other banks;
c trusts implemented by the federal government to promote the economy; or
d trusts that have as their main purpose the issuance of securities.

If the assignment or discount of the credit portfolio is intended for any other person, consent from the CNBV must be secured in advance.

Hence, credit portfolios may be assigned without customers' consent provided that notice is given. Regarding the assignment of deposits, customers' consent is required as a general rule.

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VII THE YEAR IN REVIEW

The International Monetary Fund reduced its projection of Mexico's growth by 0.4 per cent between its projection in October 2018 and its projection in January 2019. The projected growth by the International Monetary Fund of 2.1 per cent is in alignment with the projection made by Mexico's central bank, although less growth is expected by experts.

Mexico continues to focus on financial inclusion; a law on fintech was enacted in March 2018 whereby electronic payment entities now are part of the financial system. The advantage for banks in having new regulated electronic payment entities is that the latter have limitations on the amount of cash that they can receive from clients, forcing clients to open bank accounts and become part of the banking system.

VIII OUTLOOK AND CONCLUSIONS

We expect that financial growth will continue to increase in Mexico, although at a slower pace than what had been previously expected.

Although there has been an attempts by the legislative power to enact new regulations on limits to banking fees and commissions, we expect that such regulations will not go through in the next three years. Nevertheless we do not dismiss the possibility that limitations may be enacted at any time due to the fact that one political party has control over the house of representatives and the senate.

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Chapter 24

MONACO

Mireille Chauvet[1]

I INTRODUCTION

The Principality of Monaco is not a Member State of the European Union. As a consequence, the EU freedom of establishment and the EU free provision of services are not applicable in Monaco.

Monaco is, however, part of a monetary union with France and consequently the EU, and uses the euro. In this context, Monaco has entered into several bilateral monetary agreements with France and the EU, pursuant to which French and EU prudential regulations governing the organisation of credit institutions apply to those established in Monaco. In this context, France plays an important role in Monaco in the banking industry for historical, geographical and cultural reasons.

Another key element of the Monegasque banking sector is that almost all Monegasque credit institutions are controlled by foreign and French banking groups. Pursuant to the last published annual report of the Monegasque Supervisory Commission on Financial Activities (CCAF) published in 2017, there are currently 29 credit institutions established in Monaco, 14 of which are organised as branches of foreign credit institutions established in France, Switzerland, Italy and the United Kingdom. The remaining 15 are organised as Monegasque subsidiary corporations of French, Swiss, Luxembourg, Andorran or Italian parent banking companies.

Furthermore, the activities of Monegasque credit institutions established in the form of local subsidiaries are generally orientated towards private banking and wealth management.

During 2018, the major events in the Monegasque banking sector were the promulgation of a new law and sovereign ordinance on anti-money laundering updating the Monegasque legislation with provisions similar to those of the Directive on anti-money laundering.[2] In addition, the Directive on payment services (DSP II),[3] except in regards to its Titles III and IV, became applicable in Monaco as from 14 September 2018.

1 Mireille Chauvet is a partner at ALFA Monaco.

2 EU Directive No. 2015/849 on anti-money laundering.

3 EU Directive No. 2015/2633 on payment services.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

i Brief overview of the bilateral relationship between Monaco and France in the banking sector

France and Monaco entered into a treaty on exchange control on 14 April 1945, which established the principle of the application of French banking regulations to credit institutions established in Monaco. The exchanges of letters entered into between France and Monaco on 18 May 1963, 6 April and 10 May 2001, 8 November 2005 and 20 October 2010 detailed the scope of the application of this general principle. Pursuant to such exchanges of letters, the rules provided for in the French Monetary and Financial Code (CMF) governing the organisation, functioning and supervision of credit institutions shall apply to credit institutions established in Monaco.

In addition, pursuant to the provisions of Sovereign Ordinance No. 3.021 of 26 November 2010 implementing the exchange of letters entered into between France and Monaco on 20 October 2010 (Ordinance No. 3.021), Monegasque credit institutions are under the supervision of the French prudential regulator, the ACPR.

Furthermore, in the context of the introduction of the euro in Monaco, Monaco and France, itself acting on behalf of the EU, entered into a monetary agreement on 5 December 2011 (Monetary Agreement), implemented into Monegasque legislation by Sovereign Ordinance No. 3.559 dated 5 December 2011 (Ordinance No. 3.559).

Pursuant to Article 9 of the Monetary Agreement, Monaco:

a directly applies, without need for any internal implementation, decisions taken by the European Council in application of Article 129 of the Treaty on the Functioning of the European Union that concern the European system of central banks;

b directly applies, without need for any internal implementation, EU legislation relating to bank notes and coins taken in application of Article 133 of the Treaty on the Functioning of the European Union;

c directly applies, without need for any internal implementation, EU legislation relating to the activities and supervision of credit institutions, and to the prevention of systemic risks, which are directly applicable in France (i.e., EU regulations) or transposed into French regulations (i.e., EU directives), in particular into the CMF. The EU legislation directly applicable in Monaco is listed under Annex A of the Monetary Agreement; and

d implements into Monegasque legislation equivalent measures to those contained in certain EU legislation listed under Annex B of the Monetary Agreement. The EU legislation listed under Annex B regards the fields of financial law, anti-money laundering regulations, and the fight against fraud and counterfeiting.

The list of EU legislation included under Annex A of the Monetary Agreement is amended by the European Commission from time to time whenever the texts concerned are amended and whenever a new text is adopted by the EU, taking into account the date of entry into force and, as the case may be, the date of their transposition into French legislation (although, formally, any modification of the list provided for under Annex A is published in Monaco through the publication of a sovereign ordinance in the official legal gazette of Monaco).

Where they come from an EU directive and must be transposed into French legislation, the legal measures set out under Annex A should be applied by Monaco as soon as they are incorporated into French law.

As regards EU legislation included under Annex B, a joint committee composed of representatives of Monaco and representatives of the EU is competent to amend the list

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under Annex B and to examine the equivalence between the legal measures taken by Monaco and those taken by EU Member States. Decisions from the joint committee are made unanimously.

On the contrary, and pursuant to Article 11 of Ordinance No. 3.021, French regulations that do not strictly concern the organisation and regulation of credit institutions do not apply in Monaco. Consequently, Monegasque credit institutions remain subject to Monegasque-specific regulations in all other fields, such as notably contract law, securities law, anti-money laundering law and financial activities. Such financial activities are governed by Law No. 1.338 of 7 September 2007 (Law No. 1.338) and Sovereign Ordinance No. 1.284 of 10 September 2007, and are defined as follows:

a management, on behalf of third parties, of a portfolio of securities or forward financial instruments;

b management of mutual funds or other collective investment vehicles incorporated under Monegasque law;

c receipt and transmission on financial markets of orders relating to securities or forward financial instruments on behalf of third parties;

d provision of advice or assistance in the areas referred to in (a) to (c) above;

e execution of orders on behalf of third parties;

f management of collective investment vehicles incorporated under a foreign law; and

g proprietary dealing.

Consequently, a credit institution carrying out such financial activities in Monaco will also be subject, for those activities, exclusively to this specific Monegasque legislation and under the local supervision of the CCAF.

ii Legal forms of Monegasque credit institutions and licensing requirements

Monegasque credit institutions may take the form of either a local limited liability company, the *société anonyme monégasque* (SAM), or a registered branch of a foreign banking company. In practice, the Monegasque authorities now tend to require that any new banking establishment in the Principality takes the form of a local SAM, and do not favour the setting up of branches of foreign credit institutions, with the exception of branches of French credit institutions involved in retail banking activities.

Pursuant to Law No. 1.144 of 26 July 1991 governing the conditions to exercise economic activities in Monaco, in particular banking activities, and to Ordinance No. 3.021, the creation of a Monegasque credit institution, whether in the form of a SAM or in the form of a local branch, is subject to the delivery of both an authorisation from the government and a licence from the ACPR, which will ensure that the prudential requirements imposed by both EU and French legislation are satisfied.

Ordinance No. 3.021 further states that a representative of the government attends all meetings of the ACPR that are considering files related to Monegasque credit institutions and that, before granting a banking licence to a credit institution, the ACPR should confirm that the establishment of such credit institution has been, in principle, approved by the government.

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III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Pursuant to the provisions of Ordinance No. 3.021, Monegasque credit institutions are under the direct supervision of the ACPR.

It should be noted that Monegasque credit institutions are not within the scope of the EU Single Supervisory Mechanism under the authority of the European Central Bank. Consequently, the ACPR remains exclusively competent concerning the licensing and supervision of Monegasque credit institutions.

The ACPR carries out three supervisory missions in Monaco (granting of licences, prudential control and resolution) out of the five carried out in France. Indeed, the ACPR is not competent concerning the supervision of the fight against money laundering, which is supervised by a Monegasque-specific authority, the SICCFIN, or the protection of customers.

For the purposes of prudential supervision, the ACPR carries out ongoing control and on-site inspections of Monegasque credit institutions.

In the context of ongoing control, Monegasque credit institutions, as French credit institutions, are required to send their prudential and financial statements quarterly to the ACPR. In addition, regular exchanges and meetings are held between the ACPR and the key representatives of Monegasque credit institutions.

The ACPR may also proceed to on-site inspections in the premises of Monegasque credit institutions, under the same conditions as on-site inspections in the premises of French credit institutions. For such purposes, the agents of the French Central Bank, who are responsible for carrying out this type of control, may be assisted by the Monegasque authorities, if needed. Once an audit is finalised, the results are communicated to the Monegasque authorities by the ACPR.

The ACPR has the same powers of sanction over Monegasque credit institutions as over French credit institutions. Decisions taken by the ACPR in this respect are communicated to the Monegasque government, which will enforce them.

Monegasque credit institutions carrying out non-banking financial services regulated by Law No. 1.338 are also under the supervision of the CCAF, and are subject to on-site and off-site monitoring by the CCAF. In this context, Monegasque credit institutions are required, within six months after the closing of the accounting year, to communicate to the CCAF their annual report and their financial accounts, as certified by their Monaco statutory auditors. The annual report contains, in particular, a description of the measures that were put in place to comply with ethical rules of good conduct and prudential rules. The CCAF may pronounce administrative sanctions consisting of warnings, reprimands, a possible temporary suspension of an authorisation of up to six months, or the definitive withdrawal of the authorisation in certain limited cases.

ii Management of banks

Further to the provisions of Ordinance No. 3.021 and Ordinance No. 3.559, the mandatory rules concerning management of credit institutions established in Monaco are also provided by French legislation.

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As in France, credit institutions established in Monaco must comply with the provisions of the CRD IV,[4] as transposed into French legislation on 20 February 2014, and the CRR,[5] which have been included under Annex A of the Monetary Agreement.

As mentioned in Section II, Monegasque credit institutions take the form of either a local SAM or a branch of a foreign credit institution.

The executive body of Monegasque credit institutions incorporated under the legal form of a SAM is the board of directors, which must be composed of between two and eight members. Effective management must be ensured by at least two managing directors of the board of directors. The main missions of the directors are the management of the activities, risks and resources of Monegasque credit institutions.

Registered branches of foreign credit institutions must also have a local effective management composed of at least two managers. Those two managers must be empowered by a delegation of power from the board of directors (or equivalent executive body) of the foreign credit institution in order to have sufficient autonomy.

The board of directors, and other managers and compliance officers designated by the board of directors of the SAM (or, as regards branches of foreign credit institutions, the executive body of such credit institution) shall be composed of members whose knowledge, experience and expertise in the banking area are evidenced, both individually and collectively.

Monegasque credit institutions have the obligation to notify to the ACPR any change of the persons in charge of their effective management, and more broadly of their board of directors. The ACPR can use in this respect a right of opposition.

In addition, for credit institutions with a balance sheet of at least €5 billion, it is compulsory to constitute the three following committees: a risk committee, a nomination committee and a compensation committee.

Significant branches of credit institutions are exempted from constituting a nomination committee, but they must be able to prove that they constituted the two other committees or another body that achieves equivalent results.

iii Regulatory capital and liquidity

Since the CRD IV and the CRR are applicable in Monaco, credit institutions and branches established in Monaco must comply with the European standards in order to maintain their liquidity and solvency. In this context, credit institutions and branches are required to be permanently solvent.

In accordance with the provisions of the CMF, credit institutions in the form of a SAM must have a fully released initial capital of at least €5 million. The financial components included in the initial capital are the following:

a capital instruments;
b share premium accounts related to the instruments referred to in point (a) above;
c retained earnings;
d accumulated other comprehensive income; and
e other reserves.

4 EU Directive No. 2013/36 of 26 June 2013 on the access to the activity of credit institutions and the prudential supervision of credit institutions.

5 EU Regulation No. 575/2013 on Capital Requirements.

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Solvency ratios, capital buffers and liquidity ratios apply in the same manner as for French credit institutions.

Non-French foreign credit institutions are required to constitute in respect of their Monegasque branch a capital endowment of the same amount, and are subject to the same solvency ratio requirements.

Branches of non-French foreign credit institutions may benefit from a total or partial exemption from solvency and liquidity requirements. The exemption is granted by the ACPR, subject to the following conditions:

a the regulation and supervision of the country of the credit institution from which the branch is dependent take into account the risks assumed outside the branch in an equivalent manner to the provisions in force in Monaco;

b the credit institution from which the branch is dependent commits to ensure the supervision of operations of the branch in Monaco in accordance with the regulations in force in its country of incorporation and under the supervision of the competent authority in that country;

c the credit institution from which the branch is dependent confirms that it will ensure that the branch has sufficient funds in Monaco to cover its commitments, in particular to meet its short-term liquidity needs;

d the credit institution from which the branch depends undertakes to inform the ACPR of any relevant developments to verify that the conditions above are met on a permanent basis; and

e the competent authority of the country of the credit institution from which the branch is dependent:

- agrees to the requested exemption;
- confirms the regularity of the situation of the credit institution from which the branch depends; and
- undertakes to inform the ACPR of any significant change in the above conditions and to provide the ACPR, upon its request, with any information relating to the credit institution in question.

The ACPR will assess and supervise mechanisms, strategies and procedures implemented by foreign credit institutions.

iv Recovery and resolution

The Bank Recovery and Resolution Directive (BRRD),[6] which is listed under Annex A of the Monetary Agreement, applies to the Monegasque banking sector following its transposition into French legislation on 20 August 2015. Consequently, the ACPR has an exclusive power to launch and supervise the resolution procedure against a credit institution established in Monaco, and Regulation (EU) No. 806/2014 of 15 July 2014 establishing the Single Resolution Mechanism applies to credit institutions located in Monaco, as being also included under Annex A of the Monetary Agreement.

6 Directive No. 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive No. 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

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In this context, the ACPR has the following main missions:

a draft resolution plans;
b assess the capacity of credit institutions to be subject to resolution measures;
c make decisions that could reduce or suppress barriers to the implementation of resolution measures;
d assess the default of a credit institution; and
e implement resolution measures.

In this context, and in accordance with the provisions of the CMF, directors and effective managers must draft a preventive recovery plan providing measures to face the significant deterioration in the financial position of a credit institution. Such plan shall contain proceedings enabling the implementation of the planned recovery measures and for future actions to be taken by a credit institution in the event of a crisis.

The preventive recovery plan must be updated at least each year and after every substantial change within a credit institution. In addition, the ACPR can also suggest to any credit institution under its supervision a preventive recovery programme that must be implemented by the directors and effective managers if the credit institution presents a specific risk with regard to its financial stability. In cases of failure to meet this obligation, the ACPR can decide to replace them in order to ensure the recovery plan.

A credit institution is considered to be in default in the event the following situations arise:

a it no longer complies with the relevant equity capital requirements;
b it is not able to secure its payments;
c the value of its assets is less than the value of its liabilities; or
d it requires exceptional financial support from the public authorities.

If the resolution college of the ACPR considers that a credit institution is, or is likely to become, insolvent and that there is no alternative solution, the credit institution is subject to a resolution procedure. In this scenario, the resolution college of the ACPR would take control of the credit institution, and has the four following tools that could be used separately or in combination:

a a business divestiture through a transfer of shares, other title deeds, rights and obligations in the credit institution to a private purchaser;
b the separation of assets through the creation of an asset management structure, to which the poor-quality assets, rights and obligations of the credit institution that are intended to be sold or liquidated would be transferred;
c a bridging institution through which the shares and other deeds of property as well as the assets, rights and obligations of the credit institution are transferred to a bridging institution, which will continue their operation; and
d an internal bail-in instrument that allows for the absorption of losses through the recapitalisation of the credit institution thanks to the contributions of shareholders and creditors. First there is a phase of reduction of eligible commitments to such a measure to absorb the losses and reduce the net worth of the institution to zero. Then there is a conversion phase of eligible commitments to recapitalise the institution.

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In a case of the insolvency of a Monegasque credit institution, Article L 613-24 et seq of the CMF apply, however taking into account the specificities of the insolvency proceedings provided by Monegasque bankruptcy legislation, in particular as regards the exercise of the mandates of directors, liquidators and statutory auditors.

There is currently no precedent on the application of the resolution procedure as transposed in the CMF to a Monegasque credit institution. It appears that such an application would under the current state of the legislation raise numerous questions, since the Monegasque insolvency regime differs strongly from the French insolvency regime. A new exchange of letters to be entered into between France and Monaco is currently under negotiation to address those questions.

Finally, effective managers and directors of a Monegasque credit institution may be held responsible for the bankruptcy of the credit institution in the event of mismanagement or an improper continuation of operations leading to the insolvency, which will lead to civil liabilities (in which case the state of personal bankruptcy is pronounced by the Monegasque court) or criminal liabilities (in which case the state of crime of bankruptcy is pronounced by the Monegasque court).

Such effective managers and directors are subject to the ACPR's disciplinary powers, and severe penalties can be imposed on managers and directors of banks.

IV CONDUCT OF BUSINESS

There is no general Monegasque legislation governing the conducting of business of Monegasque credit institutions. In this respect, it should be noted that the ACPR is not competent to supervise the relationships between Monegasque credit institutions and their clients.

Monegasque credit institutions are, however, primarily branches or subsidiaries of foreign parent credit institutions, and may apply group codes of conducts implemented by such foreign credit institutions under their own legislation.

In the conduct of their business, Monegasque credit institutions may be exposed to civil, regulatory and criminal liabilities, and must comply with the banking secrecy rules.

i Civil liabilities

Monegasque credit institutions may be subject to civil liabilities in respect of a breach of their contractual relationships with their clients and a breach of their obligations towards their clients.

In particular, the case law of the courts of Monaco has defined several duties Monegasque credit institutions should comply with, and the breach of which should expose them to damages:

a a duty to provide information, advice and warnings to unadvised clients. The scope of this duty would depend on the knowledge and the experience of the client, his or her personal background, and the complexity of the banking transaction;

b a duty of care and prudence in connection with a client's orders; and

c a duty of non-interference in a client's business, which should not prevent Monegasque credit institutions from bringing information to the attention of the client as part of their duty to provide information, advice and warning.

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ii Regulatory liabilities

Monegasque credit institutions may be subject to sanctions and fines by the ACPR in respect of any breach of the French licensing and prudential legislation applicable to them.

In connection with any breach of the obligations provided by Law No. 1.362 of 3 August 2009, on anti-money laundering, as amended by Law No. 1.462 of 28 June 2018 (AML Law), Monegasque credit institutions may be subject to sanctions pronounced ultimately by the Minister of State, upon proposition and after instruction of a special commission, which may consist of:

a a warning;
b a reprimand;
c a prohibition on carrying out certain activities;
d the temporary or definitive withdrawal of a business authorisation, or a fine of up to €1 million, or both.[7]

iii Criminal liabilities

Monegasque credit institutions and their representatives may face various criminal liabilities in Monaco in the course of their activities, in particular in respect to the grant of usurious loans, breach of the banking secrecy rules (see below) and breach of their duties under the AML Law.

Furthermore, pursuant to Article 8 of the treaty on exchange control on 14 April 1945, any infringements of the French prudential legislation applicable to Monegasque credit institutions that constitute criminal sanctions pursuant to such legislation may be prosecuted before the French criminal courts.

iv Banking confidentiality

Monegasque credit institutions are subject to banking confidentiality. Ordinance No. 3.021 provides that credit institutions located in the territory of Monaco are subject to the provisions of Article L 511-33 of the CMF relating to banking secrecy, which should be read in combination with Article 308 of the Monegasque Criminal Code, which criminalises more generally any breach of legal professional secrecy. Pursuant to Article 308 of the Criminal Code, any breach of the banking secrecy provisions as defined by Article L 511-33 of the CMF may lead to criminal sentences of imprisonment of six months to one year, a fine ranging from €9,000 to €18,000, or both.

As an exception, credit institutions may transmit confidential information to fulfil legal obligations, in particular towards the ACPR and the French Central Bank in the context of prudential controls, towards the SICCFIN in the context of the fight against money laundering and to the judicial authorities upon their request in the context of criminal proceedings.

The principle of such communications when they relate to nominative data must be declared to CCIN, which is the local data protection authority in Monaco.

7 The members of the commission are designated by the Monegasque State Counsel, the Ministry of State of Monaco, and by the president of the court of first instance of Monaco.

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v Financial activities

Finally, credit institutions are subject to specific obligations provided for by Law No. 1.338 for the carrying out of financial activities. Pursuant to Law No. 1.338, Monegasque credit institutions must comply with general principles of good conduct, and must enquire about their client's financial situation and investment experience.

V FUNDING

Credit institutions established in Monaco are funded by the receipt of repayable funds from the public, or by the receipt of funds from the interbank market or from their foreign parent credit institutions. As of 31 December 2017, total assets deposited in Monegasque credit institutions amounted to €114 billion.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Pursuant to EU Directive No. 2007/44 of 5 September 2007 (which is included under Annex A of the Monetary Agreement), as transposed into the CMF, the ACPR receives all applications regarding the granting of a banking licence and all declarations from credit institutions concerning any change of control.

An direct or indirect acquisition or increase in a participation in a Monegasque credit institution is subject to a prior authorisation from the ACPR if one of the three following conditions is met:

a the participation of the acquirer in the Monegasque credit institution overcomes one-tenth, one-fifth, one-third or half of the share capital or the voting rights as a result of the acquisition;

b the credit institution becomes the subsidiary of the acquirer as a result of the acquisition; or

c the acquisition allows the acquirer to exercise a significant influence over the management of the credit institution.

All other transactions involving the share capital of Monegasque credit institutions must be declared for informational purposes to the ACPR. The ACPR will verify that the proposed transaction does not affect the conditions of the licence granted to the credit institution.

If an authorisation from the ACPR is required, the ACPR will evaluate the proposal made by the credit institution, in particular by verifying that the modification of the shareholding does not call into question the conditions of the authorisation issued to the credit institution. The ACPR also appreciates certain criteria regarding the quality of the proposed acquirer, including its reputation, experience and skills. The ACPR must decide within 60 days, which, if a request is made for additional information, may be suspended for up to 20 days.

ii Transfers of banking business

The sale of an ongoing business of a Monegasque credit institution is subject to the application of the rules of Monegasque civil and commercial law.

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Unless provided to the contrary in the relevant contractual documentation, transfer of ongoing business within the context of a merger or a split-off of a Monegasque credit institution would not require customer consent. The merger or split-off will have to be approved by the ACPR. If authorised, the merger or split-off will be published in the official legal gazette of Monaco allowing creditors to file an opposition.

VII THE YEAR IN REVIEW

The main event of the year impacting the Monegasque banking sector was the promulgation of the AML Law. Pursuant to the Monetary Agreement, the fight against money laundering is an area in which Monaco is required to harmonise its legislation with the EU legislation. As such, EU Directive No. 2015/849 was included under Annex B of the Monetary Agreement. The purpose of the AML Law was to achieve this harmonisation, and most of the provisions of the Directive are now reflected in the AML Law. There are, however, still some specificities in the Monegasque legislation that a foreign banking group must be aware of when implementing their compliance procedures at the level of their Monegasque branch or subsidiary.

Another major event in 2018 was the implementation of the General Data Protection (GDPR).[8] The GDPR is not applicable in Monaco *per se*. However, due to the extraterritorial scope of the GDPR, Monegasque credit institutions providing banking and financial services to EU residents may be subject to the GDPR. Monaco has its own law governing data protection, Law No. 1.165 of 23 December 1993, as amended by Law No. 1.353 of 4 December 2008, supplemented by Sovereign Order No. 2.230 of 19 June 2009. As a result of the implementation of the GDPR, such Monaco legislation should evolve in the near future to align itself with the GDPR.

Finally, Titles I and II of the DSPII, as transposed in the French CMF, are now directly applicable in Monaco as a result of their inclusion under Annex A of the Monetary Agreement on 14 September 2018.

VIII OUTLOOK AND CONCLUSIONS

The banking sector in Monaco is very stable, and the number of credit institutions present in the territory remains constant from year to year. At the same time, the amount of assets deposited in Monegasque financial institutions increases from year to year ,and Monegasque credit institutions have a good solvency ratio.

Monegasque credit institutions, despite being only slightly impacted by the 2008 crisis and enjoying great stability, seek to meet very carefully the prudential criteria provided by European and French law in accordance with the banking reform process, as envisaged by Europe.

In 2019, Monaco will be concerned with the implementation of the fifth AML Directive,[9] which must be completed by 10 January 2020.

8 EU Regulation No. 2016/679.

9 Directive No. 2018/843 of the European Parliament and of the Council of 30 May 2018.

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Chapter 25

NETHERLANDS

Mariken van Loopik and Maurits ter Haar[1]

I INTRODUCTION

The Netherlands has a long history as an open trading nation with household-name institutions such as ING Bank, cooperatively owned Rabobank and ABN AMRO operating worldwide. The Dutch banking sector is highly concentrated, with this same small group of systemically important banks accounting for the bulk of domestic lending to households and businesses. The lion's share of Dutch savings is held in accounts with these banks, which also handle most payment processing. Measured against the size of the Dutch economy, the banking sector is large. Although on a downward trend since pre-crisis years, in 2018, the size of its assets relative to the gross domestic product of the Netherlands still amounted to nearly 350 per cent.[2]

Dutch banks reported strong profits in 2018 as well as healthy risk-weighted and unweighted capital ratios. Banks profited from a still strongly performing Dutch economy, a booming housing market, and from the cost-cutting and digitalisation efforts of earlier years. In regulatory terms, banks continued to put considerable effort into the implementation of a number of important EU rules and regulations that entered into force in early 2018.[3] A major money laundering scandal and public indignation at ING Bank's proposed CEO pay package underscored banks' continued exposure to compliance and reputational risks. Other risks to the business models and operations of Dutch banks include political uncertainty, technological disruption and cybercrime.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i Basic structure of banking regulation

The Netherlands has a twin peaks supervision model, which focuses on system and prudential supervision on the one hand, and conduct of business supervision on the other. The European Central Bank (ECB) and the Dutch Central Bank (DCB) are the system and prudential supervisors. The responsibility for conduct of business supervision lies with the Netherlands Authority for the Financial Markets (AFM), the aim being to foster orderly and transparent

1 Mariken van Loopik is a partner and Maurits ter Haar is a senior associate at De Brauw Blackstone Westbroek.

2 DCB, Financial Stability Report Autumn 2018, October 2018.

3 Most importantly, the Markets in Financial Instruments Directive II (2014/65/EU) (MiFID II), the Regulation on Markets in Financial Instruments (600/2014) (MiFIR), the second Payment Services Directive (2015/2366) (PSD2), the Benchmarks Regulation (2016/1011) (BMR) and the Regulation on Packaged Retail Investment and Insurance-based Products (1286/2014) (PRIIPs).

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market processes, maintain integrity in the relationship between market parties and overseeing due care in the provision of services to customers. This cross-sectoral functional approach is reflected in the Dutch Financial Markets Supervision Act (FMSA), which has been in force since 2007. The FMSA and the various decrees and regulations deriving from it include the majority of regulatory rules that apply to the financial markets. Many of the rules contained in the FMSA follow the implementation of European directives.[4] However, with the aim of further integrating the single market, more and more regulatory requirements are adopted in the form of European regulations.[5] In view of the increasing complexity of the FMSA and difficulties in its compatibility with the sectoral approach of European legislation, in 2016 the first tentative steps were taken towards a thorough review of the design of the FMSA, although this is not expected to affect the substantive rules. During 2018, the review remained a work in progress at the Ministry of Finance, and it is not clear when further papers or proposals can be expected.

ii Regulation of banks with a registered office in the Netherlands

Banks established in the Netherlands are required to obtain a banking licence from the ECB. The DCB is responsible for the processing of licence applications. To obtain a banking licence, banks must, inter alia, comply with the following requirements:

a the day-to-day policymakers of a bank and its management team members must be suitable for the banking business;[6] in addition, the members of the supervisory board (or comparable body) should also be suitable for the performance of their supervisory tasks;

b the integrity of the persons determining or co-determining the day-to-day policy, the management team members and the members of the supervisory board (or comparable body) of the bank must be beyond doubt;

c the bank must have sound and prudent business operations, including procedures and measures for adequate risk management and client acceptance;

d at least two natural persons should determine the day-to-day policy of the bank and perform their activities from within the Netherlands;

e the supervisory board (or comparable body) should consist of at least three persons;

f the bank must have a transparent control structure safeguarding adequate supervision; and

g the bank must comply with certain financial safeguards, such as minimum own funds, solvency and liquidity requirements.

Once a licence has been granted, a bank must continue to comply with these requirements. Dispensation may be granted from certain specific requirements for obtaining a banking

4 Including CRD IV, MiFID II, PSD2, the Acquisitions Directive (2007/44/EC), the Consumer Credit Directive (2008/48/EC), the Electronic Money Directive (2009/110/EC) and the Mortgage Credit Directive (2014/17/EU) (MCD).

5 Including the CRR, MiFIR, the SSM Regulation, the SRM Regulation, the BMR, the PRIIPs, the European Market Infrastructure Regulation (648/2012), the Securities Financing Transactions Regulation (2015/2365), and various delegated acts and regulatory and implementing technical standards.

6 Since 2015, a bank's management team members (i.e., the bank's senior officers who work directly below the level of the day-to-day policymakers and who are responsible for those persons whose activities may have a material impact on the bank's risk profile) also need to be tested on their suitability and integrity. These tests are performed by the bank itself, with supplementary testing or checks, or both, by the DCB.

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licence provided the applicant demonstrates that he or she cannot reasonably comply with the requirements, and that the objectives the requirements seek to protect can be achieved through alternative means. To stimulate innovation in the financial sector, the DCB, since 2017, is also open, where appropriate, to more tailor-made solutions for innovative products, services or business models through its regulatory sandbox.[7]

In January 2019, the formal application period for a banking licence was changed from 13 weeks to 26 weeks.[8] This allows the DCB and the ECB to rely less on stop-the-clock information requests, and will give applicants a more realistic view of the required decision-making time. Other recent changes to the application process include the obligation to prepare an exit plan, which should identify how the applicant could cease its banking operations in an orderly manner when so required. In March 2018, the ECB published two guides detailing the process and requirements for acquiring a banking licence in the eurozone.[9] In January 2019, these guides were supplemented with more specific expectations regarding capital requirements and the programme of operations.[10]

If a bank wishes to render investment services or perform investment activities in the Netherlands, it must apply for a wider banking and investment firm licence. In this case, there are additional requirements that relate to the conduct of business requirements with which investment firms need to comply. A licensed bank does not need a separate licence for the provision of payment services or certain other financial services also regulated under the FMSA, such as the offering of (consumer) credit, providing advice about financial products (other than financial instruments) and acting as an intermediary with respect to such products. The services involved, however, need to be covered by the banking licence, and the bank involved is subject to additional conduct of business rules when offering such services (see Section IV).

Since 2016, the FMSA contains a separate regime for credit unions, defined as cooperatives of members sharing a certain profession or business that take repayable funds from their members and grant credits for their own account to their members for the purposes of their profession or business. For this reason, Dutch credit unions will be formally exempted from the regular rules of banking regulation in the forthcoming amendment of CRD IV and the CRR.[11]

iii Regulation of foreign banks and activities

In general, branches of foreign banks established to carry out regulated banking activities in the Netherlands are subject to the same licence requirements and ongoing obligations as banks with a registered office in the Netherlands. This means that these branches usually require a banking licence. However, foreign banks with their registered office in another EU or EEA Member State may conduct banking activities through a branch office or on a cross-border basis in the Netherlands using a European passport. On this basis, banks from other eurozone countries may conduct banking activities in the Netherlands under

7 DCB and AFM, 'More room for innovation in the financial sector, market access, authorisations and supervision', December 2016.

8 Financial Markets Amendment Act 2018.

9 ECB guide to the assessment of licence applications, March 2018; and ECB guide to the assessment of fintech credit institution licence applications, March 2018.

10 ECB guide to the assessment of licence applications, second revised edition, January 2019.

11 Directive 2013/36/EU and Regulation (EU) No. 575/2013, together also referred to as CRD IV.

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their ECB banking licence, provided the ECB has been notified thereof. Similarly, banks with their registered office in an EU or EEA Member State that is not a eurozone country may conduct banking activities in the Netherlands under their home Member State banking licence following a notification procedure in their home Member State. Those non-eurozone banks holding a European passport in the Netherlands are directly supervised by the ECB. The DCB remains responsible for the supervision of non-EEA banks that have established a branch or provide cross-border services in the Netherlands.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

As the prudential supervisor of the most significant Dutch banks,[12] the ECB has far-reaching investigatory and supervisory powers under the Single Supervisory Mechanism (SSM) Regulation.[13] In addition, the ECB has at its disposal the supervisory powers granted to the DCB under the FMSA. To the extent necessary to carry out the tasks conferred on it by the SSM Regulation, the ECB may require the DCB to use these powers.[14] The ECB is also exclusively responsible for the withdrawal of a banking licence of both significant and less significant Dutch banks. The DCB will in principle exercise its enforcement powers under the FMSA regarding the banks that are identified as less significant. Under the FMSA, the DCB is entitled to enter any place for inspection and may request information from any party. The DCB is also entitled to request business data and documents for inspection and to make copies of these. Everyone is obliged to fully cooperate with the DCB.

If the DCB concludes that a bank has violated a rule under the FMSA or, if applicable, a European regulation, it may take enforcement action. The DCB can choose from various enforcement measures and sanctions, including but not limited to:

a imposing a certain course of action to comply with the FMSA (instruction order);

b appointing one or more persons as trustee over all or certain bodies or representatives of a bank;

c imposing a particular duty, backed by a judicial penalty for non-compliance;

d imposing an administrative fine;

e publishing an imposed duty or fine on the DCB's website and by press release;

f imposing a suspension of voting rights of shareholders or partners responsible for a breach of a bank's licence or declaration of no objection requirement (see Section VI);

g imposing a temporary ban against a natural person who is held responsible for non-compliance with the CRR provisions from exercising his or her functions; and

h imposing certain measures including, but not limited to, higher solvency or liquidity requirements and the termination of banking business activities with a high risk to the solidity of the banks.

12 ING Bank, ABN AMRO, Rabobank, de Volksbank, Nederlandse Waterschapsbank (NWB Bank) and BNG Bank are currently identified as significant banks.

13 The ECB may request information, conduct general investigations and carry out on-site inspections (see Articles 10 to 13 SSM Regulation); specific supervisory powers include substantial powers of early intervention, and the right to impose fines and other administrative sanctions (see Articles 14 to 16 SSM Regulation).

14 Article 22 SSM Framework Regulation (ECB Regulation (EU) 468/2014).

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The liability of the DCB (and the AFM) under the FMSA is limited to wilful misconduct and gross negligence. In July 2018, rules entered into force to make financial sector supervision by the DCB (and the AFM) more transparent. The regulators were given greater powers to publish warnings and decisions in the event of infringements of the FMSA and to periodically publish overviews of key data of individual banks.[15]

ii Management of banks

Most Dutch banks are limited liability companies. Although a statutory basis exists for the creation of a one-tier board structure, limited liability companies in the Netherlands traditionally have a two-tier board structure composed of a managing board and a supervisory board. The managing board is responsible for carrying out the company's day-to-day affairs. As such, a bank's managing board is responsible for compliance with the FMSA. Rules on managing and supervisory boards and their members are set out in great detail in various EU, ECB and DCB guidelines, a number of which have recently been revised.[16] They contain guidance as regards, inter alia, integrity and suitability, sufficient time commitment, independence, supervisory board committees and their composition, and on the maximum number of executive and non-executive positions a board member may hold.

The managing and supervisory boards are jointly responsible for compliance (on a comply or explain basis) with the Dutch Corporate Governance Code (if applicable) and the Dutch Banking Code. Adherence to the former is mandatory for listed Dutch banks.[17] It includes principles that are held to be generally accepted, as well as detailed best practice provisions relating to both managing and supervisory boards, general meetings, the auditing process and the external auditor.[18] The Banking Code contains principles that are based on the Corporate Governance Code, but focuses on the managing and supervisory boards, risk management, auditing and remuneration policy of banks.[19] The Banking Code applies to all banks with a banking licence under the FMSA, and compliance is monitored by a special monitoring commission. The Dutch Banking Association recommends that the Banking Code be applied by all entities that operate in the Netherlands (irrespective of their country of incorporation), including banks operating under a European passport.

Restrictions on remuneration

A far-reaching Act on financial sector remuneration has been in force since 2015. One of the most important restrictions is the bonus cap, which holds that the variable remuneration of all persons working under the responsibility of banks with their registered office in the Netherlands, and Dutch branches of banks outside the EEA, may not exceed 20 per cent of the fixed component. Several exceptions apply, including for persons working predominantly in another country, or persons working for the EEA top holding of a group whose staff work

15 Act on Transparent Supervision Financial Markets.

16 This includes the DCB's 'policy rule suitability 2012', the ECB Guide to fit and proper assessments, the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under CRD IV and MiFID II, and the EBA Guidelines on internal governance.

17 Non-listed banks often voluntarily apply the Corporate Governance Code.

18 The previous Corporate Governance Code was applicable as of 1 January 2008. A revised Corporate Governance Code entered into force on 1 January 2017.

19 The original Banking Code was applicable as of 1 January 2010. A revised Banking Code entered into force on 1 January 2015.

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predominantly in another country, and, subject to approval by the DCB or the ECB, for retention bonuses. In such cases, the maximum variable remuneration is as set out in CRD IV: 100 per cent of the fixed component or, depending on the exception, 200 per cent subject to shareholder approval.

The Act also restricts severance payments. Moreover, the supervisory board may (and under certain circumstances must), inter alia, claw back bonuses where payment was based on incorrect information or the non-achievement of underlying objectives, and revise bonus payments if these were unacceptable according to standards of reasonableness and fairness. The rules also provide for a statutory ban on bonuses for management (and certain others) of state-aided banks. In March 2017, the DCB introduced a tweak to the bonus cap in that the international holding exemption would be available not only to Dutch global top holdings of financial groups but also to EEA top holdings, thus making the Netherlands more attractive for EEA top holdings of non-EEA financial groups.

An evaluation of the remuneration rules was completed in 2018. Following this evaluation, the Minister of Finance announced he would, in addition to the existing restrictions of variable pay discussed above, introduce a number of restrictions to fixed pay. Directors and employees in the financial sector who receive part of their fixed pay in shares or similar instruments whose value depends on the performance of the company will have to retain these for at least five years. Furthermore, financial undertakings will have to describe in their remuneration policy how the remuneration of its directors and employees is proportional to the firm's role in the financial sector and its position in society. Subject to advice from the Council of State, expected at the end of Q1 2019, the Minister of Finance is also considering the introduction of a claw back of fixed pay for directors of systemically relevant banks in cases of state aid. Finally, the exception from the bonus cap for persons falling outside the scope of collective labour agreements will be restricted. Another evaluation will be scheduled in five years.

In March 2018, opposition parties in Parliament proposed an act that would require the award of all fixed remuneration to directors of systemically relevant Dutch banks to be subject to *ex ante* approval by the Minister of Finance, who would have to assess whether it fits a sound, proper and sustainable remuneration policy, taking into account public support. The ECB has indicated that the act does not conflict with its own powers. However, the proposal was heavily criticised by the Council of State, and it is very uncertain that it will gather enough support be adopted.

iii Regulatory capital and liquidity

Rules of prudential supervision are provided for in the CRR and its various regulatory and implementing technical standards on a European level, and in the FMSA, the Decree on Prudential Supervision FMSA and regulations issued by the DCB on a national level. These rules relate to, inter alia, solvency (regulatory capital), liquidity and additional supervision with respect to financial conglomerates.

Solvency

Licensed banks are required to be sufficiently solvent. The Decree on Prudential Rules FMSA provides that a bank's solvency is sufficient if the bank complies with the requirements set out in Part 3 of the CRR. These requirements include both quantitative requirements (i.e., a Common Equity Tier 1 (CET1) capital ratio of 4.5 per cent of the bank's risk-weighted assets (RWA), a Tier 1 capital ratio of 6 per cent of a bank's RWA and a total capital ratio of 8 per

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cent of a bank's RWA) and qualitative requirements (conditions that own-fund items and subordinated liabilities must meet to qualify as CET1 capital, Additional Tier 1 capital or Tier 2 capital). The DCB or the ECB also impose an additional bank-specific Pillar 2 buffer following the supervisory review and evaluation process (SREP) when they identify risks not adequately covered by the standard capital requirements. In addition, since 2016 the DCB and the ECB also communicate their expectations for banks to hold additional own funds in the form of capital guidance. This practice has been included in the latest EBA SREP guidelines, and will be given a formal basis in the forthcoming amendments to CRD IV and the CRR. In November 2018, the ECB published guidance setting out its expectations of banks' internal capital adequacy assessment process.[20]

The DCB has issued a regulation on the specific provisions set out in CRD IV and the CRR (DCB CRD IV and CRR regulation). The DCB CRD IV and CRR regulation sets out how the DCB uses certain options and discretions that the CRR grants to competent national authorities, including a number of (transitional) provisions set out in the CRR, and implements the method for calculating the maximum distributable amount. In 2016, the ECB set out how it will use these options and discretions in relation to significant banks, and issued guidance on the exercise of those options and discretions by competent national authorities in relation to less significant banks.[21] The ECB also annually publishes a recommendation on dividend distribution policies, which should take into account capital demand due to future changes in the EU's legal, regulatory and accounting frameworks.[22]

Capital buffers

CRD IV prescribes four capital buffers:

a a capital conservation buffer equal to 2.5 per cent CET1 capital;

b an institution-specific countercyclical capital buffer of, in principle, between zero and 2.5 per cent CET1 capital;

c a global systemically important institutions (G-SII) buffer of, in principle, between 1 and 3.5 per cent CET1 capital; or another systemically important institutions (O-SII) buffer of a percentage, in principle, of between zero and 2 per cent CET1 capital; and

d as a Member State option, a systemic risk buffer of, in principle, between 1 and 3 per cent CET1 capital.

With regard to the G-SII, O-SII and systemic risk buffers, in principle only the highest of the three applies. In the Netherlands, the G-SII buffer only applies to ING Bank (1 per cent), and the O-SII buffer applies to ING Bank, Rabobank, ABN AMRO (each 2 per cent) and de Volksbank and BNG Bank (both 1 per cent). The government has chosen to apply a systemic risk buffer of 3 per cent to ING Bank, Rabobank and ABN AMRO. The DCB has kept the countercyclical capital buffer at zero per cent since its introduction in 2016. It continues to review the necessity of increasing this percentage on a quarterly basis. In 2019, the phase-in period of the capital buffers ended; they are now applicable in full.

20 ECB, Guide to the internal capital adequacy assessment process (ICAAP), November 2018.

21 ECB Regulation (EU) 2016/445 on the exercise of options and discretions available in Union law, November 2016, ECB recommendation on common specifications for the exercise of some options and discretions available in Union law by NCAs in relation to LSIs, and ECB guideline on the exercise of options and discretions in Union law by NCAs in relation to LSIs, November 2016.

22 ECB, 2019 recommendation on distribution policies, January 2019.

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Banks can be subject to a combination of buffers, referred to as the combined buffer requirement. When banks fail to meet the combined buffer requirement, specific restrictions apply and certain measures may be imposed, such as a limitation to make distributions or payments in connection with their CET1 and Additional Tier 1 instruments, and the required production of a capital conservation plan, including at least an estimate of income and expenditure and a forecast balance sheet, measures to increase the capital ratios, and a plan and time frame for increasing own funds with the objective of meeting the combined buffer requirement.

Liquidity

Banks must hold a sufficient amount of liquid assets.[23] Since 2018, the previous Dutch liquidity requirements and reporting rules have been fully replaced by the two liquidity requirements of the CRR: the liquidity coverage ratio (LCR) and stable funding requirements. The LCR, as further specified in the LCR delegated regulation, has a binding minimum of 100 per cent.[24]

For the stable funding requirement, only a general rule currently exists, requiring institutions to ensure that their long-term obligations are adequately met with a diversity of stable funding instruments under normal and stress conditions. A binding minimum standard for a net stable funding ratio (NSFR), as agreed upon by the Basel Committee, will be introduced in 2021, following the amendment of CRD IV and the CRR.

In addition to these requirements, the DCB normally also imposes bank-specific liquidity requirements as part of a bank's Pillar 2 requirement, such as regarding specific liquidity survival periods and diversification of sources of funding and liquidity, including through an NSFR proxy requirement. In November 2018, the ECB published a guide to the internal liquidity adequacy assessment process for significant banks.[25]

Leverage ratio

Banks are required to calculate their leverage ratios in accordance with the methodology set out in Part 7 of the CRR, report them to the relevant supervising authority and disclose them. In January 2016, the Basel Committee agreed upon a binding minimum leverage ratio of 3 per cent. This requirement is expected to be introduced in the EU in the second half of 2019 at the earliest, following the amendment of CRD IV and the CRR. The Basel Committee also agreed on an additional leverage ratio buffer requirement for G-SIIs. This buffer will also be included in the forthcoming amendment of CRD IV and the CRR. The Dutch government has argued for the extension of this buffer to O-SIIs. However, the current amendment of CRD IV and the CRR will only include an instruction to the Commission to carry out an appropriateness study for such extension.

Consolidated application of regulatory capital and liquidity requirements

The above-mentioned capital, liquidity and leverage requirements apply to banks on both an individual and consolidated basis. The DCB or ECB may, when certain criteria are met, waive the requirement to comply on an individual basis. The capital and leverage requirements apply on the basis of the consolidated situation of a bank's highest holding entity in each

23 Section 3:63 et seq. of the FMSA.

24 Regulation (EU) 2015/61.

25 ECB, Guide to the internal liquidity adequacy assessment process (ILAAP), November 2018.

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Member State and in the EU as a whole. The liquidity requirements must be met on the basis of the consolidated situation of the highest holding entity in the EU. In addition, the application of the capital requirements on a sub-consolidated basis applies in the case of subsidiary banks, investment firms and financial institutions in a third country.

Supplementary supervision of banks in a financial conglomerate

The Financial Conglomerates (FICO) Directive was implemented in the FMSA and the Decree on Prudential Supervision of Financial Groups FMSA.[26] The FICO Directive introduced the supplementary supervision of banking (insurance and investment) activities carried out in a financial conglomerate. The rules relate, inter alia, to supplementary capital adequacy requirements, risk concentration, intragroup transactions, internal control mechanisms and risk management processes. The holding company of a financial conglomerate must calculate the supplementary capital adequacy in accordance with certain methods described under the FMSA.

DCB policy rule in respect of EBA guidelines

In December 2017, the DCB issued an updated policy rule that lists which of the European supervisory authorities' guidelines it applies. This includes practically all guidelines issued by the EBA, including the Guidelines on internal governance, the Guidelines for the joint assessment of the elements covered by the SREP, and the Guidelines on sound remuneration policies.[27]

iv Recovery and resolution

Bank Recovery and Resolution Directive and Single Resolution Mechanism Regulation

The Dutch Act implementing the Bank Recovery and Resolution Directive (BRRD) entered into force in 2015, and the Single Resolution Mechanism Regulation became fully applicable in 2016.[28] These two legal acts, with the international agreement on the transfer and mutualisation of contributions to the Single Resolution Fund, provide a comprehensive European framework for the recovery and resolution of banks. The rules aim to ensure that:

a banks and authorities make adequate preparation for crises;
b supervisory authorities are equipped with the necessary tools to intervene at an early stage when a bank is in trouble;
c resolution authorities have the necessary tools to take effective action when bank failure cannot be avoided, including the power to bail-in creditors; and
d banks contribute to an *ex ante* funded resolution fund.

The DCB has been designated as the national resolution authority for the Netherlands. However, on the basis of the Single Resolution Mechanism (SRM), for significant banks and other cross-border groups in the eurozone, the Single Resolution Board (SRB) is the competent resolution authority in cooperation with the national resolution authorities. In a

26 Directive 2002/87/EC as amended by Directive 2011/89/EU.
27 DCB policy rule application guidelines, European supervisory authorities FMSA 2017.
28 Directive 2014/59EU and Regulation (EU) 806/2014.

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2017 communication, the DCB has set out a number of technical details on how it intends to use the bail-in tool.[29] For example, conversion of liabilities by bail-in will result in the creation of claim rights, which are transferable and entitles holders to new shares once issued.

During the course of 2018, the SRB and the DCB continued the process of drafting resolution plans for the major Dutch banks and of setting each bank's minimum requirement for own funds and eligible liabilities (MREL). In 2018, the SRB split its cycle in two waves: less complex banks will receive their first binding MREL target in Q1 2019, while for the most complex banks, new binding MREL targets will be set in Q3–Q4 2019 on both consolidated and individual levels, following the decision-making process in the resolution colleges. The SRB plans to set binding targets for all banking groups under its remit by 2020. MREL targets for complex banks are expected to average around 25 per cent of RWA.[30]

Meanwhile, the rules for the calibration and method of calculation of the MREL have already been subject to review. The EU Banking Reform Package, on which the EU institutions reached agreement in February 2019, will see a sweeping revision of the MREL requirements, in particular by aligning them with the international standard for total loss-absorbing capacity (TLAC), which was finalised by the Financial Stability Board in 2015.[31] Once these new rules are in force, the SRB and the DCB will adapt their policy accordingly.

Deposit insurance

The Dutch deposit insurance framework is based on the (third) Deposit Guarantee Scheme (DGS) Directive, which has been in force since 2015.[32] The framework comprises an *ex ante* funded guarantee scheme to which banks must contribute on a quarterly basis. The fund should reach a target level of 0.8 per cent of insured deposits. The guarantee covers natural persons and businesses, with the exception of financial undertakings and governments, for an amount up to €100,000. In July 2017, the DCB adopted a number of more detailed rules in relation to the Dutch DGS. Most importantly, the DCB introduced a new pay-out system in which banks must compile and deliver a uniform single customer view, containing an overview of customers' deposits and other relevant data. The new system will enable the DCB to meet the requirement of the DGS Directive that, by 2024, the payout of insured deposits must be made within seven business days of a bank's failure.[33] In August 2018, the Minister of Finance submitted a proposal to Parliament, supported by the Dutch banking sector, clarifying how banks can use customers' personal identification numbers in implementing their DGS obligations.[34] In February 2019, the DCB also implemented a number of tweaks to the detailed rules to further clarify the DGS framework.[35]

Progress on the European Commission's proposal for a European Deposit Insurance Scheme (EDIS), first circulated in 2015 to reinforce deposit protection by mutualising national deposit guarantee funds in the eurozone, continued to be slow in 2018. A number of Member States, including the Netherlands, insist that further risk reduction must precede

29 DCB, Operation of the bail-in tool, December 2017.

30 SRB, 2018 SRB policy for the first wave of resolution, November 2018, and SRB, 2018 SRB policy for the second wave of resolution, January 2019.

31 See e.g., Council Presidency progress report of 29 November 2017.

32 Directive 2014/49/EU.

33 DCB Policy Rule on the Single Customer View, July 2017.

34 Draft Act on the use of personal identification numbers in the DGS.

35 DCB first round of changes to DGS rules, February 2019.

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further risk sharing. In January 2019, the Eurogroup decided that EDIS discussions would move from a technical to a more political level by establishing a high-level working group that is due to report in June 2019.

Dutch Intervention Act

Ahead of the BRRD and the SRM Regulation, Dutch rules for bank recovery and resolution were introduced by the Dutch Intervention Act in 2012. Pursuant to this Act, the DCB had the power to take various measures in respect of banks if it perceived signs of dangerous developments regarding a bank's solvency or liquidity. These powers have largely been replaced by those following the implementation of the BRRD. The powers granted by the Act to the Minister of Finance to take immediate measures if he or she is of the view that the situation of a bank causes a serious and immediate danger to the stability of the financial system continue to apply. These include the temporary suspension of shareholder voting rights, the suspension of management or supervisory board members, and the expropriation of assets or liabilities of a bank or its parent companies with a corporate seat in the Netherlands.

IV CONDUCT OF BUSINESS

i Conduct of business rules

Conduct of business rules for banks are for the most part set forth in the FMSA. Compliance with many of these rules is supervised primarily by the DCB or the ECB when relating to governance, risk management, solvency and liquidity. Compliance with the remaining conduct of business rules, including those set out in the Decree on conduct of business supervision FMSA, is supervised by the AFM. These rules mostly relate to the activities of a bank as a financial services provider, a payment services provider or an investment firm (providing investment services or investment activities). This means that, in practice, a bank will be subject to conduct of business rules that are supervised by the AFM if it:

a provides investment services or performs investment activities (rules relating to, inter alia, client classification, the provision of information, know your customer requirements, conflicts of interest, best execution, inducements and customer order handling rules);

b offers or advises on mortgage or consumer credit or offers electronic money to consumers (requirements as to, inter alia, adequate measures to protect clients' rights, outsourcing and the availability of an internal complaints regulation); or

c provides payment services (requirements as to, inter alia, information obligations of the payment service provider towards its (potential) clients and the availability of an internal complaints regulation).

ii Consumer and mortgage credit

Under the FMSA, banks must comply with certain conduct of business rules when offering credit to consumers. Irrespective of the credit amount, additional requirements may apply to banks (and other entities) pursuant to both the Dutch Civil Code and the Act on Consumer Credit.[36] The additional rules stem mainly from the implementation of the Consumer Credit

36 The Netherlands has chosen to apply the provisions implementing the Consumer Credit Directive (2008/48/EC) to all credit agreements, including those with a value below €200 and above €75,000.

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Directive.[37] These rules relate to the civil law relationship between the bank and the consumer or borrower, and include requirements with respect to pre-contractual information, the form and contents of the credit agreement, and the consumer's right to rescind a credit agreement up to 14 calendar days after entering the agreement. Violation of the rules may lead to civil liability. When offering consumer credit, banks must also take into account the 2012 Code of Conduct for Consumer Credit as drawn up by the Dutch Banking Association.

The FMSA and the Civil Code contain specific rules in relation to retail mortgage loans, stemming mainly from the implementation of the Mortgage Credit Directive.[38] The rules concern, inter alia, creditworthiness assessments, information obligations and consumer rights in cases of early repayment and arrears and foreclosures. In 2017, the AFM provided further guidance on costs that may be imposed in the case of early repayment, requiring banks also to revisit calculations of mortgages provided since 2016.[39] In November 2018, the Minister of Finance also proposed to limit the costs banks can charge when customers want to change their interest rate during the fixed-interest period.[40]

iii Payment services

As a result of the implementation of the first Payment Services Directive (PSD1), payment service providers are subject to certain conduct of business requirements under both the FMSA and the Civil Code.[41] The rules in the Civil Code relate to the civil law relationship between a payment service provider and client, including:

a the payment service contract governing the execution of payment transactions;
b the amendment and termination of such a contract;
c the required consent of the payer regarding the execution of a payment transaction;
d the right of withdrawal;
e the maximum period to execute payment transactions; and
f costs and liability.

The AFM supervises compliance with all conduct of business rules, including those under the Civil Code. The Dutch Authority for Consumers and Markets (ACM) supervises competition issues relating to access to payment systems.

In December 2018, the act implementing the Payment Services Directive 2 (PSD2) was belatedly adopted by Parliament. PSD2 modernises the current rules on payment services by opening the EU payment market to payment initiation service providers, introducing new security requirements and enhancing consumer rights.[42] The act finally entered into force on 19 February 2019. In October 2018, the European Court of Justice clarified that a savings account from which payment and withdrawal transactions could only be made through

37 Directive 2008/48/EC.
38 Directive 2014/17/EU.
39 AFM, Guidance for the calculation of costs in case of early mortgage repayment, March 2017.
40 Draft Amendment Decree concerning the costs of changing interest rates of mortgage credit.
41 Directive 2007/64/EC.
42 Directive (EU) 2015/2366.

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a current account does not qualify as a payment account within the meaning of PSD1.[43] Meanwhile, the EBA has set up a working group to identify and resolve issues that have been raised with the use of application programming interfaces under PSD2.[44]

The rules implementing the Payment Accounts Directive, in force since 2016, contain requirements for banks and payment service providers on transparency and comparability of fees, and on the facilitation of access to, and switching between, payment accounts.[45]

iv Anti-money laundering and terrorist financing

Pursuant to the Dutch Prevention of Money Laundering and Terrorist Financing Act, licensed banks (and other financial institutions) are subject to a number of obligations so as to prevent money laundering and terrorist funding. Adequate client identification forms an important part of these obligations. Banks must identify clients with whom they intend to establish a continuing business relationship in the Netherlands, or with whom they enter into an incidental transaction, or a series of related transactions, worth €15,000 or more. If a bank suspects that a transaction is related to money laundering or terrorist financing, the Financial Intelligence Unit (FIU) of the Netherlands must be notified. The FIU is designated to receive information relating to suspicious transactions, to investigate and, if necessary, to report the transactions to the Public Prosecutor to initiate criminal proceedings. In July 2018, new anti-money laundering (AML) rules entered into force, belatedly implementing the Fourth Anti-Money Laundering Directive, which, with its accompanying regulation, had been adopted in 2015.[46] The new rules facilitate the work of FIUs in identifying and following suspicious transfers and in the exchange of information between FIUs, and establishes a coherent policy towards non-EU countries with deficient AML regimes. It also introduces a centralised register with information on all ultimate beneficiary owners (UBOs). This UBO register has not yet been established in the Netherlands, and a separate draft act was submitted to Parliament in April 2019.

Meanwhile, following a number of money laundering scandals across Europe in 2018, AML remains high on the agenda of both legislators and regulators. in May 2018, the Fifth Anti-Money Laundering Directive was adopted.[47] The Directive will extend the scope of the rules to virtual currencies and pre-paid cards, further enhance the role and powers of the national FIUs, and provide clearer rules on the nature of and access to UBO information. The Directive will also introduce a requirement to establish a centralised data retrieval portal through which authorities can get timely and automatic access to information on bank accounts. The Minister of Finance has already consulted on a draft act to establish such portal in June 2018.[48] A draft act for the implementation of the remainder of the Fifth Anti-Money Laundering Directive was published in December 2018.[49] In March 2019, the

43 Case C-191/17, *ING-DiBa Direktbank Austria*, 4 October 2018.

44 The working group on application programming interfaces under PSD2 (WG-API).

45 Directive 2014/92/EU.

46 Directive (EU) 2015/849 and Regulation (EU) 2015/847.

47 Directive (EU) 2018/843.

48 Draft Act data retrieval portal bank account information.

49 Draft Act implementing changes to the Fourth Anti-Money Laundering Directive.

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Council and the European Parliament agreed on a proposal to strengthen the powers of the EBA in enforcing AML rules.[50] Dutch banks are currently also exploring possibilities to cooperate in meeting their AML requirements.

v Bankers' oath, code of conduct and disciplinary measures

Dutch banks must ensure that all persons with an employment contract with them, or who otherwise carry out activities that are part of the operation of a banking business or its essential supporting business processes, take the bankers' oath. The bankers' oath is linked to the bankers' code of conduct and a set of disciplinary measures. A foundation established by the Dutch Banking Association supervises compliance with the code of conduct, and can impose disciplinary measures, including reprimands, fines and a temporary ban from carrying out a function in the banking sector. The foundation's disciplinary commission deals with an increasing number of cases and frequently hands out disciplinary measures, in many cases a reprimand or a temporary ban from working in the banking sector.

vi Banking secrecy

There is no specific legal provision on banking secrecy in the Netherlands. As a general principle, Dutch law requires banks to keep all client data confidential. This requirement has various sources of origin, including custom, general principles of contract law (i.e., reasonableness and fairness) and the obligation of due care, which stems in turn from the general banking conditions used by most banks in the Netherlands. Several exceptions to the banking secrecy requirement apply. The more general exception provides that a bank is authorised to disclose client data to third parties, including regulatory authorities or supervisors, if it is under a statutory obligation to do so (see Section III.i). Violation of banking secrecy may result in civil liability as a result of a breach of contract or, as the case may be, tort law. Obviously, and perhaps more importantly, violating bank secrecy may also lead to reputational damage.

V FUNDING

Dutch banks raise funds from different sources, including deposits (corporate and non-corporate), interbank transactions (including ECB transactions) and capital markets funding. In general, Dutch banks are more dependent on financing through the financial markets than other European banks. This is because they lend more than banks in other countries, which is due, inter alia, to above-average high mortgage loans. The relatively large financing deficit, in combination with a relatively large financial sector in the Netherlands, causes Dutch banks to be vulnerable to problems in the capital markets.[51] The gradual reduction of the loan-to-value limit and increasing competition on the mortgage market from non-banks is expected to reduce this vulnerability.[52]

Over the past few years, Dutch banks have increased their capital ratios up to the new requirements, largely by de-leveraging and de-risking their balance sheets and by retention of

50 COM(2018) 646 final.

51 The financing deficit or deposit funding gap is the gap between loans and deposits.

52 DCB, Financial Stability Report Autumn 2016, October 2016, and IMF, Netherlands Financial Sector Assessment Program, April 2017.

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profits. However, in recent years many Dutch banks have also launched successful issues of Additional Tier 1 instruments to meet the new leverage ratio and MREL requirements (see Section III.iv).

In December 2018, an amendment to the Dutch Bankruptcy Act entered into force, implementing the Directive regarding the ranking of unsecured debt instruments in the insolvency hierarchy.[53] This change, welcomed by many banks, allows banks to issue senior non-preferred or Tier 3 debt, ranking junior to senior debt, but senior to subordinate debt and capital instruments, to fulfil their MREL or TLAC requirement. A number of Dutch banks, including Rabobank and ABN AMRO, had already included the possibility of issuing senior non-preferred notes in their funding programmes.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Supervision of participations in banks

The Acquisitions Directive has been implemented in the FMSA.[54] Each person who holds, acquires or increases a qualifying holding in a bank with a corporate seat in the Netherlands requires a declaration of no objection (DNO) from the ECB.[55] The DCB is responsible for processing the DNO application. A qualifying holding is a direct or indirect holding of 10 per cent or more of the issued share capital of the bank, direct or indirect voting power, or a right to exercise equivalent control of 10 per cent or more within the bank. This definition is subject to certain aggregation principles: for instance, voting rights held through subsidiary companies or voting agreements are to be included.[56] Provided the integrity of the person holding the qualifying holding is beyond doubt, the DNO will be granted unless another ground for refusal applies. A DNO will be refused if:

a the integrity of the proposed acquirer or the persons who as a result of their qualifying holding can determine the day-to-day policy of the bank is not beyond doubt;

b the persons who, as a result of their qualifying holding will determine the day-to-day policy of the bank, are not fit;

c the financial soundness of the proposed acquirer, in particular in relation to the business activities of the bank, is not beyond doubt;

d the qualifying holding would constitute an impediment for the bank to comply with the prudential requirements to which it is subject;

e there are reasonable grounds to suspect that, in connection with the acquisition of the qualifying holding, money laundering or terrorist financing is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof; or

f the information provided by the proposed acquirer is incorrect or incomplete (e.g., in the event of a proposed participation of more than 50 per cent, the applicant must submit a detailed business plan with its application for a DNO).

53 Directive (EU) 2017/2399.

54 Directive 2007/44/EC.

55 Section 3:95 et seq. of the FMSA.

56 Section 1:1 juncto, Section 5:45 of the FMSA, pursuant to which the Dutch rules implementing the Transparency Directive (2004/109/EC) apply.

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Where the applicant for a DNO is a legal entity, the integrity of all its directors and other persons, if any, who can determine or co-determine the day-to-day policy of the applicant is tested. An additional DNO must be obtained for every subsequent increase as a result of which a threshold of 20, 33, 50 or 100 per cent is reached or passed. In 2016, the European supervisory authorities jointly issued guidelines with detailed further rules for assessing qualifying holdings in banks, including as regards the concepts of acting in concert and indirect acquisitions.

On the basis of Dutch law, the applicant can request a bandwidth DNO. As long as the qualifying holding remains within the range granted, no additional DNO needs to be obtained for any subsequent increase as a result of which a threshold is reached or passed; only a notification needs to be made. Until recently, the applicant could also request a group DNO, which extended to all companies within a group collectively, and meant no additional DNOs were required for transfers of qualifying holdings within a group. The ECB, however, does not apply the Dutch regime for a group DNO. If any control relating to a qualifying holding is exercised without having been granted a DNO or in violation of any conditions attached to a DNO, the resolution adopted will be liable for nullification.

Supervision of holdings by and restructuring of banks

In addition to the rules regarding holdings in banks, a bank with a corporate seat in the Netherlands must also obtain a DNO for:

a acquiring or increasing a qualifying holding in another bank, investment firm, insurance company or financial institution with a corporate seat outside the EU or the EEA, unless the balance sheet total of the bank or insurance company involved does not exceed 1 per cent of the consolidated balance sheet total of the acquiring or increasing bank;

b acquiring or increasing a qualifying holding where the target is not a bank, investment firm, insurance company or financial institution, if the total price paid for the holding amounts to 1 per cent or more of the consolidated balance sheet total of the bank;

c acquiring the whole, or a substantial part, of the assets and liabilities of another enterprise or institution, unless the total amount of the assets or liabilities to be taken over does not exceed 1 per cent of the existing consolidated own funds of the bank; or

d undertaking a financial or corporate restructuring of its own business.

For significant banks, the ECB is the competent authority in relation to the above-mentioned DNOs. For non-significant banks, the DCB remains competent.[57]

ii Transfers of banking business

Apart from the rules as set out under the FMSA (see Section VI.i and ii) and the competition rules,[58] there are no legal provisions in the Netherlands specifically aimed at prohibiting or limiting the transfer of a banking business either by Dutch or by foreign entities. The transfer of a banking business is subject to the general rules of Dutch civil and corporate

57 ECB letter SSM/2017/0140 of 31 March 2017.

58 These rules include that a proposed acquisition or merger of a bank that qualifies as a concentration under the Dutch or EU competition rules should be notified to and approved by the Dutch Authority for Consumers and Markets (ACM) or the European Commission prior to completion.

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law, including rules on legal mergers and divisions and on transfers of assets and liabilities. Although cooperation and cross-participation are permitted in the Netherlands, a merger into a single legal entity of a bank and an insurance company is prohibited.[59]

VII THE YEAR IN REVIEW

In quantitative terms, 2018 was a good year for Dutch banks, which reported solid profits and healthy balance sheets. However, a number of issues underscored a continuing lack of public trust in the financial sector. Public criticism and indignation at ING Bank's proposed CEO pay increase, which in response ING Bank had to withdraw, demonstrated that such trust – greatly damaged by the financial crisis – still needs time to be restored. It was further damaged by a scandal about the lax AML controls at ING Bank, which resulted in the departure of its CFO. There was also unrest in the top management layers of ABN AMRO, where the chair departed following criticism of her leadership style. Later in the year, managers issued public warnings of distrust and the lack of vision and strategic direction of the bank.

In terms of transactions, 2018 was another uneventful year. The Dutch state did not further sell down its stake in ABN AMRO, which was nationalised in 2008, and in which it continues to hold 56 per cent. It is speculated that the state will only sell down further after the finalisation of the new remuneration rules. The state also again decided that de Volksbank, nationalised in 2013, was not yet ready to be privatised. It will in particular require more time to further develop and implement its new shared value strategy, focusing on the interests of customers, shareholders and employees as well as taking responsibility for society. Danish Saxo Bank made a recommended offer for online broker BinckBank in December 2018, which is expected to close in Q3 2019. During 2018, two Dutch banks were listed on Euronext Amsterdam. Mid-size merchant bank NIBC listed in March 2018, which meant an exit, after more than 12 years, for investment fund JC Flowers. Much-hyped payment service provider Adyen, which had obtained a banking licence in 2017, listed in June 2018. The consortium of shareholders of care lease company and savings bank LeasePlan, led by private equity firm TDR Capital, called off its intended listing of LeasePlan for the foreseeable future.

Brexit planning led the Royal Bank of Scotland to hold on to the banking licence of its much-reduced Dutch operations. In December 2018, it applied at the Scottish court for approval to transfer European clients of its NatWest Markets business, one-third of the total, to its Dutch subsidiary. Owing to the stringent Dutch bonus cap, few other banks include the Netherlands in their Brexit strategies. However, a number of banks from the Asia-Pacific region have opted to move to the Netherlands: following an earlier move by Mitsubishi UFJ, the Commonwealth Bank of Australia and Japanese Norinchukin Bank announced the opening of licensed Dutch subsidiaries in late 2018. Amsterdam also attracted a large number of prominent trading venues and other trading specialists, including Tradeweb and Bloomberg, which both obtained a Dutch multilateral trading facility licence in January 2019. Due to Brexit, the ECB also required ING Bank to reverse an earlier decision to consolidate its trading activities in London.

As regards regulatory change, 2018 was marked by the final stages of the implementation efforts of major new EU rules, most importantly MiFID II but also the PRIIPS, the BMR and PSD2. The further implementation and elaboration of regulatory frameworks introduced in earlier years, in particular the BRRD and the DGS, also continued. On a national level, no

59 Section 3:36 of the FMSA.

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noteworthy rules were introduced, but the Minister of Finance continued to fine-tune and 'repair' existing provisions of the FMSA. With the ECB focusing heavily on risk management, the supervision of the DCB emphasised technological change, sustainability, and financial and economic crime. The DCB has in particular increased its focus on the risks of climate change, and in 2018 carried out its first climate change stress test.

VIII OUTLOOK AND CONCLUSIONS

Although forecasts indicate that economic growth has peaked and will slow down again, Dutch banks are in good shape and are still expected to do well in 2019. Banks' business models and operations will continue, however, to be vulnerable to a number of risks, including compliance risks, political uncertainty, technological disruption and cybercrime. The DCB has indicated supervision focus will again be on technological change, the transition towards sustainability, and financial and economic crime.[60] It will, inter alia, look to further embed climate change-related risks in its supervision. The focus of the AFM will be largely on the same themes.[61] The ECB will continue to focus on Brexit, as well as on a number of technical themes in the sphere of credit risk, risk management and readiness for market risk reforms.[62] Combating money laundering in particular will continue to feature high on the agenda of legislators and regulators alike, and banks will be expected to significantly step up their efforts to meet their requirements.

In terms of new regulatory requirements, banks' implementation efforts in 2019 and beyond will focus on the implementation of the EU Banking Reform Package, on which political agreement was reached by the EU institutions in February 2019. This is due to be followed by the implementation of the Basel standards agreed in December 2017, which is still a few years away. This will include the new capital floor based on standardised approaches, which will have a big impact on Dutch banks' capital requirements due to its treatment of mortgage-backed exposures. However, the long phase-in agreed by the Basel Committee will ease its impact. Finally, another significant effort in 2019 and thereafter will be the transition of financial contracts to risk-free rates. In the eurozone, a working group led by ING Bank is exploring possibilities for a smooth transition from the EONIA reference rate to the new European risk-free rate, ESTER. In parallel to the implementation of these last outstanding elements of regulatory reform, attention is also increasingly being given to the review and recalibration of existing rules, as legislators and regulators take stock of the effects of the rules that have fully overhauled banking regulation over the past decade.

60 DCB, Supervision Outlook 2019, November 2018.

61 AFM, Trend Monitor 2019, October 2018 and AFM, Agenda 2019, January 2019.

62 ECB, SSM Supervisory Priorities 2019, October 2018.

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Chapter 26

NEW ZEALAND

Guy Lethbridge and Debbie Booth[1]

I INTRODUCTION

The New Zealand banking environment is characterised by a high level of ownership by foreign banks. Of the 26 banks currently registered in New Zealand, 11 operate as branches of overseas-incorporated banks. Of the 15 New Zealand-incorporated banks, 10 are foreign-owned. Australian ownership is dominant, with the four major retail banks having the greatest market share (that is, the assets of each bank as a proportion of the total assets of the banking system) being ANZ Bank New Zealand Limited, ASB Bank Limited, Bank of New Zealand and Westpac New Zealand Limited, all operated by New Zealand subsidiaries of Australian banks.

II THE REGULATORY REGIME APPLICABLE TO BANKS

New Zealand has a twin peaks approach to the regulation of the financial system. The Reserve Bank of New Zealand has responsibility for prudential regulation of financial institutions (including banks). The Financial Markets Authority (FMA) has responsibility for the regulation of financial products (including securities and derivatives issued by financial institutions regulated by the Reserve Bank). NZX Limited operates the principal securities exchange in New Zealand, and regulates issuers and securities listed on its markets.

In New Zealand, banks are regulated in the following ways:

a if an entity wishes to use the words bank, banker and banking in its name, title or (in some situations) advertisements, the entity must be registered by the Reserve Bank under the Reserve Bank of New Zealand Act 1989 (RBNZ Act) and will be subject to ongoing prudential supervision by the Reserve Bank. Importantly, an entity is not required to be registered solely because it carries on banking activities; and

b a bank will be regulated in relation to the activities that it undertakes and the services that it provides. The provision of particular services may be subject to specific regulation, particularly where services are provided to consumers. For example, issuing financial products (including securities and derivatives), providing financial adviser services to retail investors and providing credit to consumers are all subject to prescriptive regulatory regimes. The activities carried on by banks also make them subject to more general laws, such as anti-money laundering laws and laws countering the financing of terrorism, privacy laws and general fair trading laws.

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The Reserve Bank does not register and supervise banks for the purpose of depositor protection. The registration and prudential supervision powers are conferred on the Reserve Bank under the RBNZ Act for the purposes of promoting the maintenance of a sound and efficient financial system and avoiding significant damage to the financial system that could result from the failure of a registered bank. Accordingly, when considering an application for registration, the Reserve Bank is concerned that only financial institutions of appropriate standing and repute, and that will be able to comply with the prudential requirements imposed on them, are able to become registered banks. In particular, the RBNZ Act requires the Reserve Bank to have regard to:

a the incorporation and ownership structure of the applicant;
b the size and nature of the applicant's business or proposed business, or any part of the applicant's business or proposed business;
c the ability of the applicant to carry on its business or proposed business in a prudent manner;
d the standing of the applicant in the financial markets;
e the suitability of the directors and senior managers of the applicant for their respective positions;
f the standing of the owner of the applicant in the financial markets; and
g any other matters that may be prescribed in regulations.

If the application is by an overseas person or a subsidiary of an overseas person, the RBNZ Act also requires the Reserve Bank to have regard to:

a the law and regulatory requirements of the applicant's home jurisdiction that relate to:
- the disclosure by the applicant of financial and other information of the kind that a registered bank must disclose under the RBNZ Act;
- the accounting and auditing standards applicable to the applicant;
- the duties and powers of the directors of the applicant;
- the licensing, registration, authorisation and supervision of the applicant; and
- in the case of an application from an overseas person only, the recognition and priorities of claims of creditors or classes of creditors in the event of the insolvency of the applicant; and

b the nature and extent of the financial and other information disclosed to the public by the applicant.

Registered banks currently operate in New Zealand as New Zealand-incorporated companies (often as subsidiaries of non-New Zealand banks or, in the case of The Co-operative Bank Limited, as a New Zealand-incorporated cooperative company) and as branches of non-New Zealand banks. Although the Reserve Bank must have regard to the ownership and incorporation structure of an applicant for registration, the Reserve Bank does not ordinarily prescribe the legal form that the bank must take. Rather, the Reserve Bank is concerned with ensuring that the owners are incentivised to monitor the bank's activities closely, and to influence its behaviour in a way that will maintain or improve the bank's soundness, but that still retains sufficient separation between the board and its owners to ensure that, where the interests of the bank and its owners diverge, the directors of the bank act in the best interests of the bank.

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In certain circumstances, however, the Reserve Bank will require a bank to operate through a New Zealand-incorporated company rather than a branch of an overseas bank. Those circumstances are where a bank is systemically important to New Zealand's economy, where the bank is proposing to take retail deposits in New Zealand and there is depositor protection in the bank's home jurisdiction, or where the Reserve Bank considers that the disclosure or supervisory requirements in the bank's home jurisdiction are inadequate.

The Reserve Bank itself is a statutory corporation, and it performs a number of roles in the New Zealand financial system in addition to the registration and prudential supervision of banks. The Reserve Bank:

a formulates and implements monetary policy (this is its primary statutory purpose);
b operates as the central bank of New Zealand and issues New Zealand currency;
c has oversight of certain payment and settlement systems;
d is the prudential regulator of non-bank deposit takers under the Non-Bank Deposit Takers Act 2013, including responsibility for granting licences to non-bank deposit takers;
e has an increasing role in the prudential regulation of licensed insurers under the Insurance (Prudential Supervision) Act 2010;
f is responsible for supervising banks, life insurers and non-bank deposit takers under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009; and
g operates high-value payment and settlement and clearing systems.

As part of its prudential function, the Reserve Bank has a number of macro-prudential tools at its disposal to manage the system-wide risks that can develop during boom–bust financial cycles. These tools include the ability to require banks to hold additional buffer regulatory capital and to limit high loan-to-value residential (LVR) mortgage lending. Various restrictions on high LVR lending have been imposed since 2013. LVR restrictions were relaxed in 2018, and further relaxed from 1 January 2019.

The Reserve Bank maintains relationships with other banking and financial system regulators, particularly in Australia. The Trans-Tasman Council on Banking Supervision (TTC), comprising representatives of the Australian and New Zealand Treasuries, the Reserve Banks of Australia and New Zealand and the Australian Prudential Regulation Authority (APRA), supports the development of a single trans-Tasman economic market in banking services. In particular, the TTC is mandated to develop and promote measures that enhance trans-Tasman policy harmonisation, mutual recognition, information sharing and cooperation. The TTC's work resulted in legislation in New Zealand and Australia requiring the Reserve Bank and APRA, when exercising their prudential regulation powers, to support each other in meeting their statutory responsibilities relating to prudential regulation and financial system stability and, where reasonably practicable, to avoid actions likely to have a detrimental effect on the financial system stability of the other country. The TTC members are signatories to a memorandum of cooperation setting out high-level principles that they will have regard to when dealing with trans-Tasman banking groups facing financial distress.

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III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The Reserve Bank's approach to bank supervision is based on three pillars: self-discipline, market discipline and regulatory discipline.[2]

The self-discipline pillar involves the Reserve Bank creating incentives for banks to maintain the systems and capacity to identify, measure, monitor and control their risks and maintain prudent operations. This is achieved by:

a requiring high-quality, regular and timely financial public disclosure by banks in the form of disclosure statements;

b requiring directors to sign attestations in their bank's public disclosure statements;

c not creating an impression that the Reserve Bank (rather than the banks themselves) has primary responsibility for the prudent management of banking risks; and

d the Reserve Bank avoiding explicit or implicit government support for banks.

The market discipline pillar attempts to use market forces to reinforce the incentives for the prudent management of banks. This second pillar is based on the premise that an efficient and well-informed market will reward well-run banks, for example through lower funding costs and better access to funding. This is principally achieved by the Reserve Bank maintaining a contestable and competitive banking system, and ensuring the market is well informed about a bank's financial performance and condition.

The regulatory discipline pillar involves the Reserve Bank using regulatory and supervisory tools to reinforce incentives for banks to manage their risks prudently. The Reserve Bank has deliberately sought to keep its regulatory interventions to a minimum.

The Reserve Bank monitors all banks on an ongoing basis. Monitoring occurs principally through banks' twice-yearly disclosure statements. The RBNZ Act provides the Reserve Bank with extensive powers to obtain additional information, to have that information audited if required and to have a bank's affairs investigated.

The Reserve Bank meets with the boards of directors of the larger banks on a regular basis. The Reserve Bank does not conduct on-site examinations of banks in its capacity as the prudential regulator of banks.

ii Management of banks

When considering an application for registration as a bank, the Reserve Bank will consider the suitability for their positions of the directors and senior managers of the bank. This policy applies in the case of locally incorporated applicants, to existing or proposed directors, the existing or proposed chief executive officer (CEO) and existing or proposed executives who report directly to the CEO; and, in the case of overseas-incorporated applicants, to existing directors and the existing or proposed chief executive of the New Zealand operations.

If a proposed director or senior manager has already passed a foreign banking regulator's suitability assessment, the Reserve Bank will usually accept that assessment as evidence of suitability.

2 Geof Mortlock, 'New Zealand's financial sector regulation' (2003) 66(4) Reserve Bank of New Zealand, p. 5.

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A locally incorporated bank will be required to maintain adequate separation between the bank and its owners. This will require:

a putting in place policies to monitor and limit exposures to related parties;

b the company having a constitution that does not permit the directors to act in the interests of its holding company;

c the size and composition of the board being such that it does not give rise to concerns about the bank's ability to pursue its own interests when those interests conflict with those of its shareholders; and

d the bank having an audit committee (or other committee whose mandate includes audit matters) comprising non-executive and otherwise independent directors.

The Reserve Bank generally will require a locally incorporated bank to have at least five directors. The majority of the directors must be non-executive, and at least half are required to be independent. At least half of the independent directors must be ordinarily resident in New Zealand. The chairperson must also be independent. The Reserve Bank's criteria for a director to be independent are set out in the Reserve Bank's Corporate Governance (BS14) document.

The Reserve Bank must be supplied with a copy of the curriculum vitae of any potential director, CEO or executive who reports to the CEO of a locally incorporated bank, and the appointment of such a director, CEO or executive can only be made if the Reserve Bank has advised that it has no objection to the appointment.

Directors of banks (and the New Zealand CEO of an overseas bank) are required to sign bank disclosure statements (published twice yearly), which include certain attestations by the directors. Attestations include that the directors believe, after due enquiry by them, that:

a the bank has systems in place to monitor and adequately control the banking group's material risks, including credit risk, concentration of credit risk, interest rate risk, currency risk, equity risk, liquidity risk and other business risks, and that those systems are being properly applied;

b exposures to connected persons have not been contrary to the interests of the banking group (this applies to locally incorporated banks only); and

c the bank has been complying with its conditions of registration.

In the full-year disclosure statement, a bank must also disclose the following (and address any changes to the composition of the bank's board in the half-year disclosure statement):

a details of each director (including name, occupation, technical or professional qualifications, whether he or she is executive or independent, other directorships and any details of transactions that could materially influence a director in carrying out his or her duties); this information must also be disclosed in respect of the New Zealand CEO of an overseas bank;

b whether there is a board audit committee (locally incorporated banks are required to have an audit committee or other committee that considers audit matters), and certain details of that committee; and

c the board's policy for avoiding or handling conflicts of interest that may arise from directors' personal, professional or business interests.

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In addition to the disclosure statements that are published twice-yearly by banks, the Reserve Bank publishes selected financial information for New Zealand banks side by side on what is known as the Dashboard. The Dashboard is updated quarterly with financial information that banks privately report to the Reserve Bank. The Dashboard approach aims to enhance market discipline by aggregating financial information in an accessible format that facilitates side-by-side comparison of banks based on key metrics.

Banks whose New Zealand liabilities, net of amounts due to related parties, exceed NZ$10 billion, will also be subject to outsourcing conditions of registration:

a The bank must comply with the Reserve Bank's Outsourcing Policy (BS11). The Outsourcing Policy requires the bank to have the legal and practical ability to control and execute outsourced functions. The policy is intended to minimise the impact of the failure of a large bank, or a service provider to a large bank, on the wider economy, and to preserve the available options if there is a large bank failure. The current version of the policy was issued in 2017, and affected banks have a transition period of five years to be fully compliant with the Outsourcing Policy.

b The bank must ensure that:

- the business and affairs of the bank are managed by, or are under the direction or supervision of, the board of the bank;
- the employment contract of the CEO or person in an equivalent position with the bank and the terms and conditions of the employment contract are determined by the board of the bank, and any decisions relating to the employment or termination of employment of that person are made by the board of the bank; and
- all staff employed by the bank have their remuneration determined by the board or the CEO of the bank, and are accountable (directly or indirectly) to the CEO of the bank.

No restrictions have been imposed by the Reserve Bank on bonus payments to management and employees of banks.

iii Regulatory capital and liquidity

A bank's capital requirements must be calculated under one of two approaches available under the Reserve Bank's capital adequacy framework. The first is the standardised approach and is set out in the Reserve Bank's Capital Adequacy Framework (Standardised Approach) (BS2A). This approach uses external credit assessments produced by approved credit rating agencies and is the default approach. The second permits a bank that has been accredited by the Reserve Bank to use its internal models to measure the risks of the bank's business and is set out in Capital Adequacy Framework (Internal Models Approach) (BS2B). The Reserve Bank's capital adequacy framework aligns with the Basel III global standards in almost all areas, but some departures were made to reflect New Zealand's circumstances: for example, the Reserve Bank did not support the introduction of a leverage ratio for New Zealand banks, relying instead on its liquidity policy (which is discussed below).

The Reserve Bank implemented the Basel III capital requirements in stages. Transitional relief for regulatory instruments that no longer meet the applicable criteria for recognition as Tier 1 or Tier 2 capital was removed on 1 January 2018.

A bank must have a capital policy. The capital policy must take into account any constraints on the bank's access to further capital, for instance if required in relation to an

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increase in business or an unexpected loss. In addition, a bank must satisfy the Reserve Bank that it has the capacity to implement and manage an internal capital adequacy assessment process that meets the Reserve Bank's Guidelines on a Bank's Internal Capital Adequacy Assessment Process (BS12).

A branch of a bank incorporated overseas will have to demonstrate to the Reserve Bank that the global bank complies with adequate capital standards that are at least broadly comparable with those in New Zealand, and that it is subject to adequate supervision by the bank's home supervisor.

Minimum levels of capital must be held on both a solo and group basis. Capital is divided into Common Equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital, consistent with Basel III. Locally incorporated banks generally need to comply with the following capital requirements:

a the total capital ratio of the banking group is at least 8 per cent;
b the Tier 1 capital ratio of the banking group is at least 6 per cent;
c the Common Equity Tier 1 capital ratio is at least 4.5 per cent; and
d the capital of the banking group is at least NZ$30 million.

Since 1 January 2014, most locally incorporated banks have been required to maintain a conservation buffer of 2.5 per cent above the minimum ratios or face restrictions on distributions. The Reserve Bank has the discretion to apply a countercyclical buffer of common equity of between zero and 2.5 per cent, although there is no formal upper limit. The purpose of the buffer is to protect the financial system during the downturns that follow periods of excessive credit growth. If a bank does not maintain its capital ratios above the buffer, the bank's ability to make distributions will be restricted.

Capital ratios are calculated by reference to risk-weighted on-balance and off-balance sheet credit exposures, a capital charge for market risk exposures and a capital requirement for operational risk. Locally incorporated banks must obtain a notice of non-objection before treating a capital instrument as regulatory capital, and must receive approval for certain repayments of instruments.

The Reserve Bank has been undertaking a review of the capital requirements for locally incorporated banks since 2017. In the most recent phase of the review, the Reserve Bank proposed a substantial increase to locally incorporated banks' capital requirements. The review is expected to conclude in 2019, and if any changes are implemented, the Reserve Bank has indicated that they will be phased in over a five-year transition period.

Banks must also comply with the Reserve Bank's Liquidity Policy (BS13). The Liquidity Policy requires banks to meet a minimum core-funding ratio of 75 per cent, ensuring that a greater proportion of bank funding is met through retail deposits and term wholesale funding. This has led to increased competition among banks and non-bank deposit takers for retail deposits. Basel III proposes a leverage ratio, which the Reserve Bank considers very similar to the intent of BS13. The Reserve Bank considers, however, that certain aspects of the new leverage standards are not suitable for adoption in New Zealand: for example, the requirement that government securities comprise the bulk of high-quality liquid assets held by banks is not suitable because New Zealand does not have a sufficient volume of government debt on issue.

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iv Recovery and resolution

The Reserve Bank's Open Bank Resolution (OBR) Pre-positioning Requirements Policy (BS17) applies to locally incorporated banks holding retail deposits in excess of NZ$1 billion (although other registered banks may opt in). The OBR is a tool for responding to a bank failure, allowing the bank to be open for full-scale or limited business on the next business day after being placed under statutory management. It is intended to provide an immediate and practical tool for responding to a bank failure and to reduce the moral hazard associated with implicit government support of banks (those that are too big to fail).

The OBR policy places the cost of a failure in the first instance on shareholders, but also provides flexibility to assign losses to creditors without causing unnecessary disruption to the banking system and wider economy. If a statutory manager is appointed to a bank, the bank must close, and all accounts must be frozen to enable the bank's net asset deficiency to be determined. A haircut reflecting the bank's net asset deficiency plus a buffer is applied to all creditors' accounts, and funds equal to the amount of the haircut are frozen. The non-frozen funds are guaranteed by the government, and the bank is able to reopen for core transactions business. On the following day, haircuts are applied to other non-time sensitive liabilities to enable those liabilities also to be partially satisfied. If sufficient funds become available, the frozen funds can be released during the course of the statutory management.

Banks subject to the OBR policy must pre-position for OBR; this means having IT, payments, resource and process functionality in place ahead of a crisis so that, if a statutory manager is appointed, access channels can be closed, funds can be frozen and access channels can be reopened for business by no later than 9am the next business day.

IV CONDUCT OF BUSINESS

The rules governing New Zealand banks' conduct of business are found in a range of statutes. These include the following:

a the Financial Markets Conduct Act 2013: this Act regulates how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade in them. The Financial Markets Conduct Act regulates registered banks in the following ways:

- fair dealing: the Act sets out core standards of behaviour that those operating in the financial markets must comply with. It imposes fair dealing requirements on persons acting in trade in relation to financial products and financial services by prohibiting misleading or deceptive conduct, and prohibiting false, misleading or unsubstantiated representations about certain matters relating to financial products and financial services or in connection with dealings in, or the supply or promotion of, those products or services;
- disclosure of offers of financial products: the Act replaced the previous requirement for issuers to prepare a prospectus and investment statement with a requirement to prepare a product disclosure statement and a register entry tailored to retail investors for regulated offers. There are a number of exclusions from offers being regulated offers that are available to registered banks, including for certain simple debt products. The disclosure regime also expressly applies to certain offers of derivatives;

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- licensing of market services: the Act requires providers of certain market services to be licensed. Any person acting as a derivatives issuer in respect of a regulated offer of derivatives must apply for a licence from the FMA;
- financial reporting: the Act sets out financial reporting requirements, including for registered banks, which include keeping proper accounting records and lodging audited financial statements on a public register; and
- financial advisers: as discussed below in relation to the Financial Advisers Act, the regulation of financial advice and financial advisers will be brought under the Act when the Financial Services Legislation Amendment Act 2019 comes into full effect on or before 1 May 2021.

b the Credit Contracts and Consumer Finance Act 2003: this Act principally regulates the provision of credit products to consumers. It prescribes a disclosure regime and regulates specific aspects of consumer credit products, such as prohibiting the charging of unreasonable credit fees. It also requires lenders to comply with responsible lending principles in relation to their consumer lending;

c the Financial Advisers Act 2008: this Act regulates financial advisers and brokers. The existing regime requires registration and authorisation of financial advisers and brokers (there are different levels of authorisation depending on the types of products advised on and the types of services provided), and imposes disclosure and conduct obligations. However, the Financial Services Legislation Amendment Act 2019 will reform this regime when it comes into full effect on or before 1 May 2021. The Amendment Act will repeal the Financial Advisers Act and replace it with a new regulatory regime, incorporated into the Financial Markets Conduct Act 2013. Under the new regime, financial advice providers (being any person carrying on a business of giving financial advice) will be required to be licensed by the FMA to give advice to retail clients. Any person giving financial advice on behalf of a financial advice provider will need to be either engaged (employed or otherwise) by a financial advice provider or registered as a financial adviser under the Financial Services Providers (Registration Disputes Resolution) Act 2008. The Amendment Act also imposes conduct and competence requirements for all those giving advice (both firms and individuals);

d Financial Service Providers (Registration and Dispute Resolution) Act 2008: this Act creates a register of entities that provide financial services. New Zealand banks are required to register as financial service providers and be members of an approved dispute resolution scheme in respect of services provided to retail customers. The Financial Services Legislation Amendment Act 2019 also amends this Act. The amendments to this Act are intended to prevent misuse of the register of financial service providers by offshore entities that have little or no connection to New Zealand;

e the Anti-Money Laundering and Countering Financing of Terrorism Act 2009: this Act places obligations on reporting entities (including financial institutions) to detect and deter money laundering and the financing of terrorism. Under this regime, reporting entities (including registered banks) must:

- assess the money-laundering and terrorism-financing risks they may reasonably expect to face;
- implement a compliance programme to detect, manage and mitigate those risks;
- carry out appropriate customer due diligence;
- report suspicious activities; and
- maintain robust record keeping.

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The compliance of banks, life insurers and non-bank deposit takers under the regime is supervised by the Reserve Bank. The key tools used by the Reserve Bank to monitor compliance are on-site inspections, desk-based reviews and thematic surveys;

f the Privacy Act 1993: this Act regulates the collection, retention, use and disclosure of personal information relating to individuals; and

g the Fair Trading Act 1986: this Act prohibits misleading or deceptive conduct in trade. Conduct in trade includes the marketing and sale of any financial products or services. New provisions effectively prohibiting the inclusion of unfair contract terms in standard form contracts came into force in March 2015.

With the exception of the Privacy Act (which sets out a complaints procedure), each of these statutes includes a comprehensive enforcement regime. In most cases, if a bank is in breach of the relevant act, both the bank and its directors (and often others) are subject to both civil and criminal liability provisions. In addition to the statutory rules, registered banks are subject to certain common law rules, such as the banker's duty of confidentiality (which, unlike the Privacy Act, is not limited to individuals).

Registered banks have the opportunity for self-regulation through membership of the New Zealand Bankers' Association (NZBA). The NZBA is a forum for member banks to work together on a cooperative basis. One of the NZBA's key contributions to self-regulation of the New Zealand banking industry has been its development of the Code of Banking Practice, which sets out minimum standards of good banking practices for member banks. Membership is open to any New Zealand-registered bank. Currently, 17 banks are members of the NZBA.

Banks may also elect to participate in the Banking Ombudsman scheme, which is a free and independent dispute resolution service established to assist people in resolving complaints made against participating banks. The Banking Ombudsman is an approved dispute resolution scheme for the purposes of the Financial Service Providers Act.

The primary purpose of the Banking Ombudsman is to review and recommend ways to resolve disputes that remain unresolved after consideration by a participating bank's internal complaints procedures. Where appropriate, the Banking Ombudsman may also refer complaints to other organisations, such as the Insurance and Savings Ombudsman, the Privacy Commissioner or the Human Rights Commissioner.

V FUNDING

Banks typically fund their activities through retail term deposits and the offshore wholesale markets.

The RBNZ Act includes a formal regulatory framework to support the issuance of covered bonds by New Zealand banks. Under this regime, banks may only issue covered bonds under a covered bond programme that has been registered with the Reserve Bank. A programme can only be registered if it meets certain requirements, including that the cover pool assets are held by a special purpose vehicle that meets the specified requirements; a cover pool monitor has been appointed to monitor the programme; and the programme documentation meets certain requirements (e.g., administrative requirements in relation to the cover pool assets and testing to ensure sufficient assets are held in the cover pool).

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The RBNZ Act covered bond framework addresses previous legal uncertainty associated with the effect on the covered bond guarantor and the cover pool assets if a statutory manager is appointed to a bank. The framework also provides greater transparency of covered bond issuance and minimum standards of monitoring.

The Reserve Bank also limits the amount of covered bonds a bank may issue via the bank's conditions of registration. The Reserve Bank considers a limit to be necessary to balance the benefits of covered bond issuance against the potential adverse impact on unsecured creditors. The limit is currently set at 10 per cent of a bank's total assets.

The amount of funding that can be provided by Australian-owned parents of banks is restricted by APS 222. APS 222 is a prudential standard issued by the Australian banking regulator that aims to ensure that Australian banks are not exposed to excessive risk as a result of their associations and dealings with related entities, such as their New Zealand-incorporated subsidiaries. APS 222 requires each Australian bank to monitor contagion risk between itself and other members of its group to adhere to prudential limits on intra-group exposure.

In New Zealand, the Reserve Bank is consulting on a new residential mortgage obligations (RMO) framework. The implementation of a new RMO standard will standardise the use of mortgage bonds as collateral and is ultimately intended to replace the current residential mortgage-backed securities framework.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The Reserve Bank does not seek to regulate the owners of registered banks other than, in the course of considering an application for registration, having regard to the ownership structure of the applicant and the standing of the applicant's owners in the financial markets.

As discussed in Section II, the Reserve Bank is concerned with ensuring that the ownership structure of an applicant incentivises the owners of the bank to monitor the bank's activities closely, and to influence its behaviour in a way that will maintain or improve the bank's soundness while retaining sufficient separation between the board and its owners to ensure that, where the interests of the bank and its owners diverge, the directors of the bank act in the best interests of the bank.

The Reserve Bank considers that the standing of the applicant's owner is likely to have a significant impact on the standing of the applicant itself. Accordingly, an applicant for registration must provide the Reserve Bank with an outline of the parent company's main activities and areas of expertise, including a list of the jurisdictions in which it is operating, a list of the major shareholders of the parent company and financial accounts for the parent company for the previous three years. The Reserve Bank will also seek the views of the regulator of the parent company in its home jurisdiction where relevant.

The prior written consent of the Reserve Bank is required if a person acquires or increases a significant influence in a registered bank other than a registered bank that is incorporated outside New Zealand or, if an unincorporated body, that has its head office or principal place of business outside New Zealand. A significant influence is:

a the ability to directly or indirectly appoint 25 per cent or more of the board of directors (or other persons exercising powers of management, however described) of the registered bank; or

b a direct or indirect qualifying interest in 10 per cent or more of the voting securities issued or allotted by the registered bank (the definition of qualifying interest is broad,

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and includes persons having legal or beneficial ownership of the voting securities, as well as lesser or indirect interests such as powers to exercise or control the exercise of voting rights attached to the security, or powers to acquire, dispose of or control the acquisition or disposal of the securities, in each case whether directly or by virtue of any trust, agreement, arrangement or understanding).

When considering an application for consent to an acquisition of or increase to a significant influence in a registered bank, the Reserve Bank will have regard to the same matters as when considering the ownership structure of an applicant and the standing of an applicant's owners in the financial markets in relation to an application for registration.

In addition, if the person acquiring or increasing the significant influence is an overseas person, the consent of the Overseas Investment Office (as delegated by the relevant ministers) may be required under the Overseas Investment Act 2005. To obtain consent under that Act, an applicant must demonstrate that he or she has relevant business experience and acumen, that he or she has a financial commitment to the registered bank, and that the persons controlling the applicant are of good character and are not persons of the kind who are not eligible for exemptions or permits under the Immigration Act 2009.

New Zealand's competition laws may also restrict changes of ownership of a registered bank.

In relation to New Zealand incorporated banks, the Companies Act 1993 requires certain approvals to be obtained and procedures to be followed if a company (including a bank) provides financial assistance for the purpose of or in connection with the acquisition of shares issued by that company. If a bank provided credit support such as a guarantee or security in connection with acquisition finance obtained by a person acquiring or increasing a significant influence in that bank, that credit support would need to be approved as financial assistance.

ii Transfers of banking business

There are limited ways under New Zealand law in which a registered bank can transfer all or part of its business (including deposits and loan arrangements) to another entity without the consent of the affected customers.

The Companies Act 1993 allows the court, on the application of a company or any shareholder or creditor of a company, to order that a scheme of arrangement be binding on the company and other persons specified in an order (e.g., customers). However, prior to making the final order, the court may make orders requiring meetings of affected persons such as creditors (which would include depositors) to be held for the purpose of obtaining the approval of those persons to the scheme of arrangement. Accordingly, while the consent of each customer may not be required, a certain level of approval of the affected persons would likely be required.

Although unlikely to occur frequently, legislation can be used to transfer or vest all or part of the business of an entity to or in another entity. This process was used in 2006 and 2011 to vest significant parts of the business of a registered bank operating in New Zealand as a branch of an offshore bank in a New Zealand-incorporated subsidiary of that bank. In both cases, the legislation was a private act of Parliament (that is, initiated by a person other than a member of Parliament).

The Reserve Bank has also identified that significant acquisitions, investments or business combinations by locally incorporated New Zealand banks have the potential to pose

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risks to the soundness of the financial system. Accordingly, in December 2011 the Reserve Bank imposed an additional condition of registration on locally incorporated banks relating to significant acquisitions. The condition applies to acquisitions or business combinations for which either the total consideration is equal to or greater than 15 per cent of the banking group's Tier 1 capital, or the value of the assets acquired is equal to or greater than 15 per cent of the total assets of banking group. The condition requires banks to notify the Reserve Bank of an intended acquisition or business combination before giving effect to it and, depending on the size of the acquisition, either waiting for a period of 10 working days to elapse during which the Reserve Bank can object to the transaction or (in the case of larger transactions) obtaining a notice of non-objection to the transaction from the Reserve Bank.

The rationale for having a notice of non-objection as opposed to other alternatives outlined by the bank (i.e., prior approval or prior notification) is that the directors of the bank would retain responsibility for the decision on the acquisition, but that the Reserve Bank would have a tool to assess whether there are any risks to the soundness of the financial system that need to be considered.

VII THE YEAR IN REVIEW

According to its most recent Financial Stability Report, the Reserve Bank considers that New Zealand's financial system remains sound and is operating effectively.[3] The banking system is well-capitalised, funding and liquidity buffers are above the required minimums, and reliance on offshore funding has reduced.

The Reserve Bank has identified two key risks facing the financial system: continuing high levels of indebtedness in the dairy sector, and exposure to volatility in international funding markets. Vulnerabilities in the housing market (particularly in Auckland) have improved as house prices and credit growth slowed over the past year. This has reduced perceived housing lending risk, and this sentiment is reflected in the further-relaxed LVR requirements from 1 January 2019.

The Reserve Bank's review of capital requirements has been underway since May 2017, and is expected to be concluded this year. Four consultation papers have been released, and consultation has finished on the first three. These papers address the capital adequacy framework for locally incorporated banks, and review what financial instruments should qualify as bank capital, how risk-weighted assets should be calculated and whether the current capital requirements are adequate.

The Reserve Bank expects to redraft the relevant sections of the Banking Handbook in consultation with key stakeholders in 2019.

In November 2018, the FMA and Reserve Bank completed their joint review into the conduct and culture of New Zealand's retail banking services. Although conduct and culture issues were not found to be widespread, the report concludes that the overall standard of banks' approaches to identifying, managing and dealing with conduct risk needs to improve markedly. Weaknesses in the governance of conduct risks and gaps in the measurement and reporting of customer outcomes leave New Zealand banks vulnerable to the misconduct issues experienced in other jurisdictions. Each of the 11 banks under review was required to respond to the feedback and recommendations of the FMA and Reserve Bank by the

3 Reserve Bank of New Zealand, 'Financial Stability Report', November 2018, p. 2.

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end of March 2019. Those responses were required to include a plan for implementing the recommendations. The FMA and Reserve Bank will review those responses, then monitor the progress of each bank to implement its plan on an ongoing basis.

VIII OUTLOOK AND CONCLUSIONS

Following the 2017 election, the new coalition government committed to a two-phase review and reform of the RBNZ Act. Phase 1 focused on the Reserve Bank's monetary policy roles, and culminated in the enactment of the Reserve Bank of New Zealand (Monetary Policy) Amendment Act 2018, which came into force in April 2019. The changes made by the Phase 1 Act require the Reserve Bank to act in a way that achieves productivity and maximum sustainable employment when formulating and implementing monetary policy in addition to the current objectives of achieving and maintaining price stability.

Previously, responsibility for the formulation and implementation of monetary policy rested with the Governor of the Reserve Bank. The Phase 1 Act also provided for the formation of a Monetary Policy Committee (MPC) to formulate monetary policy in accordance with a remit issued by the Minister of Finance. The members of the MPC are the Governor, Deputy Governor, two members of the Reserve Bank's staff and three external members appointed by the Minister. The Reserve Bank retains operational independence to implement monetary policy.

Phase 2 will comprehensively consider the Reserve Bank's financial policy activities, and will be organised around nine key topics:

a the overarching objectives, scope, coverage and coherence of the legislation: considering whether the Act provides clear and appropriate objectives for the Reserve Bank;

b institutional governance and decision-making: reviewing the Reserve Bank's accountability to the board, the Minister and Parliament, and whether this ought to change;

c Trans-Tasman coordination: exploring ways in which policy could be coordinated with the Australian regulatory agencies;

d prudential regulation: undertaking a comprehensive assessment of prudential regulation measures currently available to the Reserve Bank, and whether these functions ought to be separated from the Reserve Bank's other activities;

e supervision and enforcement: considering the International Monetary Fund's Financial Sector Assessment Programme recommendations and their application to the current supervisory model, alongside an analysis of the risks climate change poses to financial stability;

f resolution and crisis management: reviewing the current framework to ensure it can respond to institution-specific or systemic stresses adequately;

g macroprudential policy: reviewing the policy underlying the use of macroprudential tools available to the Reserve Bank;

h resourcing and funding: reviewing the funding model for the Reserve Bank, and considering whether some activities ought to be funded through industry levies; and

i miscellaneous issues: updating the legislation by repealing obsolete sections and clarifying unclear sections.

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The first stage of consultation for Phase 2 closed in January 2019. Two further consultation stages are planned for 2019. It is expected that the legislative changes can be advanced by 2020, within the current parliamentary term.

The Financial Markets (Derivatives Margin and Benchmarking) Amendment Bill, which is currently before Parliament, responds to developments in international financial markets and intends to remove New Zealand legal impediments to compliance with foreign margin requirements for over-the-counter derivatives; and establish a new licensing regime for administrators of financial benchmarks under the Financial Markets Conduct Act 2013.

The Bill is expected to be passed by Parliament by the end of 2019.

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Chapter 27

NIGERIA

Ibrahim Hassan, Oluwatobi Pearce, Basirat Raheem and Ezomime Onimiya[1]

I INTRODUCTION

As is the case with the banking industry of most countries, the Nigerian banking industry is highly regulated. This is no wonder, as it plays a key role in the economic growth of the country, and its regulation is fundamental considering the systemic risks associated with the failure of banks. In its role as the Nigerian apex bank and primary regulator of the banking sector, the Central Bank of Nigeria (CBN) has over the years implemented various reforms and policies aimed at developing the industry into one that is reliable and capable of driving efficiency in economic activities. Notable among these reforms is the 2004 Bank Consolidation and Recapitalisation,[2] which saw 25 banks emerge from the then-existing 89 legacy banks. As at April 2019, there are 26 licensed banks in Nigeria (excluding microfinance banks, mortgage banks, specialised banks and other entites licensed by the CBN), comprising 20 commercial banks, five merchant banks and one non-interest bank.[3]

Furthermore, the government has provided support to the banking sector through the establishment of the Asset Management Corporation of Nigeria (AMCON),[4] which has as its core objective the acquisition of non-performing loans of Nigerian banks, thereby providing the required liquidity and restoring confidence in the banking sector. AMCON has over the years acquired the assets of failing (and failed) banks; and recently, through a bridge bank (Polaris Bank Limited), it acquired the assets and certain liabilities (including deposit liabilities) of Skye Bank Plc, whose licence was revoked in September 2018 by the CBN.[5]

A notable trend in the Nigerian finance sector is an increase in the issuance of commercial papers by large corporations in Nigeria as a source of financing (as against obtaining bank loans). The Monetary Policy Committee of the CBN has continued to encourage this development as part of strategies to boost credit creation and economic growth. While this trend has impacted the volume of loan portfolios of Nigerian banks, the need for long and medium-term credit facilities to finance various projects and working capital needs has ensured the continued relevance of bank loans as a form of financing.

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1 Ibrahim Hassan, Oluwatobi Pearce, Basirat Raheem and Ezomime Onimiya are associates at Banwo & Ighodalo.

2 Under the recapitalisation exercise, the CBN increased the minimum capital base requirement for commercial banks to 25 billion naira.

3 https://www.cbn.gov.ng/Supervision/finstitutions.asp.

4 AMCON was established in 2010 pursuant to the Asset Management Corporation of Nigeria Act, 2010.

5 Further context on this is provided in Section VII.

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The following banks are the five largest banks in Nigeria by their market capitalisation on the Nigerian Stock Exchange (NSE):

a Access Bank Plc;
b Ecobank Transnational Incorporated;[6]
c Fidelity Bank Plc;
d Guaranty Trust Bank Plc; and
e Sterling Bank Plc.[7]

Separately, we understand that the merger between Access Bank Plc and Diamond Bank Plc has created the largest bank in Nigeria by customer size and retail network.[8]

II THE REGULATORY REGIME APPLICABLE TO BANKS

The Bank and Other Financial Institutions Act[9] (BOFIA) is the principal enactment that sets out the regulatory framework for banking activities in Nigeria.[10] It provides for the regulatory and supervisory powers of the CBN over Nigerian banks, including the issuance and revocation of banking licences, the opening and closing of bank branches, restructuring and reorganisation of banks, as well as the operation of foreign banks in Nigeria. Under Nigerian law, no entity shall undertake any banking business[11] in Nigeria unless it is duly incorporated in Nigeria and holds a banking licence issued by the CBN.

In October 2010, the CBN changed the Nigerian banking model from a universal banking model, which hitherto allowed licensed banks to engage in non-core banking financial activities, to a core-banking model.[12] Under the current banking model, the CBN restricts banking business to commercial banks, merchant banks and specialised banks, and the activities of such licensed banks are restricted to core-banking business.[13] Accordingly, save as expressly permitted under the BOFIA, a licensed bank cannot hold direct or indirect interests (whether or not as subsidiaries) in enterprises undertaking non-core banking business such as

6 This is a non-Nigerian holding company of a number of banks across Africa, including Ecobank Nigeria Limited (which itself is not listed on the NSE).

7 http://www.nse.com.ng/market_data-site/Pages/Indices.aspx.

8 Note 47 of Access Bank Plc's consolidated and separated financial statements for the year ended 31 December 2018.

9 Cap B3, Laws of the Federation of Nigeria (LFN), 2004.

10 Other relevant enactments include the Central Bank of Nigeria (Establishment) Act 2007; the Nigerian Deposit Insurance Corporation Act; and the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act.

11 Section 66 of BOFIA defines banking business as follows: 'The business of receiving deposits or current account, savings account or other similar account, paying or collecting cheque drawn by or paid in by customers? provision of finance or such other business as the Governor may, by order published in the Gazette, designate a banking business'.

12 The CBN repealed the Universal Banking Guideline, 2000 and issued new rules and guidelines for banking licences entitled the Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010.

13 Such as receiving deposits on current accounts, savings accounts or other similar accounts, paying or collecting cheques drawn by or paid in by customers, advancing loans, issuing letters of credit and bank guarantees, and the general provision of finance.

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capital markets activities. Promoters of banks who wish to undertake such non-core banking financial services typically adopt a non-operating financial holding company structure, and non-core banking businesses are undertaken by subsidiaries of the holding company.

The holder of a commercial banking licence has the authority to, inter alia:

a take deposits;
b maintain current and saving accounts;
c provide finance and credit facilities, retail banking, treasury management, custodial, and financial advisory (incidental to commercial banking services) services; and
d deal in foreign exchange.

A merchant banking licence permits, inter alia:

a the taking of deposits (not below 100 million naira per tranche[14]);
b providing finance and credit facilities;
c dealing in foreign exchange;
d acting as an issuing house or otherwise arranging issuance of securities; and
e providing custodial, underwriting and treasury management services.

Specialised banks include non-interest banks, microfinance banks, development banks and mortgage banks.

Foreign financial institutions are able to provide offshore credit facilities to entities in Nigeria on a 'reach in' basis without the need to obtain a banking licence from the CBN. However, where a foreign bank wishes to establish a physical presence in Nigeria and provide credit facilities in Nigeria, the bank will be required to incorporate a limited liability company in Nigeria and obtain a banking licence.[15] Foreign banks may also apply to the CBN for a licence to open and operate a representative office (typically licensed to only interact and meet with potential clients, and to conduct research activities) in Nigeria.

Furthermore, the BOFIA provides that any Nigerian bank intending to undertake offshore banking business must obtain a licence from the CBN and comply with the CBN's guidelines in that regard. Pursuant to the CBN Circular to all Banks on Offshore Expansion,[16] any Nigerian bank wanting to open an offshore subsidiary must, inter alia, have been in sound financial condition (in terms of liquidity, capital adequacy, etc.) for at least the past 12 months, and must have operated profitably for the past two years, as reflected in the audited financial statements of such applying bank. The Nigerian bank is also required, as part of the application process, to give details of how the operation of the offshore subsidiary would be monitored from Nigeria.

14 Or such other minimum amount as the CBN may prescribe from time to time.

15 Currently, four of the licensed commercial banks in Nigeria are owned or operated by foreign or international bank groups: Citibank Nigeria Limited, Ecobank Nigeria Limited, Stanbic IBTC Bank Plc, and Standard Chartered Bank Limited. The South African group, FirstRand Bank Limited, also owns one of the merchant banks in Nigeria, Rand Merchant Bank Limited.

16 Dated 7 October 2008.

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Other than the CBN, which is the primary regulator with the core objectives of ensuring monetary and price stability and promoting a sound financial system in Nigeria, the following statutory bodies also exercise regulatory oversight on Nigerian banks:

a the Nigeria Deposit Insurance Corporation (NDIC)[17] has regulatory oversight over deposit money banks/commercial banks (DMBs), and is responsible for insuring all deposit liabilities of licensed commercial banks and providing assistance to insured institutions in the interest of depositors in cases of financial difficulties;

b the Corporate Affairs Commission[18] is responsible for the incorporation of all corporate entities in Nigeria, including banks and other financial institutions;

c the Financial Reporting Council of Nigeria is responsible for developing and enforcing compliance with accounting, auditing, corporate governance and financial reporting standards by public interest entities, including banks and other financial institutions;

d the Securities and Exchange Commission (SEC)[19] regulates capital market activities and public companies in Nigeria. While a licensed bank will not in the ordinary course of its banking activities fall within the regulatory purview of the SEC, where such a bank is a public company or its affiliate undertakes capital market activities, the bank or the relevant affiliate will fall within the purview of the SEC; and

e the NSE regulates companies, including banks, that are listed on the NSE.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

While some countries have separated their financial regulators along the lines of licensing, prudential regulation and consumer protection, in Nigeria all roles are primarily performed by the CBN. In February 2011, the CBN released its Supervisory Intervention Framework for the Nigerian Banking Sector (Supervisory Framework 2011), which was designed to complement the CBN's Prudential Guidelines for Deposit Money Banks in Nigeria 2010 (DMB Prudential Guidelines). It reflects the fact that CBN has adopted a risk-based supervisory approach.

The risk-based supervisory approach is a continuous process of updating risk assessments through on-site and off-site examinations of financial institutions to create an early warning system so the CBN can anticipate and deal with emerging issues. This approach results in the CBN producing a composite risk rating for financial institutions. Under the Supervisory Framework 2011, financial institutions will be awarded one of the following risk scores:

a 1: for institutions with low risk profiles;

b 2: for institutions with moderate risk profiles;

c 3: for institutions with above average risk profiles; and

d 4: for institutions with high risk profiles.

17 Established pursuant to the Nigeria Deposit Insurance Corporation Act 2006.

18 Established pursuant to the Companies and Allied Matters Act Cap C20, Laws of the Federation of Nigeria, 2004.

19 Investments and Securities Act.

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Prudential supervisory function

Pursuant to Section 13 of the BOFIA, the CBN has the power to establish and enforce capital ratios and prudential standards over all deposit-taking financial institutions operating in Nigeria. The CBN's website sets out all the prudential guidance notes currently in force.[20] The DMB Prudential Guidelines comply significantly with the Basel II framework, but adjust certain sections of the framework to better reflect the distinctive features of the Nigerian economy.

The CBN mandates all banks licensed to carry out banking business[21] in Nigeria to perform an annual internal capital adequacy assessment process and forward copies of their reports to the CBN no later than four months after the end of the year.[22] Failure to comply with this obligation puts a bank at risk of having its banking licence revoked.[23]

Furthermore, the CBN's Framework for the Regulation and Supervision of Domestic Systemically Important Banks 2014 (D-SIB Framework) mandates that banks classified as systemically important banks[24] maintain a minimum capital ratio of 15 per cent and set aside an additional surcharge of 1 per cent of their respective minimum required capital adequacy ratio (CAR).[25] Failure to maintain the CAR stipulated by the CBN constitutes a ground for the revocation of a bank's banking licence.[26]

The NDIC

The NDIC also supports the CBN by implementing the CBN's banking policy. The NDIC, through its off-site surveillance, ensures compliance with the CBN's prudential standards and guidelines.[27] Off-site surveillance is carried out by the NDIC's insurance and surveillance department. This consists of analysing the returns from licensed banks and other deposit-taking financial institution, on a periodic basis to ascertain their compliance with prudential regulations. The analysis culminates with a report on the condition and performance of the bank in question, with recommendations for corrective action in weak areas.

Consequences of a licensed deposit-taking financial institution's failure

Where the financial position of a DMB becomes precarious, the NDIC may, after consulting with the CBN, take over management of the bank in order to salvage the operations of the

20 www.cbn.gov.ng.

21 See footnote 11.

22 CBN Circular to all Banks and Discount Houses on the Implementation of Basel II/III in Nigeria, reference number BDS/DIR/CIR/GEN/LAB/06/053, dated 10 December 2013.

23 Section 12 of the CBN Act.

24 The CBN has classified First Bank of Nigeria, Guaranty Trust Bank, Untied Bank for Africa, Access Bank, Polaris Bank and Ecobank Nigeria as systemically important banks.

25 Section 6 of the D-SIB Framework.

26 Section 14 of the BOFIA.

27 The NDIC also performs on-site surveillance with the CBN's banking supervision department for DMBs, and the CBN's other financial institutions department in respect of microfinance banks and primary mortgage banks. The equivalent departments in the NDIC are the bank examination department, which deals with DMBs, and the special insured institutions department, which carries out on-site surveillance on microfinance banks and primary mortgage banks.

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bank by the creation of a bridge bank.[28] In this regard, the NDIC is empowered to, inter alia, take over the management of the failing bank until its financial position is substantially improved; acquire, manage and dispose of the failing bank's impaired assets either directly or through an asset management company; and incorporate a bridge bank[29] to assume the deposits, assets and liabilities of the failing bank, as the NDIC may determine.

Where the restructuring of the bank proves unsuccessful, the NDIC Act establishes a legal regime for the winding up of a failed bank. Further details are set out in subsection iv.

ii Management of banks

Corporate governance requirements for banks

The corporate governance requirements for banks in Nigeria are laid out in the 2014 CBN Code of Corporate Governance for Banks and Discount Houses (Code).[30] The Code is designed to align and update corporate governance in the Nigerian banking industry with international best practices. Compliance with the Code is mandatory for all banks in Nigeria, and they are required to render returns on the status of compliance to the CBN at the end of every quarter.

In this regard, the Code provides that the size of the board of directors (board) of any bank shall be a minimum of five members and a maximum of 20 members; and the board of a bank is required to be composed of more non-executive directors than executive directors. Further to this and to ensure the continuous injection of fresh ideas, the Code stipulates that non-executive directors of banks shall serve for a maximum of three terms of four years each, while the tenure of the MD or CEO shall be subject to a maximum period of 10 years, which may be broken down into periods not exceeding five years at a time.

The Code emphasises the importance of risk governance as part of a bank's general corporate governance framework, and promotes the value of the board and several board committees with effective control functions. Specifically, the Code:

a regulates equity holding in banks by investors;
b discourages a government majority stake in banks by limiting the maximum holding of any government to 10 per cent;
c encourages a whistle-blowing framework and the protection of stakeholders' rights; and
d strengthens disclosure requirements and transparency in banks' annual reports.

Legal and regulatory duties of management of banks

In accordance with the Code, the management of banks in Nigeria are generally responsible for policy implementation, and the development of a sound system of risk management and

28 For example, following the failure of the now-defunct Skye Bank, the NDIC in consultation with the CBN incorporated Polaris Bank as a bridge bank, withdrew Skye Bank's operating licence and transferred its assets and liabilities to Polaris Bank.

29 A bridge bank is an entity incorporated by the NDIC and licensed by the CBN as a bank to act as a stop-gap arrangement between the failure of a bank and the time when the NDIC can arrange the acquisition of this newly incorporated bank by a third party, while the failing bank is wound up.

30 It is worth noting that in 26 October 2018, the CBN issued Codes of Corporate Governance in respect of the following other financial institutions: microfinance banks; development finance banks; primary mortgage banks; mortgage refinance companies; finance companies and bureaux de change.

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internal control policies that must clearly define the roles and responsibilities of the board, its risk management committee, as well as the roles and responsibilities of management and internal audit function.

Bank holding company structure: decision-making over subsidiaries

The Nigerian bank holding company (HoldCo) subsidiary structure is based on the principle of corporate personality such that the subsidiary banks are different and distinct from their HoldCos. Accordingly, pursuant to the CBN Guidelines for Licensing and Regulation of Financial Holding Companies in Nigeria, 2014 (HoldCo Guidelines), no financial HoldCo shall arrogate for itself any of the powers or functions of the board of directors, or internal management responsibilities and obligations of any of its subsidiaries or associates of any such subsidiaries. In addition, no financial HoldCo shall interfere with the day-to-day activities of the subsidiaries; nor shall it be involved in the credit administration and approval process of its subsidiaries.

Restrictions on bonus payments

There are no regulations currently in place in Nigeria that restrict bonus payments to the management and employees of banking groups. However, it is noteworthy that the Code requires every bank to have a remuneration policy established by its board, and to disclose the policy to the shareholders in the bank's annual report. Under the Code, it is also expected that a committee of non-executive directors are responsible for determining the remuneration of executive directors.

iii Regulatory capital and liquidity

The prudential standards relating to regulatory capital for Nigerian Banks are found in the DMB Prudential Guidelines, which are based on the standards of Basel II, and the CBN's Guidance Note on Regulatory Capital 2018 (Regulatory Capital Guidelines), modelled on Basel III.

Risk-weighted capital

Under the DMB Prudential Guidelines, a DMB with a national banking licence must maintain a minimum of 10 per cent of the total risk-weighted assets as capital funds on an ongoing basis.[31] DMBs that have been authorised by the CBN to carry out banking activities outside Nigeria must maintain a higher CAR of 15 per cent.[32]

Tier 1 capital

The capital a DMB must maintain to achieve its CAR must be made up of Tier 1 and Tier 2 capital. Under Section 2 of the Regulatory Capital Guidelines, Tier 1 capital includes disclosed reserves and shareholder equity, which constitute issued and fully paid up ordinary shares or perpetual non-cumulative preference shares.

31 Section 3.16 of the DMB Guidelines.

32 Section 1 of the Regulatory Capital Guidelines.

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Tier 2 capital

Under Section 3 of the Regulatory Capital Guidelines, Tier 2 capital is made up of two components: hybrid debt instruments and subordinated debt. Hybrid debt instruments feature characteristics of equity and debt.

The CBN has determined that hybrid instruments may be included in Tier 2 capital where they are able to support losses on an ongoing basis without triggering liquidation. To qualify as Tier 2 capital, hybrid instruments, inter alia:

a must be unsecured, subordinated and fully paid up;

b must be available to participate in losses without the bank being obliged to cease trading;

c must not be redeemable at the initiative of the holder or without the prior consent of the CBN;

d may carry an obligation to pay interest, but that obligation cannot permanently be reduced or waived;

e should allow the obligation to pay interest to be deferred where the profitability of the bank would not support payment; and

f where redeemable, must have an original maturity of at least 10 years, and must clearly specify that repayment is subject to authorisation by the CBN.[33]

In calculating the amount of Tier 1 and Tier 2 capital that comprise a bank's capital base, net of all permitted deductions, the calculation is subject to certain limits. Fundamental Tier 2 capital can constitute, at most, 33.33 per cent of net Tier 1 capital. There is no limit on the inclusion of Tier 1 capital for the purpose of calculating regulatory capital.

Consolidated supervision

Neither the DMB Prudential Guidelines nor the Regulatory Capital Guidelines impose specific requirements for DMBs in Nigeria that form part of a group. The HoldCo Guidelines stipulate that a financial HoldCo must have at least two subsidiaries, and the conglomerate's focus must be in the financial services sector.[34] The consolidated supervision approach for Nigerian banks is the solo-plus approach,[35] complemented by a quantitative and qualitative assessment of the banking group to assess the potential impact of other members of the group on the operations of the supervised bank.

Liquidity

The CBN requires all banks operating in Nigeria to ensure that their level of cash flow is matched by expected receipts, so that banks always have enough cash to meet the requests of their depositors. This is to ensure that each bank's cash balance plus assets, when compared to the total liabilities owed by each bank, is high enough for the bank to meet its obligations as they fall due. The CBN sets out the minimum liquidity ratio benchmarks for the banking sector in its Monetary, Credit, Foreign, Trade and Exchange Policy Guidelines (MCFT Policy Guidelines).

33 Subordinated debt can qualify as part of Tier 2 capital only if it satisfies the 13 requirements set out in Section 3.2 of the Regulatory Capital Guidelines.

34 Section 2.3.1 of the HoldCo Guidelines.

35 Solo supervision consists of the risk-based supervision of banks on a solo basis by the CBN and the NDIC.

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The MCFT Policy Guidelines are a periodic publication of the CBN designed to provide guidance to financial institutions for the medium-term fiscal period, and to demonstrate the CBN's direction and policy objectives. The latest version of the MCFT Policy Guidelines covers the period from January 2018 to December 2019. Under the current guidelines, the CBN requires that banks maintain minimum liquidity ratios as follows: DMBs: 30 per cent; merchant banks: 20 per cent; and non-interest banks: 10 per cent.

Local regime divergence from Basel III

The Basel frameworks have been progressively implemented in Nigeria since January 2013. The Basel II and III Framework Guidelines list all areas of national discretion set out under the International Convergence of Capital Measurements and Capital Standards, although these deal mostly with the International Convergence of Capital Measurement and Capital Standards, June 2006 (Basel II Framework).

Key areas of divergence include the fact that under the Basel II and III Framework Guidelines, the CBN departs from Paragraph 49xii of the Basel II Framework by not permitting banks in Nigeria to employ short-term subordinated debt as a third tier of capital.

iv Recovery and resolution

Resolution of failed banks in Nigeria

The NDIC is the main body responsible for the resolution of failed banks in Nigeria. The BOFIA also mandates the CBN to step in, when a bank is in crisis, in order to turn over management and control of such bank to the NDIC. The NDIC is empowered to provide financial and technical assistance to failing or distressed banks in the interest of depositors. Financial assistance can take the form of loans, guarantees for loans taken on by the bank or the acceptance of accommodation bills. Similarly, technical assistance may include taking over the management and control of the bank, changes in management or assistance in a merger with another viable institution.[36]

In 2002, in collaboration with the CBN, the NDIC introduced the Contingency Planning Framework for Banking Systemic Crises to facilitate the prompt resolution of failing banks. The aim of the Framework is to reduce the incidence of systemic distress by improving the supervisory processes, providing transparent and objective thresholds for regulatory intervention, and promoting self-regulation among banks. Some of the mechanisms that the NDIC (in collaboration with the CBN) has adopted for the resolution of failed banks are open bank assistance (OBA), purchase and assumption (P&A) transactions and bridge banks.[37]

The OBA

The NDIC may decide to offer a failing bank financial assistance if it meets certain requirements. Financial assistance in the form of OBA is made available to a failing bank without interrupting its operation as a going concern. The NDIC does this by offering a loan to the failing bank, guaranteeing a loan that the bank has taken on or accepting an accommodation bill. In addition to the conditions listed above, the bank must also meet the liquidity threshold prescribed by the NDIC.

36 http://ndic.gov.ng/failure-resolution/#tab-1-6.

37 http://ndic.gov.ng/failure-resolution/#tab-1-6.

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P&A transactions

This is a resolution transaction in which a healthy bank purchases some or all the assets of a failed bank and assumes some or all its liabilities. If the whole bank is purchased, the acquirer may receive a government payment covering the difference between the market value of assets and liabilities. If only some deposits are assumed, the acquirer may be given the option of assuming any of the others, and take their pick of the failed bank's assets.

Bridge bank

A bridge bank is a temporary bank established and operated by the NDIC to acquire the assets and assume the liabilities of a failed bank until a final resolution can be accomplished. In some instances, the bridge bank will retain the failed bank's licence, but it will operate under a different name in the same premises used by the failed bank. In other instances, the CBN may revoke the failed bank's licence and issue a new licence to the bridge bank. The bridge bank would permit continuity of banking services to all customers and fully protect the depositors and creditors of the failed bank.

Another form of bank resolution for failed banks is the acquisition of non-performing loans of failed banks by AMCON.

In accordance with BOFIA, in the event that a failed bank over which NDIC has assumed control cannot be rehabilitated, the NDIC may recommend to the CBN other resolution measures, which may include revocation of the failed bank's licence. Where the licence of a failed bank has been revoked, the NDIC may apply to the relevant court for a winding-up order in respect of the failed bank. Upon the court's order for winding up of the failed bank, the NDIC shall give notice by advertisement in national newspapers or other news media requiring all depositors with the failed bank to forward their claims to the NDIC. The NDIC, acting as liquidator of the failed bank, shall have power to realise the assets of the failed bank.

Bail-in powers

Currently there are no bail-in powers in the Nigerian banking industry, and we are not aware of any proposals for bail-in powers of banks or regulatory bodies.

Recent issues of convertible debt instruments by banks or their holding companies

A relatively recent case of a debt-equity convertible debt instrument within the banking industry in Nigeria is the Ecobank group convertible bond issue. Ecobank Nigeria is a subsidiary of Ecobank Transactional Incorporation (ETI), and in 2017 ETI announced the raising of US$400 million in convertible bonds from its existing shareholders. The convertible bond issue, with a five year maturity, has a coupon rate of 6.46 per cent above three months LIBOR[38] with an option to convert at an exercise price of six US cents during the conversion period. ETI explained that upon the occurrence of a change of control, the debt will be convertible at the option of the holder of the debt into ETI ordinary shares at an exercise price of six US cents during conversion period of 19 October 2019 to 13 October 2022 in accordance with the terms of the convertible debt.[39] The debt will be redeemed at 110 per cent of the principal amount if the conversion option is not exercised.

38 London Inter-Bank Offered Rate.

39 https://businesspost.ng/2017/10/28/400m-convertible-bond-issue-successful-ecobank/.

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IV CONDUCT OF BUSINESS

As noticed in Section II, the BOFIA is the primary legislation that governs banks' conduct of business in Nigeria. Other laws and rules that govern banks' conduct of business include:

a the Companies and Allied Matters Act;
b the Nigerian Deposit Insurance Corporation Act;
c the Foreign Exchange (Monitoring and Miscellaneous) Act;
d the Financial Reporting Council of Nigeria Act; and
e the Code of Conduct in the Nigerian Banking Industry (Code of Conduct).

Where banks act in contravention of the provisions of the BOFIA, they may be subject to civil, criminal or regulatory liability: for example, where a bank fails to comply with the conditions of its banking licence, this amounts to an offence with a fine (on conviction) not exceeding 50,000 naira for each day during which a condition is not complied with.

Furthermore, the CBN Consumer Protection Framework 2016, made pursuant to the CBN Act, sets high standards for efficient customer service delivery and market discipline, and provides that financial institutions are obliged to safeguard the privacy of their customers' data. The Code of Conduct also imposes confidentiality obligations on banks and their employees. In particular, Section 1(1.2) of the Code of Conduct requires banks to observe a strict duty of confidentiality about their customers' and former customers' affairs, and prohibits them from disclosing details of customers' accounts, transactions, names and addresses to third parties.

Furthermore, the Code of Conduct requires banks to insist that all directors, management and staff sign a declaration of secrecy to ensure the confidentiality of customers' information. The foregoing confidentiality obligations are subject to the general reporting obligations borne by Nigerian banks:

a to anti-graft and anti-money laundering agencies in respect of transactions exceeding certain thresholds;
b when compelled to make disclosures pursuant to court orders in proceedings (such as a garnishee process);
c where the interests of the bank requires disclosure; and
d where disclosure is made at the request, or with the consent (express or implied) of, the customer.

V FUNDING

With over 71 million active bank accounts,[40] Nigerian banks primarily raise funds to carry on their activities from customer deposits. In addition, Nigerian banks access funding from the capital market through the issuance of bonds and other financial instruments; and access loans from development finance institutions, foreign institutional (impact) lenders and international banks, the proceeds of which are typically on-lent to customers and used to fund other activities. They also source their funds from trading in securities (particularly treasury bills and other government-backed securities) as well as from interest on moneys lent to customers.

40 https://nibss-plc.com.ng/wp-content/uploads/2019/02/totalActiveBankAccounts-.xls.

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The CBN is also empowered under the CBN Act to lend money to Nigerian banks facing liquidity issues on such terms and interest rates as it deems fit. To guide banks in the management of their liquidity, the CBN in 2003 issued the Guidelines for the Development of Liquidity Management Policies in Nigerian Banks[41] (Liquidity Management Guidelines). The Liquidity Management Guidelines seek to monitor banks' liquidity at all times, ensuring that banks maintain adequate and sufficient liquidity to meet the financial obligations of their operations.

Under the Liquidity Management Guidelines, each bank is expected to have a steady cash flow, hold a reasonable stock of liquid assets and have the capacity to borrow. The Liquidity Management Guidelines thus suggest different liquidity management strategies that may be adopted by banks to ensure adequate liquidity, including:

a having a well-defined mix of assets and liabilities;
b diversifying their funding base;
c maintaining an adequate stock of liquid assets; and
d restricting dependence on intragroup liquidity.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The Nigerian banking sector has a wide variety of control mechanisms used to regulate the holding of a substantial stake in a commercial bank. The most instructive of these regulations is the Code of Corporate Governance for Banks and Discount Houses 2014, which provides that an equity holding of 5 per cent and above by any investor shall be subject to the CBN's prior approval. Where this 5 per cent share capital threshold is acquired through the capital market, the bank shall apply for a no objection letter from the CBN immediately after the threshold is reached.

The ownership and control of the holding company is also regulated by the HoldCo Guidelines, which provide that the prior approval of the CBN shall be obtained for any shareholding of 5 per cent and above or any change in ownership that results in a change in the control of a financial holding company. In situations where such shares are acquired through the secondary market, the financial holding company shall apply for approval from the CBN within seven days of the acquisition.

The HoldCo Guidelines contain provisions that deal with the ownership, control and permissible activities of HoldCos. Where a HoldCo loses control in one or all of the banking subsidiaries in the group for a period exceeding six consecutive months, the HoldCo shall cease to be a HoldCo for the purposes of the HoldCo Guidelines and will be required to return its licence to the CBN for cancellation.[42] Furthermore, the guidelines prohibit a HoldCo from engaging in any transaction or maintaining any business relationship with any of its subsidiaries unless such transaction is conducted at arm's length.[43]

41 https://www.cbn.gov.ng/OUT/CIRCULARS/BSD/2003/BSD-10-2003.PDF.
42 Section 4.1 (e) of the HoldCo Guidelines.
43 Section 6.2.1(i) of the HoldCo Guidelines.

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ii Transfers of banking business

Until 2019, the transfer of business activities in Nigeria pursuant to mergers, acquisitions, takeovers and other forms of business combinations was primarily regulated by the SEC. However, following the recent enactment of the Federal Competition and Consumer Protection Act (FCCPA),[44] Nigeria's competition regulatory framework has been transformed. The Federal Competition and Consumer Protection Commission (Commission) is now empowered to promote and maintain competitive markets in Nigeria.[45] Once a proposed merger exceeds the thresholds laid down by the Commission, that merger cannot be implemented without first being approved by the Commission. Section 92(4) of the FCCPA makes it clear that the Commission alone has the power to set the thresholds for what qualifies as a small or large merger under the FCCPA.

Consequently, under the provisions of the FCCPA, mergers of banks that are private companies will no longer require the SEC's approval: rather, the approval of the CBN and the Commission will be required. However, where a merger involves banks that are public companies, it will fall within the regulatory purview of the SEC in addition to that of the FCCPA.

The FCCPA has not vested powers in any government body or official to exercise its oversight functions, in the interim period, prior to the constitution of the Commission. In a recently published notice,[46] the SEC indicated that there will be a three-month transition period between the enactment of the FCCPA and the establishment of the Commission.

Additionally, when the entities concerned are banking organisations, Section 7(1) of the BOFIA also regulates such transactions, and provides for certain circumstances where the prior consent of the Governor of the CBN must be obtained.

Where a bank is publicly quoted on the NSE, the Rulebook of the NSE states that the NSE's consent to the merger must also be obtained.

Finally, it should be noted that the FCCPA has not repealed the provisions of the ISA that govern takeover bids,[47] or the SEC's innate power to make rules and regulations prescribing the procedure and criteria for the approval of takeovers under Section 313(1)(e) of the Investment and Securities Act 2007 (ISA). This means that Sections 131 to 151 of the ISA and Rules 445 to 449 of the SEC Rules, which regulate takeovers, are still applicable and will govern any proposed takeover bid for a Nigerian bank that is a public company.

VII THE YEAR IN REVIEW

The past year has seen significant strides and developments within the banking industry in Nigeria. In 2018, the CBN concluded a bilateral currency swap arrangement with the People's Bank of China and introduced new regulations for participants in the fintech space.

44 The FCCPA was signed into law on 30 January 2019.

45 Section 1(a) of FCCPA.

46 See sec.gov.ng/new-merger-regime-frequently-asked-questions/.

47 Sections 131 to 151 of the ISA 2007 and SEC Rules 445 to 449 govern takeover bids in Nigeria. Section 131 of the ISA and Rule 445 of the SEC Rules require that a takeover bid be submitted to the shareholders of a public quoted company, where a person or group of persons acquires or wishes to acquire a minimum 30 per cent share of such a company with the intention of taking over control of that company.

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In addition, the past year saw the revocation of the licence of a major DMB in Nigeria, while (in the current year) we also witnessed the merger of two major DMBs, resulting in the emergence of the largest bank in Nigeria by customer size and retail network.

i China–Nigeria currency swap

After two years of negotiations, a three-year bilateral currency swap agreement (BCSA) was finally executed by the Central Bank of Nigeria and the People's Bank of China on 27 April 2018. The BCSA allows for both banks to, among other things, make available liquidity in their respective currencies (the naira and the yuen) for the facilitation and promotion of trade and investments between Nigeria and China. The BCSA will involve a maximum amount of 15 billion yuen and for 720 billion naira.

ii New regulation on fintech

With the growth of fintech in Nigeria, it was considered a milestone when, on 15 October 2018, the CBN published an exposure draft circular with a new licensing structure, as well as requirements and regulations, targeted at fintech companies in Nigeria, and specifically companies offering digital banking services.[48] In formulating these policies, the CBN was tasked with balancing the innovative nature of fintech and the wide acceptance of fintech by customers against the risks associated with the precarious industry. The draft circular created three new licensing structures for payment system providers: a super licence, a standard licence and a basic licence, each with varying levels of licence renewal fees and permissible activities. What generated mixed reactions, however, were the minimum capital requirements, which were pegged by the Central Bank at 5 billion naira, 3 billion naira and 100 million naira, respectively. There are concerns that the minimum capital requirements are too high, and are more likely to serve as a barrier to entry into the fintech industry at a time when the industry is believed to require incentives.

iii Access–Diamond Bank Merger

On 17 December 2018, the boards of Access Bank Plc and Diamond Bank Plc jointly approved the entry of their respective banks into a memorandum of agreement to effect a merger between the two banks. For Access Bank, the merger is an opportunity for major expansion, and acquisitions have historically been Access Bank's preferred method of expansion over organic growth.[49] The Federal High Court granted an order approving the merger on 19 March 2019. The new Access Bank was launched on 1 April 2019, and has 28,000 staff, 600 bank branches and 29 million customers.

iv Polaris Bank Debacle

On 21 September 2018, the Governor of the CBN and the Managing Director of the Nigeria Deposit Insurance Company (NDIC) announced the revocation of Skye Bank Plc's banking licence. In its place, the assets and certain liabilities, including deposit liabilities, of the

48 Central Bank of Nigeria, 'Circular on the Exposure Draft of New CBN Licensing Regime (License Tiering) for Payment Service Providers'.

49 In 2005, Access Bank acquired Marina Bank and Capital Bank (formerly commercial bank Crédit Lyonnais Nigeria), in 2008, it acquired 88 per cent of the shares of Omnifinance Bank, and in 2012 it finalised its acquisition of (and eventual merger with) Intercontinental Bank.

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defunct Skye Bank Plc were assumed by a newly licensed bridge bank called Polaris Bank Ltd. The NDIC is currently presiding over the management of Polaris Bank, while the Asset Management Corporation of Nigeria (AMCON) is responsible for capitalising the bank and searching for investors to buy out its stake. AMCON has injected 786 billion naira into Polaris Bank, and plans to resume advertising for investors and commencing the sale process.

VIII OUTLOOK AND CONCLUSIONS

The Nigerian President, Muhammadu Buhari, was reelected for a second term in the recently concluded national elections. In light of his reelection, we expect to see the resumption of significant policy activity in the second half of 2019. The five-year tenure of the current CBN Governor, Godwin Emefiele, expires in June 2019. He is eligible to serve a second term, and we await the upcoming announcement of either his reappointment or the appointment of a successor. In the event that there is a change in leadership, it remains uncertain what implications this might have on the country's monetary policies, as a new CBN leadership may implement new monetary policies that will impact the industry.

The capital position of banks is expected to improve in 2019 relative to 2018, with the four-year transitional arrangement introduced by the CBN to cushion the effect of the expected credit loss and impact of IFRS 9 impairment figures. Also expected in 2019 is increased competition from fintechs and non-bank entities disrupting the traditional banking landscape by offering a wide range of simplified banking services to retail and micro and small businesses. The licensing of payment service banks to facilitate transactions in remittance services, micro-savings and withdrawal services in rural areas is another potential threat to the earnings of commercial banks.

Ultimately, we remain optimistic that the Nigerian banking industry will achieve economic stability.

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Chapter 28

NORWAY

Richard Sjøqvist, Markus Nilssen and Steffen Rogstad[1]

I INTRODUCTION

The Norwegian banking industry has developed in cycles during the past 200 years. From a minimal start, the number of banks increased rapidly until nearly each small municipality had at least one bank. During the recession in the late 1920s, many banks had to close but subsequently reopened. In the 1930s there were around 700 banks in Norway, of which 630 were savings banks. This continued until around 1970, when a rapid consolidation started. Today, there are 126 banks incorporated in Norway: around 100 of them are savings banks, while the rest are commercial banks. This includes subsidiaries (but not branches) of foreign banks. Around 40 credit institutions have opened branches in Norway; however, only a few operate as full-service banks, and many specialise in equipment financing, typically automobiles. Many credit institutions from EEA Member States have provided notification in respect of cross-border services; however, probably only a minority of them regularly provide services in Norway.

The Norwegian banking industry is dominated by two large commercial banks (DNB Bank ASA and Nordea Bank ABP) and two groups of independent savings banks (Eika group and SpareBank 1 group). Each savings bank operates independently, but both Eika Group and SpareBank 1 Group have certain joint operations and a common brand. Foreign banks, through branches or cross-border activities, are active, and hold a significant market share of business within the shipping, oil, or offshore and mainland industries.

The five largest banks in the Norwegian market (excluding those owned by a public body) measured by balance sheet value are:

a DNB Bank ASA;
b Nordea Bank ABP, Filial i Norge (a branch of Nordea Bank ABP);
c Danske Bank (Norge) (a branch of Danske Bank A/S);
d Handelsbanken, (a branch of Svenska Handelsbanken AB (publ)); and
e SpareBank 1 SR-Bank ASA.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

i General

Norway is not a member of the European Union, but through the EEA agreement, it is committed to implementing the relevant directives for the finance industry. This means that the free establishment rule applies for EEA institutions wishing to provide services in Norway, and for Norwegian institutions wishing to offer their services within the EEA.

The combination of accepting deposits and providing credit triggers a requirement for a banking licence under Norwegian law. The main regulation applicable to banks can be found in the Act on Financial Undertakings and Financial Groups 2015 (Financial Undertakings Act). The Financial Undertakings Act is an attempt to consolidate the main financial regulations, which were previously scattered in various pieces of legislation, into one comprehensive act (implementing, inter alia, the key elements of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR)). The Act regulates the following financial undertakings:

a banks and other credit institutions;
b finance companies;
c holding companies in financial groups;
d payment institutions;
e electronic money institutions; and
f insurance and pension institutions (not discussed in this chapter).

Banks providing investment services or investment fund services are also subject to the Securities Trading Act 2007 (implementing, inter alia, the Markets in Financial Instruments Directive (MiFID II)) or the Investment Fund Act 2011 (implementing, inter alia, the Undertakings for Collective Investments in Transferable Securities Directives).

A new Anti-Money Laundering Act was enacted with effect from 15 October 2018. The new Act and regulations have provided that the key parts of Norwegian legislation are assumed to be in compliance with the EU's fourth Anti-Money Laundering Directive and the Financial Action Task Force Recommendations.

A widely discussed subject related to this area is trade with cryptocurrencies. There has been little clarification concerning how the anti-money laundering and anti-terror financing regulations will affect this trade. This has already led to some insecurity and conflicts between financial institutions and clients that are trading such currencies. The new Norwegian legislation is aiming to address this, in particular by imposing a duty to notify the FSA before conducting such business, and that providers are subject to supervision by the FSA. The legislation is implementing the fifth Anti-Money Laundering Directive in this respect.

Finally, all financial undertakings are subject to the Financial Supervision Act 1956.

The main regulator is the Financial Supervisory Authority of Norway (FSAN). The FSAN's resources come from fees paid by the institutions it supervises. Its main purpose is to promote financial stability and a well-functioning market.

The FSAN's instruments are:

a supervision and monitoring;
b licensing;
c regulatory development; and
d information and communication.

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ii Deposit taking

Norwegian financial undertakings that wish to take deposits from the public must have a licence as a bank. Non-banking credit institutions may receive repayable funds from the public (other than deposits) by way of the issue of bonds or other comparable securities. EEA credit institutions providing services in Norway based on their home state licence (passporting) may take deposits in Norway if their home state licence allows them to do so.

iii Lending

Lending is a regulated activity, and a licence or a passport is needed. Norwegian financial undertakings without a banking licence may grant loans based on a licence as a non-banking credit institution or as a finance company, and will normally fund themselves in the bond market. Typical today are mortgage credit institutions operating in the covered bond market. These are normally owned by banks or savings bank groups, and acquire loan portfolios from the banks.

Investment firms need a separate licence to provide loans in connection with their investment activities.

iv Foreign exchange

Spot foreign exchange trading can be carried out by banks, payment institutions, electronic money institutions and finance companies as well as by foreign passported credit institutions, payment institutions and electronic money institutions, all subject to having an appropriate licence to do so.

Dealings in foreign exchange derivatives can only be carried out by an institution with an investment firm licence.

v Payment services

The Payment Services Directive (PSD1) was fully implemented into the Norwegian legislation in 2010, and the regulations implementing the public law parts of PSD2 will be effective from 1 April 2019. Simultaneously, the Ministry of Finance (MOF) has declared that the Ministry of Justice and Public Security will lay down a regulation implementing the private law parts of the Directive. The time frame for the latter is, however, still uncertain.

vi Investment services

Licences to provide investment services may be granted to banks and limited liability companies.

Banks may obtain licences in their own names or through their subsidiaries. Foreign passported firms may also provide investment services in Norway; see further below.

vii Legal structure of banks

There are two legal structures of banks available: commercial and savings.

Commercial banks have to be organised either as public limited liability companies or private limited liability companies. Pursuant to the Financial Undertakings Act, banks established after 1 January 2016 must be organised as public limited liability companies; however, those established as subsidiaries in a financial group may be organised as private limited liability companies.

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Savings banks were originally organised as independent entities without external owners. Hence, their equity capital historically consisted mainly of retained profits from earlier years. Since 1987, savings banks have been entitled to bring in external equity by issuing equity instruments, called equity certificates. These differ from shares in that they do not give holders ownership of a bank's entire equity capital. Moreover, holders have limited voting rights to a maximum of two-fifths in total in the bank's highest body, the general meeting. Around 30 savings banks, including several of the largest ones, have issued such instruments.

All banks must have a total of share capital and other equity capital of at least €5 million.

viii Branches and cross-border services

Foreign banks established within the EEA may establish branches in Norway in accordance with the EU or EEA banking directives. The prime regulator of a foreign branch is its home state regulator, but branches of foreign banks are also regulated by Norwegian rules to a certain extent, pursuant to, inter alia, the Financial Undertakings Act, and supervised by the FSAN pursuant to, inter alia, Regulation No. 1257 of 28 December 1993.

Foreign banks established within the EEA may also provide cross-border services in Norway pursuant to EU or EEA passporting rules. Foreign banks providing cross-border services in Norway are to a lesser degree regulated and supervised by the FSAN.

Banks established outside the EEA must have a Norwegian licence to provide banking services in Norway through a branch. A licence to provide cross-border services is not available for such entities.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Entities under supervision file various reports with the FSAN on which it may comment or raise questions. Communication between the FSAN and an entity under supervision will normally be in the form of written correspondence. The FSAN also has the power to give specific directives to an institution, but this is rarely done, as the supervised entities will normally follow the FSAN's guidance. The FSAN bases its supervision and monitoring of the market on global standards.

From time to time, the FSAN will conduct a physical inspection of a bank, normally with a couple of weeks' notice. The object of such inspection varies, but an evaluation of the bank's ability to monitor risks will normally be a main area of interest, as will money laundering routines. The FSAN divides risks into four categories: credit, market, liquidity and operational.

The instruments available to the FSAN are listed in Section II. The main purpose of the FSAN, according to its strategy document for the period from 2019 to 2022, are to promote and secure financial stability and a well-functioning market through six sub-goals:

a solid and liquid finance institutions;
b robust infrastructure;
c investor protection;
d consumer protection through good information and advice;
e efficient crisis management; and
f prevention of economic crime.

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In its strategy, the FSAN has identified the following supervisory priorities:

a macroeconomic supervision;

b solvency supervision of financial institutions;

c supervision of the distribution of loans and trading of pension savings schemes, collective investment vehicles and other financial instruments;

d supervision of financial infrastructure, payment, trade and settlements systems; and

e supervision of compliance with the money laundering regulations.

ii Management of banks

The promulgation of the Financial Undertakings Act implies a modernisation and coordination of the corporate governance requirements of banks, which, inter alia, means that the Norwegian requirements are brought in line with international developments. As a result, certain previously required management structures, such as a committee of representatives and a control committee, are no longer required.

Commercial banks are organised either as public limited liability companies or, if established prior to 2016, as private limited liability companies, and are as such required to have a board of directors and a chief executive officer (CEO). Note, however, that a bank established as a subsidiary in a financial group may still be organised as a private limited liability company.

The general meeting is the highest body of both savings and commercial banks. The general meeting of a commercial bank is governed by the ordinary company laws. In savings banks, at least three-quarters of the members of the general meeting shall be persons who are not employed by the company. The details regarding the election of members to the general meeting in a savings bank shall be set out in the company's articles of association.

Banks with more than 200 employees might have a corporate assembly, if so agreed between the bank and a majority of the employees. The corporate assembly will have tasks such as to elect members of the board of directors and the chair of the board of directors, to supervise the board, the management and the bank's operations, and to decide in cases regarding major investments.

Banks must, as a main rule, have an audit committee, a compensation committee and a risk committee, all consisting of members of the board of directors. The purpose of the audit committee is to support and advise the board of directors with respect to, for example, internal control systems, risk management and auditing of the bank's financial statements. The compensation committee draws up proposals and issues recommendations to the board of directors regarding remuneration, and acts generally in an advisory capacity with respect to remuneration and other important personnel-related matters. The purpose of the risk committee is to support and advise the board in its role as supervisor and governing body of risk and risk control.

In addition, for banks with securities listed on a regulated market in Norway, the Norwegian Code of Practice for Corporate Governance will apply.[2] The Code is based on the comply or explain principle, whereby companies must comply with the Code of Practice or explain why they have chosen an alternative approach.

2 The Code of Practice is issued by the Norwegian Corporate Governance Board: see www.nues.no.

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Banks operating in Norway through a branch are not subject to the regime described above, but must nevertheless register a CEO or similar contact person with the Norwegian Business Register and the FSAN, and may also choose to have a Norwegian board of directors.

If a Norwegian branch or subsidiary of a foreign bank is subject to an internal group approval regime, the extent to which the branch or subsidiary may pass on customer information to other members of its company group will depend on the nature of the information. While Norwegian law does not contain an absolute prohibition against such arrangements, any information sharing will be subject to, inter alia, applicable banking confidentiality and data protection rules. Most foreign banks with a presence in Norway operate through a branch, which enables a more efficient flow of information between the branch and its head office. In addition, since banks are subject to strict rules with respect to risk control and capital requirements on a consolidated basis, there is a legitimate need for reporting. The law has been rather unclear on these questions, but the Financial Undertakings Act does explicitly allow for such sharing of information, as set out in Section IV.

As for remuneration policies and practices, new regulations were brought into effect as of January 2015 based on the CRD IV. In accordance with the Directive, it is not possible to award remuneration on more than 100 per cent of the basic salary. The CRD IV does, however, allow for remuneration of up to 200 per cent in some cases for EU Member States, and the MOF has implemented the same approach. The Norwegian remuneration rules are applicable regardless of the size, nature, scope or complexity of institutions. Accordingly, Norwegian regulations are in some ways stricter than those set out in the CRD IV and the European Banking Authority (EBA) guidelines, which includes, inter alia, the principle of proportionality.

iii Regulatory capital and liquidity

Norwegian banks are subject to ongoing capital adequacy requirements, which implement EU directives based on the Basel III regime. Financial groups are considered on a consolidated basis. In line with the recommendations of the Basel Committee on Banking Supervision, the regulatory approach in the Financial Undertakings Act is divided into three pillars:

a Pillar I – calculation of minimum regulatory capital: banks shall at all times fulfil the own funds' requirements reflecting credit risk, operational risk and market risk. The current requirement is that a bank's own funds shall constitute at least 8 per cent of a calculation basis reflecting such risks. The Common Equity Tier 1 (CET1) capital ratio requirement is at least 4.5 per cent and the Additional Tier 1 capital ratio requirement is at least 6 per cent. Own funds can be in the form of core and supplementary capital. Core capital will typically consist of equity capital, while supplementary capital can be hybrid capital or subordinated loan capital. The capital requirements must be complied with at all times. Banks are obligated to document their fulfilment of the requirements by reporting quarterly to the FSAN;

b Pillar II – assessment of overall capital needs and individual supervisory review: banks must, inter alia, have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. The FSAN reviews and evaluates these internal capital adequacy assessments and strategies, and it may take supervisory action if not satisfied with the result of an evaluation process; and

c Pillar III – disclosure of information: banks are required to disclose relevant information regarding their activities, risk profile and capital situation.

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In addition to the minimum capital standards, Norway has adopted the following buffer standards:

a a capital conservation buffer of 2.5 percentage points in addition to the minimum CET1 capital ratio;

b a systemic risk buffer of 3 percentage points in addition to the minimum CET1 capital ratio and capital conservation buffer;

c if the financial undertaking is defined as systematically important, it has a buffer of 2 percentage points in addition to a minimum CET1 capital ratio, capital conservation buffer and systemic risk buffer; and

d a countercyclical capital buffer of 2 percentage points in addition to the CET1 capital ratio, capital conservation buffer, systemic risk buffer and, if applicable, the buffer for systematically important institutions. This buffer will increase to 2.5 percentage points from 31 December 2019.

If a financial undertaking does not meet the buffer standards, it is required to develop a plan on how to increase its CET1 capital ratio, and cannot pay dividends or make bonus payments without approval from the FSAN.

The capital requirements for banks and other financial institutions in Norway are described in detail in Chapter 14 of the Financial Undertakings Act (which implements the capital and liquidity rules in the CRD IV and the CRR). For credit risk and market risk, the calculation basis may be found using either risk weights specified in regulations, or in accordance with internal procedures. Operational risk may be calculated using one of three calculation methods: share of average income (basis method), share of income within each business area multiplied by a loss indicator determined by the MOF (template method) or internal measuring methods (foundation or advanced).

Contrary to EU law, the MOF has decided to maintain the 80 per cent Basel I floor for banks that calculate capital on the basis of internal models. However, the Minister of Finance has indicated that this floor will be removed when the CRD IV and the CRR are incorporated into the EEA agreement, which is expected during 2019.

Since July 2014, all Norwegian banks are required to report their liquidity coverage ratio and net stable funding ratio to the FSAN.

Local branches of banks incorporated outside Norway are not subject to this regime, but are primarily subject to the regime in the jurisdiction of the bank.

iv Recovery and resolution

A Norwegian bank cannot be subject to ordinary insolvency proceedings (e.g., bankruptcy) in the same manner as a Norwegian company or private individual. Instead, banks experiencing financial difficulties will be subject to resolution pursuant to the rules of the Bank Recovery and Resolution Directive (BRRD) as implemented in Chapter 20 of the Financial Undertakings Act. The BRRD was implemented in Norway from 1 January 2019. The FSAN has not yet determined the minimum requirement for own funds and eligible liabilities (MREL) for individual Norwegian banks, but it is expected that this will happen during 2019. The FSAN has indicated that the banks will be granted a reasonable transitional period to fulfil the MREL. It is still unclear how the BRRD2 will affect Norwegian banks, but it is expected that Norway will adapt the legislation to the final text of BRRD2 when it is ready.

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A notable feature of the Norwegian banking regulations is the generous deposit guarantee scheme, which currently covers deposits of up to 2 million kroner. In connection with the implementation of the BRRD and the Deposit Guarantee Scheme Directive, both in January 2019, the EU has exerted pressure to lower the deposit guarantee scheme coverage to the EU level of €100,000. Nevertheless, the Norwegian guarantee coverage level has been upheld, and the Parliament Standing Committee on Finance and Economic Affairs has requested the government to continue talks with the EU in order to maintain the Norwegian guarantee level. Hence, it is still uncertain whether the Norwegian guarantee coverage level will be lowered or not.

IV CONDUCT OF BUSINESS

The Finance Agreements Act 1999 (which implements the Consumer Credit Directive) imposes certain conduct of business obligations upon banks, especially when dealing with consumers. In short, the Act provides that banks have a general duty to properly inform their clients, often in writing, and to ensure that a client has understood the information he or she has received. The Act also sets certain limits with respect to the kinds of materials and procedural provisions that can be included in a financial agreement (e.g., a loan agreement). A great number of the Act's provisions can be derogated from in a bank's dealings with business customers, but the Act is mandatory with respect to dealings with consumers.

Pursuant to Section 4 of the Finance Agreements Act, trade organisations for banks, insurance companies and other financial institutions in Norway have, with the Norwegian Consumer Ombudsman, established a mediation board for consumer complaints with respect to banks and banking products. However, the mediation board's resolutions are non-binding on the parties.

There have been discussions regarding a new Finance Agreement Act. The Ministry of Justice and Public Security sent a draft of a new act on public hearing in 2017. The draft received considerable criticism from various interested parties. The Minister of Justice has stated to Parliament that the Ministry of Justice and Public Security is currently considering the various comments received during the public hearing and aims to issue a proposal to Parliament for a new Finance Agreement Act during 2019.

Norwegian banking confidentiality rules are set out in the Financial Undertakings Act Sections 9-6, 9-7 and 16-2. The main rule is that, in the absence of a statutory exception, any non-public information concerning a bank or its customers that the bank's officers, employees or anyone who carries out an assignment for the bank, such as external auditors and lawyers, gain knowledge about in their position within the bank, is subject to a duty of confidentiality. The confidentiality obligation is directed both at the individual and the bank itself. In principle, the obligation extends to internal disclosure within the bank, but exceptions are available with respect to internal disclosure on a need-to-know basis.

Several exceptions apply to this main rule. Disclosure can be made without regard to the confidentiality obligation if:

a the customer consents to disclosure;

b disclosure is needed to fulfil requirements for reporting, control and internal governing within a banking group;

c the disclosure is made to another finance institution pursuant to specific rules in the Financial Undertakings Act;

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d the disclosure is required pursuant to the Money Laundering Act 2018 or similar regulations;
e the disclosure is requested by the police or prosecuting authorities;
f the disclosure is made in a civil or criminal court proceeding pursuant to a decision by the court;
g the disclosure is made to certain other authorities, such as tax authorities, competition authorities, the FSAN or the Norwegian stock exchange, and in accordance with specific regulations; or
h to a certain extent, for the purpose of establishing a central client register in a banking group.

This list is not exhaustive, and illustrates that the main rule of absolute confidentiality is subject to quite a few exceptions. A breach of the confidentiality obligation is a criminal offence punishable by a fine or, if considered a serious offence, imprisonment for up to three years.

V FUNDING

The main funding sources for Norwegian banks are deposits from customers, which amount to around 40 per cent of funding and the bond market (both domestic and international), which amount to around 20 per cent of the banks' total funding. A number of Norwegian banks have also established euro medium-term note programmes.

Another funding source is the raising of regulatory capital (see Section III.iii). Banks also fund themselves through credit lines with domestic or foreign third-party banks.

An increasingly important source of funding is the covered bond market. The Norwegian covered bonds legislation allows banks to set up specialised mortgage credit institutions, which in turn issue covered bonds to investors. The bonds are backed by a pool of specific types of mortgages (usually residential) or public sector loans acquired by the issuing mortgage credit institutions. The mortgage credit institution must be licensed as such, but it does not necessarily have to be affiliated with the bank from which it has acquired the mortgages.

As of the second quarter of 2018, the proportion of market funding with a residual maturity of more than one year was at 66 per cent. This has significantly increased over the past ten years, which in turn implies a lower liquidity risk of Norwegian banks. Only the largest Norwegian banks have access to the international capital markets, and Norway's largest bank, DNB Bank ASA, is an important source of funding for smaller banks. Norges Bank (the Norwegian central bank) offers certain funding to banks on a secured basis, and also acts as lender of last resort.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The shares of a commercial bank and the equity certificates of a savings bank are freely transferable, unless the bank's articles of association state otherwise. There are no limitations under Norwegian law on the rights of non-residents or foreign owners to hold and vote for a commercial bank's shares or a savings bank's equity certificates. The Financial Undertakings Act does, however, contain non-discriminatory ownership control rules. Pursuant to these

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rules, an acquisition of ownership in a bank that represents 10 per cent or more of the sum of the capital or the votes, or that otherwise gives the right to exercise significant influence on the management of the bank and its business, requires prior authorisation from the FSAN and the MOF. The same rules apply to holding companies of banks.

Ownership by closely committed persons is consolidated, and convertible loans are deemed to be included in a person's holding.

Whether authorisation shall be granted is regulated in the Financial Undertakings Act and pertinent regulations, the main consideration being whether the acquirer is deemed fit and proper to exercise such influence over the financial undertaking as the qualified holding will enable. Additionally, the MOF must make an assessment as to whether the acquisition is sound in light of the financial undertaking's current and future business. The application will contain, inter alia, information about the following:

a current and proposed holding of shares;
b the acquirer's other business and available financial resources;
c ownership in other financial undertakings; and
d the purpose of the acquisition. If the financial undertaking in question will become a subsidiary, a plan for the organisation and activities of the group must be submitted.

An application for authorisation shall be decided within 60 business days of the FSAN having confirmed that it has received the application, but this may be prolonged if the MOF or the FSAN deem that additional information is necessary or desirable in connection with the fit and proper assessment.

The above applies not only to acquisitions resulting in a qualified holding, but also to acquisitions increasing an (already) qualified holding to a total holding of more than 20, 30 or 50 per cent, as the case may be.

Banks and other financial undertakings are subject to limitations on their ability to grant security for their assets. As a main rule, the FSAN's permission is necessary for a bank to grant security for assets representing more than 10 per cent of its core capital. Exceptions apply to security granted for real estate, as well as security transactions entered into in accordance with market practice and on standard arm's-length terms.

In relation to an acquisition of a commercial bank, the bank will be restricted under Norwegian corporate law from providing capital or security in support of the acquisition.

By a letter dated 12 December 2018, the MOF has ordered a study on the Norwegian ownership rules. The mandate of the study is, inter alia, to consider whether the Norwegian law on ownership for banks is in accordance with EEA law. The deadline for submitting the report to the MOF was 15 March 2019.

ii Transfers of banking business

Transfers of customers' deposits would, as a starting point, require the consent of each customer in accordance with ordinary rules relating to the transfer of debtor positions. Even if consent is given, it is at present technically impossible to transfer a customer's unique bank account from one bank to another. This is due to the fact that Norwegian bank account numbers are assigned systematically, and serve a special identification function: for instance, the first four digits of an account number are used to identify the bank with which the account is registered. In other words, the account number belongs to the bank and not to the customer. It has been proposed to enact legislation that would enable customers to retain their account number when changing banks, but this has yet to be resolved.

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With respect to loans, Section 45 of the Finance Agreements Act provides that banks may transfer loans without the borrowers' explicit consent only to other financial undertakings (as defined in the Financial Undertakings Act). Transfers of loans from banks to non-financial undertakings require the borrowers' consent. Until 2015, the Norwegian financial legislation contained special securitisation rules that allowed for the transfer of loans from a financial institution to a non-financial institution without active consent from the borrowers in connection with a securitisation transaction. However, these rules were abolished when the Financial Undertakings Act came into effect on 1 January 2016.

The Financial Undertakings Act also contains a provision regarding the transfer of substantial portfolios of loans or other receivables by banks and other financial undertakings. If the portfolio to be transferred is deemed substantial in light of the involved companies' business, consent from the MOF is required to effect the transfer. The exact scope of application of the provision has yet to be clarified.

If a bank's business is transferred by way of a merger or demerger in accordance with the applicable Norwegian company legislation, customer consent will not be necessary with respect to loans or deposits that, as a result of the merger, have been transferred to a new legal entity. The acquiring party in a merger or demerger is considered to automatically assume all rights, obligations and liabilities of the acquired party without the need for customer consent. However, mergers and demergers of banks must be applied for and are subject to the consent of the Norwegian regulator.

VII THE YEAR IN REVIEW

No major changes took place in the Norwegian banking market in 2018. The Norwegian banking industry retained strong profit levels. Both pre-tax profits and return on equity rose as compared to 2017, and the former is currently at roughly the same level as it was prior to the international financial crisis. Moreover, the overall net interest income of the banks has increased, while operating expenses have decreased as compared to 2017. This is partly due to the industry's focus on digitalisation and streamlining, and Norwegian banks are among the most efficient in Europe according to figures from the EBA. The unsecured consumer loan market was strong in the first three quarters of 2018, and figures show a 12 per cent increase in distributions as compared to 2017.

Moreover, the capital adequacy of the Norwegian banks has been further strengthened, and the banks' combined own equity is at nearly 16 per cent as of September 2018. This increase is mainly because of a decline of the average risk weights due to high growth in lending with low risk weight, and the implementation of to internal ratings-based models.

Similarly, the Norwegian deposit guarantee scheme has further stabilised. As of June 2018, the scheme covers approximately 60 per cent of the total deposits in Norwegian banks.

The MOF has prolonged the temporary regulation imposing stricter requirements for mortgage lending until 31 December 2019, with some alterations. Furthermore, an interim regulation on unsecured consumer loans came into effect on 12 February 2019. The regulation requires financial institutions to undertake more extensive assessments of their customers when distributing unsecured loans to consumers. Accordingly, the banks must, inter alia, ensure that a customer can bear an interest increase of five percentage points, and that the total debt does not exceed five times his or her annual salary. Moreover, amortisation

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of unsecured loans must be made monthly, and with not more than a five-year amortisation profile. Work on creating a debt register related to consumers has continued, and we expect that such register will be operative during 2019.

As described in Section II, a new Anti-Money Laundering Act was enacted in October 2018. During 2018, Parliament enacted changes to the Securities Trading Act (STA), effective from 1 January 2019, which incorporates MiFID II into the STA. Simultaneously, the Stock Exchange Act was repealed, and the relevant provisions are now to be found in the revised STA.

VIII OUTLOOK AND CONCLUSIONS

We expect a number of legislative changes to the Norwegian banking industry in 2019.

First, we expect that the government will propose a new Finance Agreement Act during 2019. We expect that this new Finance Agreement Act will comprise, inter alia, the above-mentioned interim regulation on unsecured customer loans.

Secondly, a number of EU directives are expected to be implemented in Norwegian legislation during 2019. Forthcoming implementation of and amendments to the EEA Agreement are expected to result in less gold plating, and special Norwegian rules for banks and other financial market participants. Both the CRD IV and the CRR are expected to be incorporated in the EEA shortly. Furthermore, the MOF has initiated preliminary work on implementing the Packaged Retail and Insurance-based Investment Products Regulation. While these directives will require certain amendments to the current Norwegian banking law, we do not expect any radical changes to the current legislative environment for banking activities.

Moreover, as outlined in Section II.v, the PSD2 is expected to be implemented during 2019. This will most likely lead to new participants in the Norwegian financial market.

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Chapter 29

PHILIPPINES

Rafael A Morales[1]

I INTRODUCTION

Banks in the Philippines are classified into (1) universal banks, (2) commercial banks, (3) thrift banks, (4) rural banks, (5) cooperative banks, (6) Islamic banks, (7) government-owned banks and (8) other banks as may be classified by the Bangko Sentral ng Pilipinas (BSP).[2] Universal and commercial banks are the dominant groups, representing approximately 70 per cent of the resources of the banking system.[3] Under the General

1 Rafael A Morales is managing partner at Morales & Justiniano.

2 The BSP describes the banks in categories (1) to (5) above in 'BSP Supervised Banks/Statistics' (www.bsp.gov.ph/banking/bspsup.asp) as follows:

- *Universal and commercial banks represent the largest single group, resource-wise, of financial institutions in the country. They offer the widest variety of banking services among financial institutions. In addition to the function of an ordinary commercial bank, universal banks are also authorised to engage in underwriting and other functions of investment houses, and to invest in equities of non-allied undertakings.*
- *The thrift banking system is composed of savings and mortgage banks, private development banks, stock savings and loan associations and microfinance thrift banks. Thrift banks are engaged in accumulating savings of depositors and investing them. They also provide short-term working capital and medium- and long-term financing to businesses engaged in agriculture, services, industry and housing, and diversified financial and allied services, and to their chosen markets and constituencies, especially small and medium-sized enterprises and individuals.*
- *Rural and cooperative banks are the more popular types of banks in rural communities. Their role is to promote and expand the rural economy in an orderly and effective manner by providing people in the rural communities with basic financial services. Rural and cooperative banks help farmers through the stages of production, from buying seedlings to marketing their produce. Rural banks and cooperative banks are differentiated from each other by ownership. While rural banks are privately owned and managed, cooperative banks are organised or owned by cooperatives or federations of cooperatives.*

With regard to category (6) above, the BSP recognises as an Islamic bank the Al-Amanah Islamic Investment Bank of the Philippines (see BSP Circular-Letter dated 14 September 2001). The government-owned banks referred to in category (7) above are the Development Bank of the Philippines and the Land Bank of the Philippines.

3 The five largest privately owned universal banks in terms of assets, as well as their subsidiaries that are thrift banks, account for approximately 50.2 per cent of the resources of the banking system. See Nestor A Espenilla Jr, 'Financial Regulation and the Central Bank', in *Central Banking in Challenging Times: The Philippine Experience* (BSP: 2009), p. 469. As at 30 September 2018, these five universal banks were BDO Unibank, Inc, Metropolitan Bank and Trust Company, Land Bank of the Philippines, Bank of the Philippine Islands and Philippine National Bank. www.bsp.gov.ph/banking/psoc/by_ranks/assets.htm.

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Banking Law of 2000 (GBL), a universal bank is defined as a commercial bank with the additional authority to exercise the powers of an investment house and invest in non-allied enterprises.[4] An ordinary commercial bank does not have that authority.

There are branches, subsidiaries and affiliates of foreign banks in the Philippines that are licensed either as universal or commercial banks. Others have offshore banking units with more limited functions.[5]

The BSP, which is the Philippine central bank, acting through its Monetary Board, is mandated by law to ensure that the control of 60 per cent of the resources or assets of the banking system is held by domestic banks that are at least majority-owned by Philippine nationals.[6]

II THE REGULATORY REGIME APPLICABLE TO BANKS

The GBL governs universal and commercial banking. Special laws or charters regulate the operations of the other banks,[7] but the GBL still applies to them insofar as it is not in conflict with those laws or charters. In fact, the Philippine Cooperative Code of 2008 recognises the primacy of the GBL in the regulation of cooperative banks.[8]

The rules implementing the various banking laws are embodied in the Manual of Regulations for Banks issued by the BSP. From time to time, additional circulars and other issuances are promulgated by the BSP to regulate new matters, if not to amend, repeal or otherwise modify existing rules.

The New Central Bank Act,[9] which is the BSP charter, is applicable as it contains provisions on banking regulation in line with the mandate of the BSP as the primary overseer of banks in the Philippines. Relevant too is the Charter of the Philippine Deposit Insurance Corporation (PDIC),[10] the insurer of bank deposits.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

An effective prudential regulator is central to a safe and sound banking system. In the Philippines, that role is fulfilled entirely by the BSP. Section 4 of the GBL expressly states that the 'operations and activities of banks shall be subject to supervision of the Bangko Sentral'. Supervision, as defined in Section 4, not only contemplates the promulgation by the BSP of rules of conduct and standards of operations for banks (now set out in the Manual of Regulations for Banks, as supplemented or modified by the BSP from time to time), but also

4 Section 23 of the GBL (Republic Act No. 8791).

5 See Sections 45 to 60 of the BSP Manual of Regulations on Foreign Exchange Transactions.

6 Section 3 of Republic Act No. 7721 (as amended by Republic Act No. 10641).

7 These special laws or charters are the Thrift Banks Act (Republic Act No. 7906), the Rural Banks Act (Republic Act No. 7353, as amended), the Philippine Cooperative Code of 2008 (Republic Act No. 9520), the Charter of the Al-Amanah Islamic Investment Bank of the Philippines (Republic Act No. 6848), the 1986 Revised Charter of the Development Bank of the Philippines (Executive Order No. 81) and the Charter of the Land Bank of the Philippines (Republic Act No. 3844, as amended).

8 Article 104 of the Philippine Cooperative Code of 2008.

9 Republic Act No. 7653.

10 Republic Act No. 3591, as amended.

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visitorial powers, that is, the conducting of examinations and investigations of the activities of banks with a view to determining their compliance with those rules and standards, and enforcing prompt and corrective action in cases of breaches of the same. Ultimately, the aim is to ensure the continued solvency and liquidity of banks.

As a rule, the BSP conducts regular investigations of banks not more than once a year. However, the Monetary Board, by an affirmative vote of five members, may order a special examination of a bank.[11] In this regard, the BSP is required to immediately address findings of irregularities or deficiencies. When examining a bank, the BSP also has the authority to examine an enterprise that is wholly or majority owned by the bank.[12]

Under the PDIC Charter, the PDIC can also examine banks once a year with the prior approval of the BSP. To avoid the overlapping of efforts, the PDIC has to 'maximise the efficient use of relevant reports, information and findings of the Bangko Sentral which it shall make available to the [PDIC]'.[13] Under the amendments to the PDIC Charter made by Republic Act No. 10846, if the PDIC has submitted to the Monetary Board a report of examination asking that corrective action be taken against a bank determined by the PDIC to be conducting unsafe and unsound banking practices, and no corrective action is taken by the Monetary Board within 45 days of submission of the report, then the PDIC can, *motu proprio*, institute the necessary corrective action and thereafter inform the Monetary Board of the action taken.

ii Management of banks

The management of a locally incorporated bank (such as a subsidiary of a foreign bank) is vested in a board of directors with five to 15 members, at least two of whom must be independent directors. Foreign nationals may become directors to the extent of the foreign equity in the bank concerned.[14]

The Monetary Board has prescribed the criteria for individuals to be elected as bank directors, in line with the fit and proper rule, to maintain the quality of bank management, and better protect depositors and the public in general. Here, the Monetary Board considers the integrity, experience, education, training and competence of the individual concerned. The election of bank directors must be confirmed by the Monetary Board.[15]

11 Section 28 of the New Central Bank Act.

12 Section 7 of the GBL.

13 Section 8 (Paragraph 8) of the PDIC Charter.

14 Section 15 of the GBL.

15 A bank director must have the following minimum qualifications prescribed by the Monetary Board. He or she: must be at least 25 years old at the time of election; must be at least a university graduate, or have at least five years' experience in business; and must have attended a BSP-accredited seminar on corporate governance for directors (Subsection X141.2 of the Manual of Regulations for Banks). For additional qualifications or disqualifications prescribed, from time to time, by the Monetary Board, see Section X141 et seq. of the Manual of Regulations for Banks, and the BSP Supervision and Examination Sector's 'Basic Guidelines in Establishing Banks' (see also Appendix 37 to the Manual of Regulations for Banks). The Monetary Board has to confirm the election or appointment of directors, as well as officers with the rank of senior vice president and above, of universal and commercial banks (Subsection X143.5, Manual of Regulations for Banks, as amended by BSP Circular No. 391 dated 15 July 2003).

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Board meetings may be conducted via teleconferencing or videoconferencing.[16] Accordingly, directors of a bank need not all be physically present in one room to hold a valid meeting. A bank director must, however, participate in at least 50 per cent of all board meetings every year and physically attend at least 25 per cent of all such meetings.[17]

As in other domestic corporations, all corporate powers of a locally incorporated bank are exercised by its board of directors.[18] After the election of the directors, the shareholders can participate in the management of the bank only in certain fundamental matters, such as the amendment of the articles of incorporation or by-laws of the bank, its dissolution, or its merger or consolidation with another bank.[19]

The BSP published the Handbook on Corporate Governance 'to improve corporate governance in the Philippine banking system'. The BSP also issued the rules of procedure on administrative cases involving directors and officers of banks.[20] It is also aligning its rules with international best practices that foster good corporate governance in the banking sector, such as the Principles for Enhancing Corporate Governance promulgated by the Basel Committee on Banking Supervision.[21] In this regard, the BSP has required each bank to appoint a full-time chief compliance officer to manage a compliance system designed to identify and mitigate business risks that may erode the franchise value of the bank.[22]

To protect the funds of the depositors and creditors of banks, the Monetary Board may regulate the payment of compensation, allowances, fees, bonuses, stock options, profit-sharing and fringe benefits to bank directors and officers, in exceptional cases and when circumstances warrant, such as when a bank is under comptrollership or conservatorship, when it is found to be conducting business in an unsafe and unsound manner, or when it is in an unsatisfactory financial condition.[23] Towards this end, the Monetary Board requires that the total amount of unbooked valuation reserves and deferred charges be deducted from the net income of the bank in the event of profit sharing.[24] Further, when the total compensation package (including salaries, allowances, fees and bonuses) of directors and officers is significantly excessive when compared with peer group averages, the Monetary Board may order a reduction of the package to a more reasonable level.[25] It must also be noted that the compensation of directors in general is regulated by Section 30 of the Corporation Code, which mandates that the total annual compensation of directors must not exceed 10 per cent of the bank's net income before tax during the preceding year.

Philippine branches of foreign banks are bound by the pertinent provisions of the GBL and the Manual of Regulations for Banks, except those providing for (1) the creation, formation, organisation or dissolution of corporations, and (2) the fixing of the relations,

16 Section 15 of the GBL.

17 Subsection X141.1 of the Manual of Regulations for Banks.

18 Section 23 of the Corporation Code of the Philippines.

19 See Sections 16, 48, 77, 118 and 119 of the Corporation Code of the Philippines.

20 BSP Circular No. 477.

21 BSP Circular No. 757.

22 BSP Circular No. 747; the BSP also issued Circular No. 766, 'Guidelines in Strengthening Corporate Governance and Risk Management Practices on Trust, Other Fiduciary Business, and Investment Management Activities'.

23 Section 18 of the GBL.

24 Section X147 of the Manual of Regulations for Banks.

25 Ibid.

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liabilities, responsibilities or duties of shareholders, directors or officers of corporations.[26] These excluded matters will be governed by the applicable law in the jurisdiction of the foreign bank. Apart from the aforementioned in items (1) and (2), branches of foreign banks are required to conduct their operations subject to the same standards required of domestic banks. A branch does not have a board of directors. It is usually managed by an individual appointed by the head office, and his or her authority is normally set out in a power of attorney from the head office.

iii Regulatory capital and liquidity

Section 34 of the GBL enjoins the BSP to conform the 'minimum ratio which the net worth of a bank must bear to its total risk assets' to 'internationally accepted standards, including those of the Bank of International Settlements relating to risk-based capital requirements'.

In the case of non-compliance by a bank with the prescribed minimum ratio, the Monetary Board may, until that ratio is met or restored by the bank:

a limit or prohibit the distribution of net profits by the bank, and require that those profits be used, in full or in part, to increase the capital accounts of the bank;

b restrict or prohibit the acquisition of major assets by the bank; and

c restrict or prohibit the making of new investments by the bank, with the exception of purchases of readily marketable evidence of indebtedness of the government and the BSP, and other evidence of indebtedness or obligations, the servicing and the repayment of which are fully guaranteed by the government.[27]

Universal and commercial banks are subject to the capital adequacy standards under Basel III. The Basel Committee on Banking Supervision has outlined a staggered implementation of Basel III up to the end of 2018 to allow internationally active banks time to raise capital organically. However, the BSP decided to adopt Basel III-based capital standards in full on 1 January 2014 on a non-staggered basis. This is in recognition of the strong capital position of the Philippine banking industry.[28] Under the rules, the risk capital ratio, expressed as a percentage of qualifying capital to risk-weighted assets, is 10 per cent for solo bases (head office plus branches) and consolidated bases (parent bank plus subsidiary financial allied undertakings, but excluding insurance companies). The Common Equity Tier 1 (CET1) ratio is 6 per cent, while the Tier 1 capital ratio is 7.5 per cent. Moreover, there is a capital conservation buffer of 2.5 per cent, composed of CET1 capital. In addition, the BSP subjects domestically systematically important banks to a higher loss absorbency by requiring them to have a higher share of their balance sheets funded by instruments that increase their resilience as a going concern. To restrict the build-up of leverage, banks must meet a leverage ratio of not less than 5 per cent on both a solo and consolidated basis. Finally, there is a required liquidity coverage ratio, which is the ratio of high-quality liquid assets to total net cash outflows. As a minimum, the stock of liquid assets should enable the bank to withstand significant liquidity shocks that last 30 calendar days, which would give time for corrective actions to be taken by the bank management or the BSP, or by both.

26 Section 77 of the GBL.

27 Section 34 of the GBL.

28 See 'BSP to Fully Implement Basel 3 Capital Adequacy Rules for Universal and Commercial Banks in 2014' (BSP media release, 6 January 2012), www.bsp.gov.ph. The current Basel III-based rules are embodied in Sub-part E, Part One, Volume I of the Manual of Regulations for Banks.

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Thrift banks, rural banks and cooperative banks, which are not subsidiaries of universal and commercial banks, are covered by a separate risk-based capital adequacy system labelled by the BSP as the Basel 1.5 framework – a simplified version of Basel II that takes into account the simple operations of those banks.

iv Recovery and resolution

Under Section 29 of the New Central Bank Act, the Monetary Board may appoint a conservator for a bank that is in a 'state of continuing inability or unwillingness to maintain a condition of liquidity deemed adequate to protect the interest of depositors and creditors'. The conservator will:

a have such powers as the Monetary Board deems necessary to take charge of the assets and liabilities of the bank;
b manage the bank or reorganise its management;
c collect all monies and debts due to the bank; and
d exercise all powers necessary to restore its viability.

The conservator must be competent and knowledgeable in bank operations and management. There is a one-year limit to conservatorship.[29]

The Monetary Board will terminate the conservatorship when the bank can continue to operate on its own. Termination is also an option if the Monetary Board determines that the continuance in business of the bank would involve probable loss to the depositors and other creditors of the bank, in which case Section 30 of the New Central Bank Act would apply.[30]

Under Section 30, the Monetary Board may summarily forbid a bank from doing business and designate the PDIC as a receiver of the bank if that bank 'has insufficient realisable assets, as determined by the Bangko Sentral, to meet its liabilities'. The appointment of a receiver is also warranted without prior hearing in the event that the Monetary Board finds that a bank is unable to pay its liabilities as they become due in the ordinary course of business; cannot continue in business without involving probable losses to its depositors or creditors; or has wilfully violated a final BSP cease-and-desist order involving acts or transactions that amount to fraud or dissipation of bank assets.[31]

The receiver must determine, as soon as possible but not later than 90 days after the takeover, whether the bank may be rehabilitated or otherwise placed in a condition that would permit it to resume business with safety to its depositors and other creditors, and the general public. Any such determination for the resumption of business is subject to prior Monetary Board approval. In the event that the receiver determines that the bank cannot be rehabilitated or permitted to resume business, the Monetary Board will notify the board of directors of the bank accordingly, and instruct the receiver to liquidate the bank. The receiver will then file an *ex parte* petition in court for assistance in the liquidation of the bank pursuant to a liquidation plan adopted by the PDIC for general application to all closed banks and convert the assets of the bank to money, disposing of the same to creditors and

29 Section 29 of the New Central Bank Act.
30 Ibid.
31 Section 30 of the New Central Bank Act.

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other parties, for the purpose of paying the debts of the bank in accordance with the rules on concurrence and preference of credits under the Civil Code of the Philippines, and institute actions to collect and recover accounts and assets of, or defend any action against, the bank.[32]

The actions of the Monetary Board taken under Section 30 of the New Central Bank Act are final and executory, and may not be restrained or set aside by a court, save on petition for *certiorari* on the ground that the action in question was in excess of jurisdiction or done with such grave abuse of discretion as to amount to lack or excess of jurisdiction.[33]

Under the amended PDIC Charter, a bank ordered to be closed by the Monetary Board will no longer be rehabilitated. The PDIC, as the designated receiver, will proceed with the takeover and liquidation of the closed bank, without the consent of the stockholders, board of directors, depositors and the other creditors of the closed bank.

IV CONDUCT OF BUSINESS

Section 2 of the GBL requires banks to exercise 'high standards of integrity and performance'. A breach of this fiduciary duty could make the erring bank liable for damages to its customers, and result in the conduct of banking business in an unsafe and unsound manner that may lead to a bank run and eventual insolvency. To minimise this systemic risk, prudential measures have been put in place in the GBL and the Manual of Regulations for Banks. Apart from the capital adequacy discussed earlier, these measures include the reserve requirement, single borrower's limit (SBL), the directors, officers, stockholders and related interests (DOSRI) limit, loan-loss provisioning and equity investment limit.

The BSP is also reinforcing prudential measures to minimise systemic risk, as exemplified by its adoption of a stress test for the real estate exposures of local banks. Further, the BSP issued Circular No. 857 on the minimum standards of consumer protection in the areas of disclosure and transparency, confidentiality of client information, fair treatment, effective recourse and financial education. BSP-supervised financial institutions must adhere to the highest service standards in their dealings with their customers. They are required to have a consumer protection risk management system whereby they are able to identify, measure, monitor and control consumer protection risks inherent in their operations. The BSP considers consumer protection as a core function complementary to its prudential regulation and supervision, and to its agenda for financial stability, inclusion and education.

i Reserves

Banks are required to maintain reserves against their deposit and deposit-substitute liabilities.[34] The reserve requirements are not static, as they may be varied from time to time by the Monetary Board. The BSP imposed a unified reserve (initially of 18 per cent) for the deposit and deposit-substitute liabilities of universal and commercial banks.[35] These reserves, aside from being an instrument of monetary policy of the BSP, have a prudential purpose, since they serve as a ready source of funds that will respond to an unusually large number of withdrawals of deposits taking the shape of a bank run. Under manageable circumstances, the reserves and other funds at the bank's disposal should stem the run.

32 Ibid.

33 Ibid.

34 Section 94 of the New Central Bank Act.

35 BSP Circular No. 753.

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ii SBL

The SBL serves to allocate bank resources to different sectors of the economy. It prevents banks from making excessive loans and other credit accommodations to a single borrower or corporate group. Thus, banks are prohibited from placing all their eggs in the basket of a single client, thereby safeguarding them from too large a risk exposure to a single client. Currently, the SBL is 25 per cent of the net worth of a bank.[36] There could be an incremental SBL of 10 per cent of the net worth of the bank, provided that the additional liabilities of the borrower are adequately secured by documents of title to goods that are readily marketable, non-perishable and fully insured.[37]

iii DOSRI limit

The general policy behind the DOSRI limit is to level the lending field between insiders (namely, directors, officers, stockholders and their related interests) and outsiders. The rules require that loans and other credit accommodations to DOSRI are to be in the regular course of business and upon terms no less favourable to the bank than those offered to those outside the DOSRI circle. The aim is to prevent banks from becoming a captive source of finance of the DOSRI.[38]

The existing DOSRI rules have three ceilings: an individual ceiling, an aggregate ceiling and a ceiling on unsecured loans. The individual ceiling relates to the total allowable outstanding direct credit accommodation to a DOSRI, which is an amount equivalent to the individual's unencumbered deposits in the lending bank plus the book value of the paid-capital contribution therein. It is also required that the unsecured credit accommodations must not exceed 30 per cent of the total DOSRI credit accommodations. On the other hand, the aggregate ceiling refers to the total credit accommodations to DOSRI: this is 15 per cent of the total loan portfolio of the bank or 100 per cent of its net worth, whichever is lower.[39]

Before a bank can extend a DOSRI loan, a specific resolution must be passed by the board of directors, without the participation of the interested director. The resolution must be entered into the records of the bank, and a copy of the entry must be transmitted to the BSP within 20 banking days of board approval.

iv Loan-loss provisioning

Appendix 18 to the Manual of Regulations for Banks contains the basic minimum guidelines for setting up allowances for credit losses (ACL) in respect of banks 'with operations that may not economically justify a more sophisticated loan loss estimation methodology or where practices fell short of expected standards'. Loans and other credit accommodations with unpaid principal or interest are to be classified (as pass, especially mentioned, substandard, doubtful or loss, as the case may be) and provided with ACL based on the number of days of missed payments.[40]

36 Section X303 of the Manual of Regulations for Banks.

37 Subsection 35.2 of the GBL.

38 Section 36 of the GBL.

39 Sections X326 to X337 of the Manual of Regulations for Banks.

40 Under Subsection X178.17 of the Manual (cited above), The pass category includes loans and other credit accommodations (such as accounts receivables, sales contract receivables, accrued interest receivables and advances) that 'do not have a greater-than-normal credit risk', as distinguished from those 'especially mentioned' that have 'potential weaknesses that deserve management's close attention'. Loans and other

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v Equity investment limit

There are limits as to how much universal and commercial banks can invest in equities of enterprises. Under Section 24 of the GBL, the total investment by a universal bank in equities of allied and non-allied enterprises must not exceed 50 per cent of its net worth, while its equity investment in any one enterprise is not to exceed 25 per cent of its net worth.[41] On the other hand, the total investment by a commercial bank in equities of allied enterprises

credit accommodations become substandard if they have 'well-defined weakness that may jeopardize repayment/liquidation in full, either in respect of the business, cash flow or financial position, which may include adverse trends or developments that affect willingness or repayment ability of the borrower'. They become doubtful when they 'exhibit more severe weaknesses than those classified as substandard' and 'on the basis of currently known facts, conditions and values make collection or liquidation highly improbable', although 'the exact amount remains undeterminable as yet'. They are not classified as loss yet, since there are 'specific pending factors which may strengthen the assets'. However, they are to be classified as loss once they are considered as 'uncollectible or worthless and of such little value that their continuance as bankable assets is not warranted although the loans may have some recovery or salvage value'.

41 Section X377 of the Manual of Regulations for Banks (as amended by BSP Circular No. 316 dated 29 January 2002) lists the following as possible financial allied enterprises of a universal bank: (1) leasing companies, (2) banks, (3) investment houses, (4) financing companies, (5) credit card companies, (6) financial institutions catering to small and medium-sized industries, including venture capital corporations, (7) companies engaged in stock brokerage or securities dealership, (8) companies engaged in foreign exchange dealership or brokerage, (9) insurance companies, and (10) holding companies investing in allied or non-allied enterprises.

As clarified by BSP Circular No. 316, category (1) above includes enterprises engaged in the 'leasing of stalls and spaces in a commercial establishment'. However, a bank's entry into these leasing enterprises should be through 'conversion of outstanding loan obligations into equity'.

On the other hand, Section X380 of the Manual (as amended by BSP Circular No. 317 dated 29 January 2002 and BSP Circular No. 338 dated 18 July 2002) classifies the following enterprises as non-financial allied: warehousing companies; storage companies; safe deposit box companies; companies primarily engaged in the management of mutual funds but not in mutual funds themselves; management corporations engaged in an activity similar to the management of mutual funds; companies engaged in providing computer services; insurance agencies or brokerages; companies engaged in house building and home development; companies providing drying or milling facilities for agricultural crops; service bureaus organised to perform for banks and non-bank financial institutions the services allowed to be outsourced under BSP Circular No. 268 dated 5 December 2000; the Philippine Clearing House Corporation; the Philippine Central Depository, Inc; and the Fixed Income Exchange (i.e., Philippine Dealing and Exchange Corp). Health maintenance organisations are also classified as non-financial allied enterprises in which universal banks may invest.

All enterprises not otherwise specified as allied (whether financial or non-financial) would be classifiable as non-allied. Thus, investments in mutual funds (as opposed to their management companies) would be considered as non-allied. In addition, Subsection 1381.1 of the Manual identifies the following as non-allied enterprises: enterprises engaged in physically productive activities in agriculture, mining and quarrying, manufacturing, public utilities, construction, wholesale trade, and community and social services following the industrial groupings in the Philippine Standard Industrial Classification as enumerated in Appendix 22 of the Manual; industrial park projects or industrial estate developments; and financial and commercial complex projects (including land development and buildings constructed thereon) arising from or in connection with the government's privatisation programme. An airport terminal company is a non-allied enterprise (see *Agan, Jr, v. Philippine International Air Terminals Co, Inc*, 402 SCRA 612, 651–652 (2003); see also *Agan, Jr, v. Philippine International Air Terminal Co, Inc*, GR No. 155001, 21 January 2004).

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must not exceed 35 per cent of its net worth, while the individual limit is 25 per cent of its net worth. It must be stressed that only universal banks can invest in non-allied enterprises. In all cases, the approval of the Monetary Board is required.

A breach of any of the foregoing prudential measures would constitute a violation of the GBL or the Manual of Regulations for Banks. Under Section 36 of the New Central Bank Act, any person responsible for a breach or violation may be criminally prosecuted, and if convicted may be punished with a fine ranging from 50,000 to 200,000 pesos, with imprisonment for a period ranging between two and 10 years, or with a combination of a fine and imprisonment, at the discretion of the court. Further, whenever a bank persists in carrying on its business in an unlawful or unsafe manner, the Monetary Board may take action under Section 30 of the New Central Bank Act for its receivership and liquidation, without prejudice to the penalties provided above and the administrative sanctions provided in Section 37 of the New Central Bank Act, namely:

a fines in amounts determined by the Monetary Board, but in no case to exceed 30,000 pesos a day for each violation;
b suspension of rediscounting privileges or access to BSP credit facilities;
c suspension of lending or foreign exchange operations or authority to accept new deposits or make new investments;
d suspension of interbank clearing privileges; and
e revocation of a quasi-banking licence.

The bank is subject to certain confidentiality obligations. Any information relating to the funds or properties of clients of a bank are to be kept confidential by that bank and its directors, officers, employees or agents. Under Subsection 55.1(b) of the GBL, this information cannot be disclosed to any unauthorised person without a court order. However, under Section 11 of the Anti-Money Laundering Act of 2001,[42] no court order is required if:

a the funds or property involved consist of investments (other than those in bonds issued by the government or its political subdivisions and instrumentalities, as those are governed by the Secrecy of Bank Deposits Law mentioned below); and
b the said investments are related to:
- kidnapping for ransom;
- unlawful activities under Sections 4, 5, 6, 8, 9, 10, 12, 13, 14, 15 and 16 of the Comprehensive Dangerous Act of 2002;
- hijacking and other violations under Republic Act No. 6235; and
- destructive arson and murder, including that perpetrated by terrorists against non-combatants and similar targets.

The term unauthorised person in Subsection 55.1(b) of the GBL does not include BSP officials involved in the periodic or special examination of a bank, or other persons authorised by the bank to undertake certain activities on its behalf (e.g., a service provider under an outsourcing arrangement allowed under Subsection 55.1(e) of the GBL). It must also be noted that the persons entitled to protection under Subsection 55.1(b) are 'private individuals, corporations, or any other entity'. Thus, the protection would not extend to non-private persons, such as public officials.

42 Republic Act No. 9160, as amended.

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With regard to bank deposits in pesos (as well as investments in bonds issued by the government or its political subdivisions and instrumentalities), the Secrecy of Bank Deposits Law applies.[43] Under this Law, those deposits and investments may not be examined, enquired about or looked into by any person, government official, bureau or office, except:

a upon written permission of the depositor or investor;

b in cases of impeachment;

c upon an order of a competent court regarding bribery;

d for dereliction of duty by public officials; or

e where the money deposited or invested is the subject of the litigation.

The following cases are additional exceptions to the Secrecy of Bank Deposits Law:

a prosecution for unexplained wealth under Republic Act No. 3019, as amended, otherwise known as the Anti-Graft and Corrupt Practices Act;[44]

b upon order of a competent court in cases of violation of the Anti-Money Laundering Act of 2001 when it has been established that there is probable cause that the deposits or investments involved are in any way related to an unlawful activity or a money laundering offence under the said Act, except that no court order is required in cases of:
- kidnapping for ransom;
- unlawful activities under Sections 4, 5, 6, 8, 9, 10, 12, 13, 14, 15 and 16 of the Comprehensive Dangerous Drugs Act of 2002;
- hijacking and other violations under Republic Act No. 6235; and
- destructive arson and murder, including that perpetrated by terrorists against non-combatants and similar targets (Section 11 of the Anti-Money Laundering Act of 2001);

c the BSP's enquiry into or examination of deposits or investments with any bank when the enquiry or examination is made during the course of the BSP's periodic or special examination of a bank (Section 11 of the Anti-Money Laundering Act of 2001);

d an enquiry by the Commissioner of Internal Revenue into the deposits of a decedent for the purpose of determining the gross estate of the decedent (Section 6(F) of the National Internal Revenue Code of 1997);[45] and

e disclosure of certain information about bank deposits, which have been dormant for at least 10 years, to the Treasurer of the Philippines in a sworn statement, a copy of which is posted in the bank premises (Section 2, Unclaimed Balances Law (Act No. 3936, as amended)).

On the other hand, deposits in foreign currency deposit units of banks may be examined in any of the following instances:

a upon the written permission of the depositor (Section 8 of the Foreign Currency Deposit Act);

43 Republic Act No. 1405, as amended.

44 See *Philippine National Bank v. Gancayco*, 15 SCRA 91 (1965); and *Banco Filipino Savings and Mortgage Bank v. Purisima*, 161 SCRA 576 (1988)).

45 Republic Act No. 8424.

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b upon an order of a competent court in cases of violation of the Anti-Money Laundering Act of 2001, when it has been established that there is probable cause that the deposits involved are in any way related to an unlawful activity or a money laundering offence under the said Act, except that no court order is required in cases of:
- kidnapping for ransom;
- unlawful activities under Sections 4, 5, 6, 8, 9, 10, 12, 13, 14, 15 and 16 of the Comprehensive Dangerous Drugs Act of 2002;
- hijacking and other violations under Republic Act No. 6235; and
- destructive arson and murder, including that perpetrated by terrorists against non-combatants and similar targets (Section 11 of the Anti-Money Laundering Act of 2001);

c an enquiry by the Commissioner of Internal Revenue into the deposits of a decedent for the purpose of determining the gross estate of the decedent (Section 6(F) of the National Internal Revenue Code of 1977); and

d the BSP's enquiry into or examination of deposits with any bank when the enquiry or examination is made during the course of the BSP's periodic or special examination of the bank (Section 11 of the Anti-Money Laundering Law of 2001).

Notwithstanding the provisions of the Secrecy of Bank Deposits Law, the Foreign Currency Deposit Act and Subsection 55.1(b) of the GBL, the BSP and the PDIC may enquire into or examine deposit accounts and all information related thereto in cases where there is a finding of unsafe or unsound banking practices.[46]

Further, under the Terrorism Financing Prevention and Suppression Act 2012, the Anti-Money Laundering Council is authorised, in connection with an investigation of financing of terrorism, to enquire into or examine deposits and investments with any bank and any of its subsidiaries or affiliates without a court order.[47]

V FUNDING

Funding for banks comes from equity contributions from its shareholders, and from loans and credit accommodations from the BSP and other lenders.[48]

The BSP has prescribed certain minimum levels of capitalisation for banks. For instance, a universal bank (with more than 100 branches) must have a minimum paid-in capital of 20 billion pesos at the time of its establishment, while a commercial bank (with the same number of branches) must have 15 billion pesos.[49] Furthermore, the risk-based capital adequacy ratio of universal and commercial banks has continued to be above the BSP's minimum ratio of 10 per cent and the Basel Accord's standard ratio of 8 per cent, despite global financial uncertainties.[50]

46 Section 8 (Paragraph 8) of the PDIC Charter, as amended by Republic Act No. 9576.

47 Section 10 of the Republic Act No. 10168.

48 Banks have raised Basel-based capital through subordinated debt issuances.

49 BSP Circular No. 854.

50 See 'U/KBs Remain Adequately Capitalized in Q3 2015' (BSP media release, 4 March 2016), www.bsp.gov.ph.

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The BSP, for its part, provides rediscounting and other credit facilities to banks, including loans for liquidity purposes and emergency loans during periods of financial panic that directly threaten monetary and banking stability.[51]

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Under Subsection X126.1 of the Manual of Regulations for Banks (as amended by BSP Circular No. 718), the shareholdings of an individual or a corporation in any bank are subject to the following limits:

a foreign individuals and non-bank corporations may collectively own or control up to 40 per cent of the voting stock of a domestic bank;

b qualified foreign banks[52] may own or control up to 100 per cent of the voting stock of a domestic bank;

c a Filipino individual and a domestic non-bank corporation may each own up to 40 per cent of the voting stock of a domestic bank, but there is no ceiling on the aggregate ownership by such individuals and corporations in a domestic bank; and

d an individual and corporations wholly or majority-owned by him or her can own or control only up to a combined 40 per cent of the voting stock of a domestic bank.

ii Transfers of banking business

The prior approval of the Monetary Board is required for transactions involving voting shares of a bank if they will result in ownership or control of more than 20 per cent of voting shares of stock of a bank by any person (whether natural or juridical), or will enable that person to elect or be elected as a director of the bank; or effect a change in the majority ownership or control of the voting shares of stock of the bank from one group of persons to another.

The transaction will not be approved by the Monetary Board unless the bank concerned immediately complies with the prescribed minimum capital requirement for new banks.[53]

Under the Philippine Competition Act, a bank merger or consolidation whose value exceeds 1 billion pesos is to be notified to the Philippine Competition Commission. However, a favourable or no-objection ruling by the Commission will not dispense with the Monetary Board and PDIC approvals for a merger or consolidation.[54] Further, without PDIC consent, no insured bank can assume another bank's liability to pay deposits.[55]

51 Sections 81 to 88 of the New Central Bank Act.

52 Under Republic Act No. 7721 (as amended by Republic Act No. 10641), the BSP considers only those foreign banks that are widely owned and publicly listed in their country of origin, if not owned or controlled by the government. Further, the BSP will '(i) ensure geographic representation and complementation; (ii) consider strategic trade and investment relationships between the Philippines and the trade and investment relationships between the Philippines and the country of incorporation of the foreign bank; (iii) study the demonstrated capacity, global reputation for financial innovations and stability in a competitive environment of the applicant; (iv) see to it that reciprocity rights are enjoyed by Philippine banks in the applicant's country; and (v) consider willingness to fully share their technology'.

53 Subsection X126.2 of the Manual of Regulations for Banks.

54 Section 16, Philippine Competition Act; Subsection X108.1 of the Manual of Regulations for Banks; Section 21(c) of the PDIC Charter.

55 Section 21(c) of the PDIC Charter.

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VII THE YEAR IN REVIEW

The Philippine banking system remained sound and stable during 2018, with robust expansion in credit and demonstrating asset quality, liquidity, profitability and capital adequacy well above national and international thresholds.[56]

The average inflation rate in 2018 was 5.2 per cent, higher than the 3.2 per cent average in 2017 and the government's target range of 3 per cent plus or minus one percentage point.[57] At the end of 2018, the gross international reserves (GIR) stood at US$78.46 billion, sufficient to cover more than 6.9 months' worth of imports of goods and payment of services.[58]

The economy grew by 6.1 per cent in 2018, representing 80 quarters of uninterrupted growth.[59] The country's balance of payments (BOP) position posted a surplus of US$2.44 billion in December 2018.[60] Foreign direct investments for the first 10 months of 2018 reached US$8.5 billion.[61] The GIR is equivalent to 6.2 times the country's short-term external debt based on original maturity and 4.2 times based on residual maturity.[62]

VIII OUTLOOK AND CONCLUSIONS

The outlook for the Philippine banking system remains positive, as the economy continues to grow and be resilient amid the global anxiety regarding the inward-looking policies of the Trump presidency and the escalating trade tensions between the United States and China. The balance sheets of banks expanded in 2018, with 16.4 trillion pesos in assets by end-November 2018 due mainly to deposit growth, and credit flowed steadily to the productive sectors of the economy.[63] This is expected to continue in 2019.

With the ongoing economic integration of the ASEAN, the BSP will continue to encourage mergers and consolidations of domestic banks, as well as require them to raise their capital, to make them more competitive with their regional counterparts. The Philippines and the rest of the ASEAN members established the ASEAN Financial Integration Framework for banking, a feature of which is the launching of the Qualified ASEAN Banks (QABs). Philippine banks are expected to upgrade themselves as QABs and expand regionally.

The passage and ratification of Republic Act No. 11054, or the Bangsamoro Organic Law, which is the legislative charter of the Bangsamoro Autonomous Region in southern Philippines, augurs well for the development of Islamic banking and finance in the country.

56 See 'Optimism, Commitment and Reform' (speech by the BSP governor at the 2019 Annual Reception for the Banking Community on 25 January 2019), www.bsp.gov.ph.

57 See 'Inflation Drops Further to 5.1 Percent in December, Averages at 5.2 Percent in 2018' (BSP media release, 4 January 2019), www.bsp.gov.ph.

58 See 'End-December 2018 GIR Level Rises to US$78.46 Billion' (BSP media release, 7 January 2019), www.bsp.gov.ph.

59 See footnote 56.

60 See 'Overall BOP Position Posts a Higher Surplus of US$2.44 Billion in December 2018' (BSP media release, 18 January 2019), www.bsp.gov.ph.

61 See 'FDI Posts US$491 Million Net Inflows in October 2018 & US$8.5 Billion in January – October 2018' (BSP media release, 10 January 2019), www.bsp.gov.ph.

62 See footnote 60.

63 See footnote 56.

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Chapter 30

POLAND

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I INTRODUCTION

The Polish economy, like that of other central and eastern European countries, continues to be characterised by a low level of financial intermediation. The assets of the financial sector in Poland amount to only 124 per cent of gross domestic product, compared with 476 per cent in the eurozone. At the same time, the Polish financial sector is heavily dominated by banks, which hold 72 per cent of all financial assets. According to information from the Polish Financial Supervision Authority (PFSA), in January 2019 there were 32 commercial banks operating in Poland, 31 branches of EU credit institutions and 549 cooperative banks. The total assets of the banking sector in Poland amount to approximately 1.9 trillion zlotys, and the sector employs approximately 163,000 people. Generally, Polish banks have remained well capitalised, with capital ratios comfortably beyond the Basel III requirements (with an average capital adequacy ratio of 19.2 per cent).

In recent years, the ownership structure of the Polish banking sector has changed. As a result of a series of merger and acquisition (M&A) transactions, the state has gained or regained influence over new entities, for example Alior Bank and Bank Pekao. This process became known as the 'repolonisation' or domestication of the banking sector. As a result, the importance of Polish investments grew in the banking industry. For the first time since 1999 domestic investors, either state or private, controlled the majority of the assets in the Polish banking sector. However, foreign investors still had control over a significant part of the assets in the Polish banking sector, including 19 commercial banks and all branches of EU credit institutions. The main investments came from Spain, Germany, France and the Netherlands. The Polish State Treasury holds control over eight commercial banks.

The concentration level of the Polish banking sector (i.e., the market share in assets of the 10 largest banks) in 2018 was 71 per cent. The largest Polish bank was state-controlled PKO BP, with a total balance sheet of approximately 324 billion zlotys, followed by Bank Pekao (controlled by the largest Polish insurer, PZU), with a total balance sheet of about 184 billion zlotys, Santander Bank Polska (formerly Bank Zachodni WBK, a member of Santander Group) with a total balance sheet of around 183 billion zlotys, ING Bank Śląski (ING Group), with a total balance sheet of approximately 137.7 billion zlotys, and mBank (formerly BRE Bank, a subsidiary of Germany's Commerzbank) with a total balance sheet of approximately 137.6 billion zlotys.

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In 2018, there were few M&A deals in the Polish banking sector. In this context, Austrian Raiffeisen sold its banking business in Poland to BNP Paribas, and Portuguese Millennium acquired Eurobank from Societe Generale. Some activities during 2018 were still focused on the consummation of transactions started the previous year. For instance, in November 2018, Santander Bank Polska finalised a legal and operational acquisition of the retail part of Deutsche Bank's banking business in Poland. The PFSA considers the market to be of an optimal structure, and the regulator will therefore carefully examine its further consolidation. The PFSA may be especially supportive of Polish-owned financial institutions in view of the concept of domestication of the Polish banking sector.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Pursuant to the legal definition, a bank is a legal person, established in accordance with the applicable laws, operating under an authorisation to perform banking transactions involving any risk for the funds entrusted to the bank and repayable in any way. Under Polish law, banks can be established either as state banks (by the government) or as private banks in the form of a joint-stock company or a cooperative.

Alongside the commercial banks, there are about 35 credit unions operating in Poland. The number is continually decreasing as a result of the intensive restructuring process in this sector. Credit unions merge or are being acquired by other credit unions or banks. In general, the situation of the credit unions sector is difficult and requires intensive remedial actions.

Credit institutions in other EU Member States may provide cross-border financial services in Poland on the basis of the single banking passport, or operate in Poland via a branch. Foreign banks may operate in Poland via a subsidiary (which is formally a separate bank licensed by the Polish regulator) or a branch: the establishment of a branch by a non-EU institution requires an authorisation from the PFSA. Branches of foreign non-EU banks must accede to the Polish deposit insurance system to the extent that the guarantee system in the country of origin does not ensure the disbursement of guaranteed funds within the limits stipulated by Polish law (i.e., the equivalent of €100,000).

Foreign banks and EU credit institutions can open a representative office in Poland. The scope of activities of such an office may consist exclusively of advertising and marketing for the foreign bank or the EU credit institution within the limits specified in the authorisation.

Polish law provides for a list of activities that can be performed exclusively by banks, which comprise:

a taking deposits payable on demand or at a specified maturity, and maintaining those deposit accounts;
b maintaining other bank accounts;
c extending credit;
d extending and confirming bank guarantees,
e issuing and confirming letters of credit;
f issuing bank securities; and
g bank monetary settlements.

Banks may also engage in other activities that can be performed not only by banks, such as:

a extending cash loans;
b operations involving cheques and promissory notes, and operations relating to warrants;
c providing payment services and the issuance of electronic money;

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d forward transactions;
e purchasing and selling debts;
f the safekeeping of assets and securities, and the provision of safe deposit facilities;
g purchasing and selling foreign currencies;
h extending and confirming endorsements;
i intermediation in money transfers and foreign exchange settlements;
j receiving or acquiring shares and rights attached thereto, shares of other legal persons and participation units in investment;
k assuming commitments relating to the issuance of securities;
l trading in securities;
m swapping debt for a debtor's assets on terms agreed with the debtor;
n purchasing and selling real property;
o providing financial consulting and advisory services;
p providing certification services within the meaning of the regulations on electronic signatures, except for the issuance of qualified certificates used by banks in activities to which they are a party;
q intermediation in concluding structured deposit agreements;
r providing advisory services in relation to structured deposits;
s providing other financial services; and
t performing other activities, if permitted by other laws.

Polish law does not provide for the separation of commercial and investment banking. Banks may provide services under provisional underwriting agreements and firm commitment underwriting agreements, or under the execution and performance of other similar agreements on financial instruments and – subject to authorisation by the PFSA – also perform other brokerage services, such as:

a accepting and transferring orders to purchase or sell financial instruments;
b executing purchase and sell orders of financial instruments for a customer's account;
c acquiring or disposing of financial instruments for the bank's account;
d managing portfolios that include one or more financial instruments;
e investment advice; and
f offering financial instruments.

The activities of banks, their branches and their representative offices are supervised by the PFSA. The supervision of activities of a branch or representative office of foreign non-EU banks in Poland, including the scope of examinations and procedures for their performance, may be performed to the extent laid down in an agreement between the PFSA and the supervisory authorities in their home countries. The PFSA is a consolidated supervisor that was created in 2006 as a result of a merger of the securities, insurance, pension system and banking supervisors. The PFSA is in charge of banking, capital markets, insurance and pension scheme supervision, as well as supervision of payment institutions and credit unions. Despite the consolidation, however, the supervisor serves as an umbrella under which cross-regulatory functions are housed, and under which traditional sectoral supervisory units are maintained as separate operating divisions that focus on traditional sectors such as banking, insurance and securities.

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The legal nature of the PFSA changed in 2019. It has become a state legal person instead of an administrative body. This has resulted in more flexible way of dealing with its budget, which is created mainly from contributions paid by supervised entities. The composition of the PFSA has been extended to include new members, such as the representatives of:

a the Prime Minister;
b the Bank Guarantee Fund;
c the President of the Office of Competition and Consumer Protection; and
d the minister in charge of supervising intelligence.

The new members of the PFSA mentioned in points (b) to (d) have no voting rights.

The aim of the change was to improve the circulation of information between the state authorities.

The Ministry of Finance and the presidents of the PFSA, the National Bank of Poland (National Bank) and the Bank Guarantee Fund coordinate their actions in the Financial Stability Committee. The Financial Stability Committee is also the competent body for the macroprudential supervision of the financial system and crisis management. In performing its tasks, the Committee cooperates with the European Systemic Risk Board. It is responsible for, inter alia, identifying financial institutions posing material risks to the financial system and the execution of macroprudential instruments, including presenting opinions and issuing recommendations on limiting systemic risk.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The objective of banking supervision is to ensure the safety of funds held in banks, and the compliance of the banks with the provisions of law, statutes and their banking licences.

Since 2007, the PFSA has been implementing a risk-based approach to supervision. The goal of the regulator is to develop a harmonised methodology for supervision that would use risk as the major factor in determining priorities and the frequency of supervisory actions. Every department of the PFSA is expected to follow a standardised approach for supervisory assessment based on a set of criteria that specify the risks associated with the activities of supervised entities and provide for more accurate quantification of risks associated with the activities of various capital groups on the Polish market. The harmonised methodology encompasses the method of assessing the risk management and control mechanisms of supervised entities, the compliance of activities of supervised entities with the law and the method for identifying irregularities in business conduct.

Banks are required to submit audited financial statements to the PFSA, on a consolidated and unconsolidated basis, with an auditor's opinion and report. Banks, branches and representative offices of non-EU banks in Poland are also required to:

a notify the PFSA of the commencement and cessation of business activity; and
b enable authorised PFSA staff to perform their supervisory functions, in particular by:
- making books of account, balance sheets, records, plans, reports and other documents available to them;
- allowing them, on receipt of a written request, to make copies of such documents and other information media; and
- providing explanations to any questions raised.

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Furthermore, banks must provide to the central bank, at the request of the National Bank, the data necessary to assess their financial standing and the risks to the banking system. Those banks that participate in monetary clearing and interbank settlements must also provide the data necessary for assessing the monetary clearing and interbank settlements.

In recent years, the major focus of the PFSA has continued to be the regulation of the retail markets and the marketing of bank products to retail clients. The PFSA has issued specific recommendations with regard to the marketing by banks of structured investment products, the distribution of insurance products (bancassurance) and the selling of long-term deposits formally structured as insurance to avoid capital gains tax.

The past year was also influenced by a discussion concerning the restructuring of mortgage loans denominated in Swiss francs.

Before the financial crisis, most long-term credits extended by banks in Poland (in particular, mortgage loans) were denominated in foreign currencies (Swiss francs or euros) to take advantage of lower interest rates and thus reduce the total cost of the credit; however, as most retail clients earn their wages in Polish zlotys, they are confronted with foreign exchange volatility with almost no possibility of hedging against that risk. To eliminate the foreign exchange risk, apart from the capital adequacy measures, the PFSA requests that:

a banks inform their clients about the currency spread and the associated risks, both before and during the credit relationship;

b set the exchange rate for the repayment of loans at the same level as for their other customers; and

c enable repayment of a loan directly in a foreign currency acquired from a source other than the lending bank.

In the autumn of 2011, Parliament allowed consumers to repay loans and credits denominated in foreign currencies directly in cash in those currencies, and thus limited the additional source of income for banks resulting from currency spreads. However, the issue has become very acute since the sudden rise of the Swiss franc in mid-January 2015, brought about by the monetary policy decisions of the Swiss National Bank, and the resulting substantial increase of the value of loans and credits denominated in Swiss francs.

The issue of mortgage loans denominated in Swiss francs has been vigorously debated since 2015. Banks and lenders have presented their own ideas for resolving the crisis. However, there were so many discrepancies between these parties, in particular regarding bearing costs of planned operations, that they have not managed to reach a compromise. In consequence, there are numerous lawsuits pending before Polish courts in which clients are attempting to invalidate mortgage loan agreements or at least be reimbursed for the bank spreads. At the Regional Court in Warsaw, the cases related to the loans denominated in Swiss francs constituted nearly 30 per cent of all new cases initiated in 2018.

In January 2016, a draft law aimed at regulating the issue of mortgage loans denominated in Swiss francs and other currencies was presented by the Chancellery of the President of Poland (Chancellery). The draft involved the possibility of converting mortgage loans denominated in Swiss francs and other foreign currencies into Polish zlotys at a fair exchange rate, which was to be calculated individually in relation to each mortgage loan agreement, and the reimbursement of borrowers for bank spreads. However, calculations made by the PFSA proved that the proposed law could jeopardise the financial stability of certain banks and would adversely affect the entire Polish banking sector. Therefore, in August 2016, the Chancellery presented another draft law aimed at regulating the issue of

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mortgage loans denominated in Swiss francs and other currencies concentrated primarily on the reimbursement of borrowers for bank spreads. In August 2017, the Chancellery presented yet another draft law aimed at resolving the issue, targeting amendments to the Act on support for borrowers in difficult financial situations, regarding borrowers who took out mortgage loans. Proposed changes included increasing the amount (from 1,500 zlotys to 2,000 zlotys) and length (from 18 months to 36 months) of financial support, reducing the requirements of obtaining support and introducing the possibility of getting a loan in the event of a sale of a credited real property. According to the draft, in the event of a sale of a credited real property, borrowers would be entitled to draw a loan in an amount up to 72,000 zlotys. Moreover, banks that decide to restructure mortgage loans denominated in foreign currencies by converting them into zlotys would be reimbursed for balance sheet differences in mortgage loan values resulting from the restructuring. It remains to be seen what the final shape of this law will be and how it will influence the financial situation of Polish banks.

ii Management of banks

Following the implementation of the Capital Requirements Directive IV (CRD IV), which entered into force in November 2015, Polish law provides for specific corporate governance requirements for banks. Banks that operate as joint-stock companies are governed by general corporate law with modifications originating from the Banking Law. The supervisory board of a bank must comprise at least five persons, and the management board must comprise at least three. Banks must inform the PFSA of the composition of and any changes to the supervisory or management board. The chair of a bank's management board is in charge of internal audit. It should also be indicated which member or members of the management board are responsible for supervising material risks for the bank's activities. The member or members of the management board should not be supervising the area of the bank's activities that is generating the risk. Moreover, it is not permissible to combine the positions of the president of the management board and the member of the management board in charge of supervising material risk. Further, the division of responsibilities between the members of the management board of a bank should indicate the persons responsible for supervising compliance with laws, internal regulations and market standards, and accounting and financial reporting, including financial control.

Members of a bank's management and supervisory boards should have knowledge, skills and experience relevant to their functions and duties, and give an adequate guarantee of due performance of their duties. In general, the number of functions permitted for members of the management and supervisory boards depends on individual circumstances and the character, scale and degree of complexity of the bank's activities. In the case of significant banks,[2] a member of a management or supervisory board may at the same time perform the duties as a member of no more than one management board and two supervisory boards, or four supervisory boards. In certain situations, the PFSA may give consent to a member to perform duties on one additional supervisory board.

2 Significant banks are those that are significant in terms of size, internal organisation, or type, scope and complexity of conducted business, and that fulfil one of the following conditions: their shares are admitted to trading on a regulated market, or their share in assets, deposits or own funds of the banking sector is not less than 2 per cent; or they are other banks deemed to be significant by the PFSA.

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Certain members of the management board of a bank, namely the chair and those in charge of supervising material risk in the bank's activities, must be approved by the PFSA. Consent may be refused if the candidate, inter alia:

a has been convicted of an intentional or fiscal offence;

b does not have knowledge, skills and experience relevant to his or her functions and duties;

c does not give an adequate guarantee of due performance of his or her duties; or

d cannot prove sufficient knowledge of the Polish language. This last requirement can be waived if knowledge of Polish is not necessary for prudential supervision, taking into account in particular the level of permissible risk or the scope of the bank's activities.

The consent of the PFSA is also necessary for the appointment of the manager and deputy manager of a branch of a non-EU bank. The PFSA uses the same criteria as previously described to evaluate candidates. There are no such requirements with respect to the managing personnel of a branch of an EU credit institution or a representative office.

The PFSA may ask the relevant bank authorities (i.e., a meeting of shareholders or the supervisory board) to dismiss a member of its management or supervisory board who does not fulfil the requirements imposed by law. Moreover, the PFSA is entitled to suspend a member of a bank's management or supervisory board until the relevant bank authorities adopt a resolution on his or her dismissal. The PFSA is obliged to dismiss a member of a bank's management board in the event of a conviction for an intentional or fiscal offence, with the exception of offences tried in a private prosecution, or of a failure to inform the PFSA of charges relating to an intentional or fiscal offence, with the exception of offences tried in a private prosecution, within 30 days of the charges being brought.

The articles of association of a bank shall specify the management system, which is a set of principles and mechanisms relating to the decision-making processes and to evaluating banking activities. The management system comprises the risk management system and internal control system. It must include a procedure of anonymous reporting of violations of the laws, internal regulations and ethical standards applicable to the bank (whistle-blowing). The procedure shall provide protection for whistle-blowers against retaliation, discrimination and other possible instances of unfair treatment.

Except for the general duties imposed on bank managers by corporate law, such as the duties of care and loyalty, the Polish Banking Law provides for specific legal and regulatory duties. Members of a bank's management and supervisory boards are obliged to perform their functions honestly and fairly, and to be driven by independent judgements, to provide efficient assessment and verification of making and enforcing decisions connected with the current management of the bank. General corporate law also governs the decision-making process within the bank – as the default rule, the management board has broad discretion with respect to the conduct of the bank's business. However, the internal regulations (in particular the articles of association) can impose restraints and provide that, for example, certain credit commitments need to be authorised by the supervisory board or the shareholders.

With the exception of state-owned banks, Polish law does not contain any restrictions on bonus payments to management and employees of banking groups, and this issue has never been subject to closer scrutiny by the regulator. Unlike in the United Kingdom and the eurozone countries, the topic of bonus payments in the financial industry has been absent from Polish public discourse, and the remuneration of high-level bankers has not been subject

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to public scrutiny. This may be explained by the fact that during the financial crisis, none of the Polish financial institutions needed to be bailed out by the government, and at no time was there a risk of collapse of the financial sector.

As at March 2019, Polish law also does not provide any limitations on the amount of remuneration that the managers of a Polish bank, except for state-controlled banks, can receive. However, it should be noted that following the implementation of the CRD IV, banks are obliged to draw up and implement remuneration policies for the categories of persons whose professional activity has significant effect on the risk profile of a bank. The remuneration policy applies to bank's subsidiaries, and should be in line with the remuneration policy adopted by the dominant entity of the bank. Every year, banks shall provide the PFSA with information about persons whose professional activity has significant effect on the risk profile of a bank, and whose total remuneration for the previous year amounted to at least the equivalent of €1 million. A remuneration committee composed of members of the supervisory board should be established in significant banks. The purpose of the remuneration committee is assessing and monitoring remuneration policies, and supporting bodies of a bank in shaping and implementing these.

iii Regulatory capital and liquidity

The CRD IV package entered into force on 1 January 2014. The Capital Requirements Regulation (CRR) is directly applicable in Poland, whereas the CRD IV needed to be implemented into Polish law (this occurred in November 2015). Following the implementation of the CRD IV, the relevant provisions of the Banking Law regarding banks' own funds, internal capital and capital adequacy have been amended.

The entry into force of the CRR and the implementation of the CRD IV resulted in material changes in the structure of banks' own funds, which were previously regulated solely by provisions of the Banking Law. Banks must currently maintain own funds defined as the sum of Tier 1 and Tier 2 capital adjusted to the size of the conducted business. Capital instruments and subordinated loans may be qualified as additional instruments in Tier 1 or instruments in Tier 2 after obtaining the consent of the PFSA.

Banks are required to maintain a sum of own funds at a level not lower than the higher of:

a the amount resulting from the fulfilment of requirements regarding own funds specified in the provisions of the CRR;[3] or

b the amount estimated by a bank to be necessary to cover all identified material risks appearing in the bank's activities and changes in the economic environment, taking into account the expected level of risk (the internal capital).

Banks are obliged to draw up and implement strategies and procedures for estimating and constantly maintaining their internal capital. On the demand by the PFSA, banks are required to provide information regarding the structure of own funds and the fulfilment of requirements and norms specified in the Banking Law and the CRR. In addition, banks are obliged to maintain capital buffers, in particular the safeguarding and countercyclical capital buffer. Additional capital in the form of a countercyclical buffer is collected by banks during

3 Subject to Article 92 of the CRR, banks shall at all times satisfy the following own funds requirements: a Common Equity Tier 1 capital ratio of 4.5 per cent, a Tier 1 capital ratio of 6 per cent and a total capital ratio of 8 per cent.

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a period of economic growth, and is aimed at weakening the credit expansion of banks, which shall result in smoothing fluctuations in the cycle. During an economic downturn, banks will be exempt from the requirement to maintain countercyclical buffer capital, and will be able to use additional capital accumulated during the period of economic growth.

The PFSA may recommend that a bank comply with additional requirements relating to liquidity and own funds, or may order a bank to withhold the payment of dividends until liquidity is restored or normal standards of permissible risk in the bank's activities are achieved. The PFSA is also entitled to impose on a bank additional requirements relating to own funds, or to impose higher factors than were previously adopted in the event of significant irregularities in identifying risk using an internal method of calculating own funds. In January 2019, the PFSA issued recommendations relating to the payment of dividends by commercial banks, pursuant to which only banks meeting supervisory expectations regarding the minimum level of total capital ratio and security capital, and not realising a recovery programme, shall be entitled to pay dividends in the full amount.

Generally, Polish banks were well capitalised in 2018. Own funds of Polish banks increased from 198 billion zlotys at the end of 2017 to 209 billion zlotys at the end of Q3 2018. The total capital ratio of Polish banks increased from 19 per cent at the end of 2017 to 19.2 per cent at the end of Q3 2018.

Poland has not adopted any bank holding regulations that would restrict the permissible activities of bank holding companies. According to information from the European Commission, so far no financial conglomerates have been identified in Poland: the provisions regarding the supplementary supervision of financial conglomerates therefore remain a paper exercise. If a Polish bank operates in a holding company, supervision of that entity is exercised on a consolidated basis. The Banking Law contains a set of default rules on the selection of the consolidated supervisor depending on the type of the holding and the home country of the parent company.

In 2015, the national rules regarding liquidity standards were replaced by the liquidity coverage ratio specified in the CRR and Commission Delegated Regulation 2015/61 of 10 October 2014 to supplement the CRR with regard to the liquidity coverage requirement for credit institutions. Consequently, banks shall currently hold liquid assets, the sum of the values of which covers the liquidity outflows less the liquidity inflows under stressed conditions, so as to ensure that institutions maintain levels of liquidity buffers that are adequate to face any possible imbalance between liquidity inflows and outflows under gravely stressed conditions for a period of 30 days. During times of stress, banks may use their liquid assets to cover their net liquidity outflows. The liquidity coverage ratio was introduced gradually, and reached the target level of 100 per cent as from 1 January 2018.

iv Recovery and resolution

Following implementation of the Bank Recovery and Resolution Directive (BRRD), which entered into force in October 2016, Polish law requires banks to draw up recovery plans. Each bank that is not operating in a holding (banks operating in holdings will be included in group recovery plans) must draw up a recovery plan, including actions to be taken in the event of a significant deterioration of the bank's financial standing, a threat to the bank's financial standing, a difficult economic situation, or other circumstances that may adversely affect the financial market or the bank's situation. In the case of a breach or the threat of a breach of the provisions regarding the required level of own funds or liquidity measures, the bank's management board is obliged to inform the PFSA and the Bank Guarantee Fund

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thereof and ensure implementation of the recovery plan. The bank's management board shall promptly notify the PFSA and the Bank Guarantee Fund of the above-mentioned violations and ensure implementation of the recovery plan in the event of a material deterioration of the bank's financial standing, such as:

a the occurrence of a balance loss or a threat thereof;
b a danger of insolvency or loss of liquidity,
c an increasing level of leverage; or
d an increasing number of loans and credits that are at risk or an increasing concentration of exposures.

The PFSA is entitled, inter alia, to:

a impose on a bank's management board the obligation to implement the recovery plan;
b restrict the granting of credits and cash loans to a bank's shareholders, members of its management and supervisory boards, and its employees;
c impose a reduction of the variable component of the remuneration of a bank's senior management; and
d order implementing changes in a bank's business strategy, or amendments to its statutes or its organisational structure.

In the event of a breach or the threat of a breach of the legal provisions regarding the required level of own funds or liquidity measures, the PFSA may establish a curator in the bank to improve the bank's standing or to ensure the effectiveness of the implementation of the recovery plan. The curator's powers include participating in meetings of the bank's authorities and opposing decisions thereof to the competent commercial court. If the implementation of the recovery plan proves ineffective, the PFSA may decide to establish a receivership administration. In that case, the right to adopt resolutions and make decisions in all matters vested by law or by statute with the bank's authorities and governing bodies is transferred to the receivership administrators. However, the PFSA may stipulate that certain actions require its approval. Upon establishing the receivership administration, the supervisory board is suspended, members of the management board are automatically recalled, and previously established commercial proxies and powers of attorney expire. For the duration of the receivership administration, the rights of other bodies of the bank are also suspended. Receivership administrators may close the bank's ledgers and prepare a financial statement of the bank for the day indicated by the PFSA, and adopt a resolution on the coverage of loss for the period ending on that day, and a loss from previous years.

Moreover, the BRRD introduced a compulsory restructuring mechanism. The body responsible for compulsory restructuring is the Bank Guarantee Fund. In performing its functions relating to compulsory restructuring, the Bank Guarantee Fund cooperates with the PFSA, the National Bank and the Minister of Finance. The aims of compulsory restructuring are, inter alia, maintaining financial stability, in particular by protecting confidence in the financial sector; ensuring market discipline; and protecting funds entrusted to banks by their clients. The Bank Guarantee Fund shall draft plans for the compulsory restructuring of each bank that is not part of a group subject to consolidated supervision in a Member State conducted by an authority other than the PFSA (those banks will be included in a group plan for compulsory restructuring). However, banks are obliged to provide the Bank Guarantee Fund with assistance in drafting and updating the plans if the Bank Guarantee Fund requests them to do so. If a bank refuses to provide assistance, the Bank Guarantee Fund is entitled

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to impose a penalty of up to 10 per cent of the projected annual turnover of the bank (but not exceeding 100 million zlotys). It should be noted that following the implementation of the BRRD, banks are obliged to maintain a level of own funds and liabilities subject to redemption or conversion as determined by the Bank Guarantee Fund.

Compulsory restructuring proceedings will be conducted by the Bank Guarantee Fund after receiving information about the threat of insolvency of a bank from the PFSA. During the course of compulsory restructuring proceedings, the Bank Guarantee Fund is entitled to use the following instruments:

a the acquisition of an enterprise: the Bank Guarantee Fund is entitled to issue a decision on the acquisition of a bank's enterprise or its organised part by another entity;

b a bridge institution: the Bank Guarantee Fund is entitled to set up a bridge institution in the form of a capital company. The aim of the bridge institution's activity would be managing the acquired share rights in a bank under restructuring and exercising the rights thereof, or continuing the activity of the acquired enterprise of the bank under restructuring or its organised part until the disposal to a third party or liquidation thereof;

c the redemption or conversion of liabilities: the Bank Guarantee Fund is entitled to:
- redeem or convert liabilities to recapitalise the bank under restructuring;
- redeem or convert liabilities transferred to a bridge institution to equip it with own funds;
- redeem or convert liabilities transferred under the instrument of the separation of property rights; or
- redeem liabilities under the instrument of the acquisition of an enterprise; and

d the separation of property rights: the Bank Guarantee Fund is entitled to set up an entity in the form of a capital company and transfer to that newly established entity separated property rights and liabilities of a bank under restructuring or a bridge institution. The separation of property rights is permissible if:
- the liquidation thereof could adversely affect the market situation;
- the transfer thereof is necessary for continuing the activity of a bank under restructuring or a bridge institution; or
- the transfer of property rights shall increase the revenues from those property rights.

If application of the above-mentioned instruments of restructuring does not lead to the disposal of the bank under restructuring, or the application of those instruments is not possible, the bank under restructuring shall be subject to liquidation through insolvency proceedings. During compulsory restructuring proceedings, the right to adopt resolutions and make decisions in all matters vested by law or by statute with the bank's authorities and governing bodies is transferred to the Bank Guarantee Fund. The Bank Guarantee Fund is entitled to appoint an administrator of the bank under restructuring who exercises those powers in its name.

Banks are required to pay contributions to a compulsory restructuring fund, which will be used to finance the actions of the Bank Guarantee Fund under compulsory restructuring proceedings.

The legal framework for the government's bail-in powers in a crisis situation is provided in the Act on recapitalisation of certain institutions and government instruments of financial stabilisation. This Act allows the government to guarantee the increase of own funds by

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a financial institution or to use government instruments for financial stabilisation, which include capital support (a public instrument) and the temporary takeover of an institution by the State Treasury. A guarantee issued by the state is triggered when the shares or bonds issued by a bank are not acquired by the existing shareholders or third parties, and can only be extended if a bank is not threatened by bankruptcy. The government's financial stabilisation instruments may be used in the event of a financial crisis to avoid the liquidation of a bank that is subject to compulsory restructuring proceedings if the application of the compulsory restructuring instruments would be insufficient to avoid adverse consequences for Poland's financial stability or public interest. The use of the capital support instrument involves the State Treasury acquiring or purchasing instruments in a bank's Tier 1 or Tier 2 capital, or the issuance by the State Treasury of a guarantee by a bank to increase its own funds. The temporary takeover of a bank by the State Treasury consists in the transfer of all shares in the bank to a state legal person or a company in which the State Treasury has a dominant position. All this being said, as at March 2019, Polish banks remain well capitalised, and the Act on recapitalisation of certain institutions and government instruments of financial stabilisation has never been tested in practice.

Furthermore, a mechanism pursuant to which a bank that does not meet requirements relating to own funds may be acquired forcibly by another bank, subject to an administrative decision of the PFSA, was re-introduced in 2018. In such case, following a decision of the PFSA, the acquiring bank steps into the rights and obligations of the bank being acquired. The bodies of bank being acquired are dissolved, and previously established commercial proxies and powers of attorney expire. The Bank Guarantee Fund may provide financial support to a bank acquiring another bank.

IV CONDUCT OF BUSINESS

Banks have to follow consumer protection rules with regard to consumer credit and the distance marketing of consumer financial services, as provided in the laws implementing EU directives. With respect to usury laws, the Polish Civil Code introduces a cap on the maximum amount of interest that can result from a legal act; the interest rate cannot exceed twice the sum of the reference interest rate of the National Bank and 3.5 per cent. The reference rate is currently set at 1.5 per cent, so the maximum annual interest charged by banks cannot exceed 10 per cent. Any agreements to the contrary, or attempts to circumvent the usury law, are null and void. Legislation setting limits on costs other than interest charged on consumers, which is applicable to banks, came into force in 2016. The costs shall not exceed 25 per cent of the amount of borrowed cash, and shall not exceed 30 per cent of the amount of borrowed cash per year. Furthermore, non-interest costs throughout the whole crediting period shall not exceed the total amount of a consumer loan (which also refers to consumer credits advised by banks). However, it should be noted that at the very end of 2016, the Ministry of Justice announced a draft of a law aimed at further reducing permissible amounts of interest rates. Work on the draft has not been finalised, and it remains to be seen what the final shape of that law will be. Moreover, since 2019 banks are allowed to compound interest on long-term credits only with regard to interest accrued after bringing a case to court, unless after the arrears have arisen the parties to a long-term credit agreement have agreed to add the outstanding interest to the debt amount.

As far as the offering of investment services is concerned, banks in Poland must comply with specific provisions resulting from the implementation of the Markets in Financial

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Instruments Directive II (MiFID II), which impose certain pre-contractual disclosure requirements and requirements regarding the suitability of financial products. Banks providing investment services are obliged to provide, inter alia, information to clients or potential clients about such things as their services, financial instruments, and costs and charges, and to obtain the necessary information regarding a clients' knowledge and experience in order to assess the suitability of a financial service or product. The protection of clients is currently even further enhanced than it was after the implementation of the MiFID I. In particular, the pre and post-trade information requirements have been enhanced, and additional financial instruments have been brought within the scope of the MiFID II regime.

Banks, bank staff and other persons involved in the performance of banking operations are subject to far-reaching banking secrecy requirements. As a rule of thumb, information that is subject to banking secrecy may be disclosed when, owing to the nature of a banking operation or the regulations in force, proper performance of the agreement under which the banking operation is performed, or proper execution of activities related to the conclusion and execution of the agreement, are not possible without the disclosure of information that is subject to the secrecy obligation. The Banking Law further provides for a detailed, illegible and poorly drafted catalogue of circumstances in which banking secrets may be divulged to other financial institutions and public authorities. Depending on the circumstances, alongside banking secrecy, banks may also be required to follow general data protection laws that impose restrictions on the disclosure of personal data of retail clients. From May 2018, this includes rules relating to personal data protection resulting from the General Data Protection Regulation (GDPR) (e.g., the right to be forgotten). Failure to obey the regulations relating to personal data protection may result in significant penalties. A regulation imposing an obligation on banks to provide institutions established to collect, process and provide information subject to the obligation of banking secrecy (the most important of which is Biuro Informacji Kredytowej, established by leading Polish banks, and the Association of Polish Banks) with information about their clients' liabilities in the scope needed to extend loans, cash advances, bank guarantees and other guarantees, and to assess the creditworthiness of customers, came into force in 2016. The aim of the regulation is to increase the possibility of assessing the creditworthiness of banks' clients. However, the performance of this obligation is burdensome for banks, as it refers to all liabilities without any exclusions.

Banks are subject to general liability rules in tort and in contract. When assessing the non-performance of obligations by banks, the courts employ a high standard of review and demand that banks act with the standard of care expected from a professional body. Further, the activities of the President of the Office of Competition and Consumer Protection need to be noted: banks are subject to increased scrutiny on antitrust grounds with respect to, inter alia, interchange fees, spreads on foreign currencies and mis-selling practices. New rules required by the President of the Office of Competition and Consumer Protection, pronouncing provisions for standard form contracts to prevent illicit activities and a prohibition of mis-selling of financial services, entered into force in 2016. Moreover, since then, the President of the Office of Competition and Consumer Protection may use a mystery shopper as part of its consumer protection activities.

Pursuant to the provisions of the Act on reviewing complaints by financial market entities and the Financial Spokesman, banks are obliged to review client complaints within 30 days. Only for complaints in especially complicated cases may the review period be

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extended to a maximum of 60 days. In the event of a failure by a bank to comply with provisions relating to reviewing complaints, the Financial Spokesman may impose a penalty of up to 100,000 zlotys.

The Act on tax on certain financial institutions also came into force in 2016, pursuant to which domestic banks, branches of foreign banks and branches of EU credit institutions are obliged, inter alia, to pay additional tax amounting to 0.0366 per cent on the amount of their assets exceeding 4 billion zlotys. This additional financial burden influenced the profitability and rate of return of the Polish banking sector, and resulted in higher costs of conducting banking activities.

V FUNDING

Banks participating in SORBNET 2 – a real-time gross settlement system operated by the National Bank – may cover their liquidity shortages with intraday credit extended by the central bank. A significant number of commercial banks also participate in the TARGET2 system, directly or indirectly. In 2012, Krajowa Izba Rozliczeniowa, a payment and settlement intermediary created in 1991 on the initiative of the major Polish commercial banks, the National Bank and the Association of Polish Banks, launched a new payment and settlement system, Express ELIXIR, which provides for the immediate processing, all day every day, of wire transfers between the participating banks.

During the financial crisis, interbank lending was heavily disrupted, and it continues to stagnate. To limit the liquidity risk of banks, the National Bank adopted a package of measures aimed at facilitating its requirements for open market operations. In particular, repo transactions between commercial banks and the National Bank may be entered into for longer periods (six months instead of three), and the list of eligible collateral has been extended to include debentures issued by local authorities, mortgage-backed debentures and treasury papers denominated in euros. The National Bank also lowered the mandatory reserve requirements for banks and agreed to repurchase its own debentures prior to their maturity date. Those instruments proved to be sufficient during the crisis, as no bank was forced to ask the National Bank for individual liquidity assistance.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The regime for the approval of qualifying holdings in Polish banks is fully compliant with the CRD IV. The Banking Law states that an entity that intends to directly or indirectly take up or acquire shares or rights on shares in a domestic bank in an amount that would result in that party being entitled to more than 10, 20, 33 or 50 per cent of the total number of votes at a general meeting or of the share capital of a bank is required to notify the PFSA each time of its intention of taking up or acquiring shares. Moreover, each time an entity intends to directly or indirectly become a dominant entity of a bank in a way other than by taking up or acquiring shares, or rights on shares in a domestic bank in an amount guaranteeing the majority of votes at the general meeting, it is required to notify the PFSA of that intention. The notifying entity may accomplish the intention expressed in the notification when the PFSA does not deliver an objection within 60 working days of the date of receipt of the notification and all required information and documents, or if the PFSA issues a decision on the lack of grounds for filing an objection.

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The PFSA shall file an objection, by way of an administrative decision, against the taking up or acquisition of shares or rights on shares, or becoming a domestic bank's dominant entity if:

a the notifying entity has not remedied defects in the notification or in the documents or information enclosed thereto;

b the notifying entity did not submit in time the additional information or documents required by the PFSA; or

c this is justified by the requirement of cautious and stable management of a domestic bank, or as a result of an assessment of the notifying entity's financial standing.

As far as assessing notifying entities' financial standing is concerned, the PFSA's representatives have made it clear in their public statements that an entity that needs to improve its solvency ratios in its home jurisdiction to meet the Basel III requirements would not be considered favourably by the regulator as a potential acquirer of a Polish bank.

When assessing whether the filing of an objection is justified by the requirement of cautious and stable management of a domestic bank or as a result of the assessment of the notifying entity's financial standing, the PFSA takes into consideration, in particular, commitments regarding the domestic bank, and the prudential and stable management of the bank undertaken by the notifying entity in connection with the conducted procedure. The commitments may vary. For example, they may refer to the positioning of a domestic bank in the structure of a multinational financial group, or to the dual-listing of the shares of the bank's dominant entity on the Warsaw Stock Exchange. Although the commitments are formally made voluntarily, in practice the PFSA often expresses its expectations and suggestions relating thereto. For instance, in 2012, during an assessment of the following acquisitions, the PFSA requested notifications from the purchasers that they undertook to dual list their shares on the Warsaw Stock Exchange. Commitments to this effect were made by Santander in the acquisition of Kredyt Bank, and by Raiffeissen in the acquisition of Polbank. According to the PFSA, the owners of key financial institutions in Poland should also be subject to increased transparency and the capital market information requirements.

Voting rights on shares may not be exercised where those shares or rights on shares are taken up or acquired:

a in breach of the obligation of notifying the PFSA;

b despite an objection having been filed by the PFSA;

c before the end of the period authorising the PFSA to file an objection; or

d after the end of the time limit set by the PFSA for the taking up or acquisition of shares or rights on shares.

In the case of the exercising of the powers of a dominant entity of a domestic bank in the aforementioned manner, members of the management board of the domestic bank appointed by the dominant entity, or members of the management board, proxies or persons performing managerial functions at the dominant entity, are not allowed to participate in actions considered to be a representation of a domestic bank; where it is impossible to establish whether any board members have been appointed by a dominant entity, the appointment of the management board shall be ineffective from the day of obtaining the powers of a dominant entity of that domestic bank. In particularly justified cases, if the interests of a domestic bank's customers so require, the PFSA may, inter alia, by way of a decision issued at the request of a shareholder or a dominant entity of a domestic bank, remove the above-mentioned prohibitions.

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In certain cases, the PFSA may decide to prohibit the execution of voting rights on shares of a domestic bank or the execution of the powers of a dominant entity of a domestic bank. This may happen in the event of, inter alia, a failure to respect the commitments made in the proceedings regarding taking up or acquiring shares or rights on shares in a domestic bank, or of becoming its dominant entity. The aforementioned decision may be followed by a decision by the PFSA ordering the disposal of shares of a domestic bank within the fixed period. If a shareholder does not fulfil the obligation to dispose of the shares within the prescribed time, the PFSA is entitled to impose a fine of up to 20 million zlotys on a domestic bank's shareholder who is a natural person, and a fine of up to 10 per cent of his or her annual turnover on a shareholder who is a legal person. Since 2018, the failure to fulfil investors' commitments can also result in a fine up to the value of the shares or rights on shares imposed by the PFSA on a bank's shareholder. In such case, the regulator may order that all payments made by the bank to its shareholders shall be assigned to cover the penalty.

ii Transfers of banking business

Pursuant to the Banking Law, subject to an authorisation from the PFSA, banks may divide by the transfer of some assets of a bank to an existing or a newly formed domestic bank or an EU credit institution (spin-off or division by separation). The PFSA shall refuse its authorisation if the division may turn out to be detrimental to the sound and prudent management of the bank being divided, the banks to which the assets of the bank being divided are transferred, or if the division may cause substantial loss to the national economy or to the national interest. The division of a bank is considered to be effected as a universal succession and does not require the consent of consumers.

Banks may also use other techniques to transfer part of their business. The acquisition by a bank of a banking enterprise or an organised part thereof requires authorisation from the PFSA. In this case, there is the assignment of the entire contract, and customers' consent may be necessary. Banks may also employ other techniques to achieve capital relief on assets, such as true sale securitisation (i.e., assignment of the individualised claims on a special purpose vehicle. Assignment of claim does not require the consent of the debtor, unless the contract provides otherwise) and synthetic transfer (such an agreement may, however, only be effected with a mutual fund that constitutes a securitisation fund or with a securitisation fund. There is no legal transfer of the underlying assets, so the consent of clients is not necessary). Moreover, Polish law allows for the sale of non-performing loans in a public tender process whereby the banks can publicly disclose to the potential acquirers information that is normally subject to banking secrecy rules.

A bank may only merge with another bank or an EU credit institution with the authorisation of the PFSA. The PFSA shall refuse to authorise a merger if it would lead to a violation of law or the interests of customers of the bank participating in the merger, or if it would jeopardise the safety of funds held in that bank.

VII THE YEAR IN REVIEW

The financial results of the Polish banks in Q1 to Q3 2018 (11.5 billion zlotys net) were higher than those in the same period of 2017 (10.5 million zlotys). This improvement in the financial results of the banking sector was mainly due to the increase in net interest income combined with a moderate increase in the operational costs of conducting banking activities.

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The Payment Accounts Directive (PAD) came into force in August 2018. The new law introduces a free-of-charge basic payment account designed for consumers who have no other account that allows for making payments. The basic payment account must give consumers access to certain basic services, such as making payments into the account and withdrawing cash from ATMs. Moreover, the new legislation introduced a standard procedure of account switching, and rules on the functioning of websites that compare payment account offers. Following the implementation of PAD, payment account providers are responsible for presenting consumers, at least once a year, a list of fees charged in relation to a payment account during that period. They are also obliged to use, in commercial information and contractual provisions dedicated to consumers, a standardised terminology set out in a list of most representative services linked to payment accounts. A consumer must be provided with a standarised document concerning fees charged by a payment account provider before entering into a payment account agreement. This helps consumers to compare different payment account offers.

The implementation of the Payment Services Directive II (PSD II) into the Polish legal framework took place in June 2018 and became effective in December 2018; this has affected the provision of payment services by banks. The changes included, inter alia, the introduction of new payment services involving third-party providers (account information services and payment initiation services), a reduction of customers' liability for unauthorised transactions from €150 to €50, and a prohibition on card subcharges. In this context, the European Commission delegated regulation regarding regulatory technical standards for strong customer authentication, and common and secure open standards of communication will become applicable from September 2019. This will finalise the process of the implementation of PSD II.

The implementation of the Anti-Money Laundering Directive IV also took place in 2018. This was done by introducing a new Act on Counteracting Money Laundering and Terrorist Financing. This resulted in, among other things:

a enhanced measures for local politically exposed persons;
b the creation of a central register of beneficial owners;
c the extended applicability of the anti-money laundering obligations; and
d a much greater emphasis on a risk-based approach to money laundering.

Moreover, the threshold of permitted transactions in cash has been lowered from €15,000 to €10,000.

Recent amendments to the tax law have also influenced the conducting of banking activities. Poland introduced the split payment mechanism based on the assumption that a purchaser of goods and services remits the amount of value added tax (VAT) into a dedicated VAT bank account of the supplier. Therefore, banks are required to keep for non-consumers VAT accounts connected with clearing accounts. The use of the split payment is currently optional; however, this may change in the future. New regulations also imposed on banks new reporting obligations towards the tax authorities.

Following the implementation of the Insurance Distribution Directive, which took place in 2018, the cross-selling of insurance products by banks is regulated primarily by provisions of the Act on insurance distribution. That Act provides for detailed requirements about:

a the information that banks acting as insurance distributors must disclose to customers before the conclusion of an insurance contract;

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b the rules of cross-selling and bundled products;
c the management of possible conflicts of interests between insurers and insurance distributors;
d the requirement to improve the professional skills of insurance distributors; and
e administrative sanctions that may be imposed on insurance distributors.

The increased number of consumer complaints has also resulted in increased litigation, often in the form of class action lawsuits. In particular, mortgage loans denominated in foreign currencies have become the subject of a growing number of class actions against banks. Many banks are currently facing numerous individual or class action lawsuits regarding the invalidation of mortgage loan agreements denominated in foreign currencies (mostly Swiss francs). Borrowers are demanding that the agreements be invalidated in whole, pronouncing indexation clauses to be abusive, or to be reimbursed for bank spreads. The decisions in such cases vary significantly, and it remains uncertain in which direction the judiciary will finally go. In a judgment issued by the Regional Court in Wrocław, the Court stated that changes of interest on credit cannot be at a bank's absolute discretion. In several other cases, the courts have ruled that indexation clauses in mortgage loans denominated in foreign currencies were null and void. In a judgment issued at the end of 2018, the Regional Court in Łódź stated that high spreads used by a bank to determine the principal amount of credit, and consequently the amount of instalments paid by borrowers, shall be held contrary to good practice and to infringe collective consumer interests. Moreover, the Supreme Court stated in 2018 that the assessment of whether a contractual clause is abusive, shall be made as at the time of conclusion of an agreement. This resolution remains in line with the arguments presented by many creditors in their claims against banks. However, there are also numerous decisions of the courts in which the claims of banks' clients have been dismissed.

The past year also witnessed increased activity by the President of the Office of Competition and Consumer Protection (President), who issued several decisions against banks, claiming that the structure of their banking products was abusive and infringed the collective interests of consumers. In the case of many banks, the regulator found provisions of credit agreements relating to currency spreads used for the repayment of credit to be imprecise and to favour the banks. The President also questioned the high fees charged by several banks for issuing certificates necessary to sue a bank (e.g., certificates regarding the repayment of credit). Furthermore, several banks faced proceedings before the President regarding whether qualifying messages sent through their internet banking systems could be considered as the use of a durable medium. The regulator argued that this could not be considered as the use of a durable medium, because the messages were under the control of the banks and could easily be replaced by them. The regulator also stressed that the messages may not simply be deposited in e-banking systems, but that clients must be informed that this has taken place, which requires action by a bank. The position of the President remains in line with the recent jurisprudence of the Court of Justice of the European Union, which set the criteria of a durable medium. Eventually, the regulator issued several decisions against banks in 2018 stating that the above-mentioned practice infringed the collective interests of consumers. As a result, banks have started work on improving their e-banking systems so that they will meet the expectations of the regulator. Possible technical solutions to be implemented by Polish banks are based on blockchain and WORM technologies.

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In November 2018, the chair of the PFSA resigned following corruption allegations. Jacek Jastrzębski, a former deputy general counsel at the state-controlled bank PKO BP and a professor of law at Warsaw University's Faculty of Law and Administration, has been appointed as the new chair for a five-year term.

Moreover, in 2018 the Polish financial market experienced turbulence resulting from the mis-selling of bonds issued by one of the biggest Polish debt collection companies, Getback. It appeared that the company had been in a much worse financial situation than had been presented to potential investors. Financial institutions that were involved in selling the bonds, which included certain banks, are prone to the risk of administrative sanctions and civil lawsuits.

Also worth mentioning is the fact that in November 2018 the PFSA denied Polski Bank Apeksowy, which was to be the third bank associating cooperative bank (i.e., a bank in the form of a joint-stock company whose shareholders may be only cooperative banks, and that performs certain functions for those cooperative banks), authorisation to commence its business. The decision was justified by the facts that the bank had not been properly prepared in organisational terms to commence the business, and had not been in possession of facilities suitable for the safekeeping of monetary funds and other valuables taking into consideration the scope and kinds of banking activity to be conducted.

VIII OUTLOOK AND CONCLUSIONS

A big challenge faced by the Polish banking industry in 2019 will be compliance with the new legislation that has recently come into force. The legal and regulatory environment of banking business remains unstable. The conditions for conducting banking business have changed significantly, in particular as a result of the implementation of PAD, PSD II, MiFID II and AML IV, the entry into force of GDPR and changes to Polish tax law.

Conclusive decisions on the final shape of the law aimed at regulating the issue of mortgage loans denominated in Swiss francs can finally be expected in 2019. This will be important for the profitability of banking business in Poland.

Banks in Poland, like those in other countries, are facing increasing competition from various fintech companies, especially in payment services sector. At the same time, some institutions are intensively collaborating with fintech startups, which is resulting in innovations in financial products and services. Banks are also investing in new technologies and developing new solutions, which seems to be a permanent trend.

Further changes in the structure of the Polish banking sector are likely. For example, there have been reports in the press about a possible withdrawal of some multinational financial groups from the Polish market (e.g., Credit Agricole) and a division of BOŚ Bank between Alior Bank and Bank Gospodarstwa Krajowego. Moreover, in January 2019 the merger of two Polish banks, Getin Noble Bank and Idea Bank, controlled by a well-known investor, Leszek Czarnecki, was announced. This may result in the increased consolidation and concentration of the Polish banking sector. At the same time, there will be no merger of two banks, namely Bank Pekao and Alior Ban, controlled by the largest Polish insurer.

In 2019, the priorities and supervisory policy of the new chair of the PFSA shall become known. This will be important for all supervised financial institutions in Poland.

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Chapter 31

PORTUGAL

Pedro Ferreira Malaquias and Hélder Frias[1]

I INTRODUCTION

The Portuguese financial system is fully integrated with the international and European financial markets. The Portuguese banking regulator, the Bank of Portugal (BOP), joined the European System of Central Banks (ESCB) on 1 January 1999. As a result, the definition and implementation of the country's monetary and exchange rate policy, the management of official currency reserves, the efficiency of the payment systems and the issuing of banknotes are now controlled by the ESCB. Likewise, the Portuguese regulatory system governing credit institutions and financial companies is identical in broad terms to the legal framework in force in other EU Member States.

Since the conclusion of the Financial and Economic Assistance Programme in 2014, the Portuguese economy has been slowly improving and has been growing in the past few years, even though this growth has been slowing and there are still some uncertainties as to the financing conditions Portugal may face in the foreseeable future.

Regarding the political context, the left-wing government has maintained the necessary majorities in Parliament and, as at the end of 2018, has concluded the third year of its mandate. In respect of state-owned enterprises, following a few years of intense privatisations of state-owned companies and 2016 as the first year in this century without privatisations in Portugal, no new major transactions were carried out by the government during 2018.

In respect of the banking sector itself, following the period after the conclusion of the Financial and Economic Assistance Programme, in which the BOP has determined the application of resolution measures to Banco Espírito Santo (BES) and Banco Internacional do Funchal (Banif), the past three years were marked by the sales of some of the largest banks in Portugal and the recapitalisation of other major banks.

Notwithstanding the foregoing, the list of the top five largest banks in Portugal (by gross assets and in no particular order) has not seen any changes, and still comprises Caixa Geral de Depósitos (a state-owned bank), Banco Comercial Português, Banco BPI, Banco Santander Totta and Novo Banco (the bridge bank created in the context of the resolution measure applied to BES).

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II THE REGULATORY REGIME APPLICABLE TO BANKS

The regulatory regime applicable to credit institutions and financial companies is set out in the General Framework for Credit Institutions and Financial Companies, enacted by Decree-Law No.298/92, of 31 December, as amended (RGICSF). In turn, payment institutions are subject to the Legal Framework of Payment Institutions and Payment Services, enacted by Decree-Law No. 91/2018, of 7 November, which implemented the PSD2 into Portuguese law.

As credit institutions must take the legal form of companies limited by shares and have their registered offices located within the Portuguese territory, they are also subject to the general principles and rules of company law further to the banking regulations.

Banks are a central part of the Portuguese financial system not only because of the sheer volume of their business but also because of their involvement in every segment of the Portuguese economy. They may provide a full range of banking services for corporate and private customers, including lending, taking deposits and other repayable funds from the public, granting credit on their own account to third parties in general, and collection and payment services within or outside Portugal (either through foreign branches or on a freedom to provide services basis). Foreign credit institutions may also pursue their banking activity in the territory under the right of establishment rules or on a freedom to provide services basis (this latter structure is reserved for credit institutions of other EU Member States only) provided that the relevant passporting requirements are duly fulfilled.

The BOP is the Portuguese central bank, being responsible for the prudential and market conduct supervision of credit institutions, financial companies and payment institutions, to ensure the stability, efficiency and soundness of the financial system, as well as compliance with the rules of conduct and transparency requirements towards bank customers, thereby ensuring the safety of deposits and depositors, and the protection of consumer interests.

In addition to the RGICSF, credit institutions, financial companies and payment institutions are also required to comply with the notices, instructions and circular letters issued by the BOP.

By the same token, whenever credit institutions or financial companies also pursue financial intermediation activities, they will be subject to the supervision of, and regulations issued by, the Portuguese Securities Market Commission (CMVM). The same applies to the insurance intermediation activities that may be pursued by banks, which are also subject to the supervisory powers of the Portuguese Insurance and Pension Funds Supervisory Authority, and are required to comply with the regulations or circular letters issued by the latter.

In view of the foregoing, credit institutions may ultimately be subject to the supervisory powers of the three above-mentioned Portuguese regulatory authorities, in addition to the European Central Bank (ECB), as a result of the introduction of the Single Supervisory Mechanism (SSM) in 2014.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Given its participation in the SSM, the BOP qualifies as a national competent authority, which implies that Portuguese credit institutions considered as significant are supervised by the ECB, while those deemed less significant are directly supervised by the BOP and indirectly by the ECB.

Four groups of banks supervised by the SSM are considered significant.

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The main means of supervision by the BOP are as follows:

a issuance of notices and recommendations regarding rules of conduct for the management of banks;

b establishment of rules of conduct for banks ensuring transparency of information during the pre-contractual and contractual stages (including the verification of maximum rates and charges for banking services rendered by credit institutions);

c assessment of complaints presented by banks' customers;

d analysis of the information regularly reported by banks;

e assessment of banks' exposure to risks, and of the adequacy of banks' strategies, mechanisms and procedures to mitigate those risks;

f analysis of the results of the stress tests imposed on banks;

g evaluation of systemic risks; and

h on-site inspections.

The BOP has the power to enforce Portuguese banking laws and regulations through:

a fines and ancillary penalties;

b injunctions for the fulfilment of certain duties;

c seizure of documents and valuables;

d special audits through on-site inspections; and

e withdrawal of a bank's authorisation.

Following the 2008 financial crisis, Portuguese banks were required to increase their own funds and restructure their capital to meet the new requirements on minimum capital, in addition to providing information on complex financial instruments and implementing new depositors' protection rules. The rules applicable to the recovery and resolution of credit institutions also went through a major review and change.

On-site inspections on a permanent basis became a normal practice.

The CMVM is the relevant supervisory authority for the financial intermediation activities pursued by Portuguese credit institutions and financial companies and their activities in the stock markets. It is entrusted with the task of supervising and regulating securities and other markets in financial instruments, as well as the activities of all those who operate within said markets.

The supervision carried out by the CMVM includes the following:

a constant supervision of the acts of individuals and entities that operate in capital markets for the purpose of detecting unlawful acts, particularly in stock market trading;

b monitoring compliance with rules;

c detection of criminal offences;

d punishment of infringers, namely by the imposition of fines;

e granting registrations of individuals and transactions to check compliance with the applicable rules; and

f information disclosure, particularly on listed companies, through its website.

ii Management of banks

The board of directors of a credit institution (with at least three members) has prominent powers to manage the operations and financial matters of the entity. Members of the management and supervisory boards and senior management must comply with the requirements set forth in the RGICSF, and the regulations issued by the BOP on suitability,

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professional qualifications, independence and availability. Additionally, members of the management and supervisory boards of credit institutions that are significant in size may not hold more than four non-executive positions simultaneously, or one executive position with two non-executive positions, with the exception of positions in management and supervisory boards of entities included in the same banking supervision consolidated scope. The RGICSF requires credit institutions to put corporate governance arrangements in place that are sound and proportionate in view of the risks taken by the institution.

Significant attention has been devoted to remuneration policies during the past few years, as has been the case at both European and international levels. In particular, the RGICSF includes the provisions of the Capital Requirements Regulation (CRR)[2] and the Capital Requirements Directive of 26 June 2013 (CRD IV) relating to the obligation of credit institutions to put in place remuneration policies that are consistent with their risks. In summary, these provisions relate to the obligation to make a clear distinction between the criteria used for setting fixed remuneration and variable remuneration; the obligation that the remuneration policy is subject to the approval of the shareholders' general meeting; and the principles that will apply to variable elements of remuneration.

iii Regulatory capital and liquidity

The rules on capital adequacy requirements have undergone deep reform with the entry into force of the CRD IV package, which created a single rule book throughout the European Union in this domain.

Portuguese law establishes minimum share capital requirements for each type of credit institution – including banks – and financial companies. For instance, banks are required to have a minimum share capital of €17.5 million, and investment firms are in general required to have a minimum share capital of €5 million.

In addition, since 1 January 2014, the rules on regulatory capital adequacy requirements have been harmonised throughout the European Union. Hence, banks and other credit institutions as well as investment firms must meet the rules on regulatory capital and liquidity established by the CRD IV package.

Under the CRR, institutions must maintain a Common Equity Tier 1 (CET1) capital of at least 4.5 per cent of their risk-weighted assets (RWAs), a Tier 1 capital of at least 6 per cent of their RWAs and a total capital of at least 8 per cent of their RWAs.

However, and as agreed with the ECB, the European Commission and the International Monetary Fund in the context of the bail-out package provided to Portugal in 2011, the BOP determined that Portuguese credit institutions and investment firms must have a CET1 ratio not below 7 per cent. This obligation is to last until the adoption in full by these entities of the rules applicable under the CRD IV package.

The BOP is entitled to demand that credit institutions and financial companies promptly adopt the measures or take the action necessary to overcome any non-compliance by them with the rules regulating their business, including the capital adequacy guidelines.

Among the powers granted to the BOP for this purpose is that of suspending or substituting one or more members of the management and the supervisory corporate bodies of a credit institution, and the power to appoint both a provisional board of directors and a supervisory committee or a sole supervisor.

2 Regulation (EU) No.575/2013 on prudential requirements for credit institutions and investment firms.

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In the event that a credit institution becomes undercapitalised, the BOP may apply corrective measures over the entity in distress, which may consist of, notably, the presentation by the entity of a restructuring plan setting out:

a measures such as a share capital increase, a reduction thereof or the disposal of shareholdings or other assets;

b the suspension or substitution of one or more members of its management and supervisory corporate bodies; or

c making certain acts or transactions subject to the prior approval of the BOP.

Where the corrective measures applied are not sufficient for the credit institution to recover, or they are deemed insufficient for the purpose, the BOP may also choose to appoint a provisional board of directors, to apply a resolution measure (in certain circumstances) or even to repeal the authorisation of the credit institution in Portugal, causing its dissolution and winding-up.

Further changes are expected, most notably those resulting from the adoption of the acts implementing the CRD IV and the CRR, which are to be enacted in coming years.

iv Recovery and resolution

The BOP is the competent regulatory authority for the purposes of approving and implementing resolution procedures in this jurisdiction.

The BOP may apply certain resolution measures in the event that a bank is in a situation where it may need to cease to be duly authorised for the pursuit of a banking activity (or presents a serious risk of non-compliance), which may consist of either the disposal, in part or in whole, of the business of the credit institution to another credit institution, or the transfer, in part or in whole, of its business to one or more transition banks, to be funded by the Resolution Fund, which shall be supported by contributions from Portuguese banks. Among others, the RGICSF establishes three situations deemed as a serious risk of non-compliance: when a bank's losses surpass its share capital; when its assets are lower than its obligations; or when it is unable to fulfil its obligations.

The resolution measure must be adequate and proportional in terms of its possible (or likely) consequences on the financial soundness of the institution, the interests of its depositors and, generally, the effects of the resolution on the stability of the financial system. Since 2010 we have witnessed the resolution of four banks: Banco Privado Português, Banco Português de Negócios, BES and Banif.

With the enactment of the Banking Recovery and Resolution Directive (BRRD), the EU Member States created a harmonised framework to address certain financial institutions that are failing or likely to fail, with the intent of preventing their insolvency or to minimise the negative consequences arising from insolvency. Hence, Portuguese law, in line with the BRRD, establishes an order of priority regarding liability for the losses of an institution: first, the shareholders are held liable for the losses, and only subsequently are the creditors held liable. No creditor can be put in a worse situation resulting from a resolution measure than it would be in a standard winding-up procedure.

The conditions that may evidence the existence of risks that jeopardise the ability of a credit institution to comply with its legal obligations and therefore trigger a resolution procedure are the following:

a risk of non-compliance with the minimum mandatory legal requirements regarding capital adequacy ratios;

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b existing difficulties in maintaining a stable liquidity situation, which can lead to non-compliance with the legal duties imposed on credit institutions;
c the system of governance in place or the management corporate body of the credit institution can no longer provide adequate assurances of sound and prudent management undertakings; and
d the accounting organisation or the internal control system of the credit institution presents serious deficiencies that prevent a proper evaluation of the financial situation of the institution.

Under such circumstances, since 1 January 2016, the BOP, with the ECB, is allowed to directly intervene in a failing credit institution or investment firm and apply certain measures called resolution tools, which are as follows:

a partial or total transfer of the business to another authorised institution;
b partial or total transfer of the business to a bridge bank;
c segregation and partial or total transfer of the business to asset management vehicles; and
d bail-in procedures (imposing direct losses on creditors – bondholders and depositors – of the institutions).

When addressing a failing institution, the regulatory authorities are entitled to adopt one or more resolution tools as they deem appropriate for each case.

Whenever adopting these measures, the BOP must follow certain general principles, such as shareholders bearing the first losses and creditors bearing losses thereafter in accordance with the priority of their credits, as well as creditors of the same class being treated in an equitable manner.

Whenever a resolution measure is applied, the members of the management and supervisory corporate bodies (as well as the certified public accountant or the company responsible for the legal certification of the entity's accounts) are dismissed, unless otherwise determined by the BOP. In such an event, the BOP shall appoint new members to the management and supervisory corporate bodies. In this scenario, the members of the management corporate body will have full capacity as recognised by law and by the articles of association to both the shareholders' general meeting and the management corporate bodies. However, that capacity may only be exercised under the guidance of the BOP.

Each deposit-taking institution must have in place a recovery and a resolution plan. These plans must be submitted to the BOP and must be drafted in accordance with the applicable legal requirements. The recovery plan has the purpose of identifying the measures that must be applied when an institution is in a situation of financial imbalance (or, at least, when there is a risk of getting into such a situation). In contrast, the resolution plan must ensure that all the relevant information is provided to the BOP to allow an orderly resolution of the bank through the application of resolution measures.

With the exception of certain definitions concerning the ranking or priority of creditors, local insolvency rules (e.g., insolvency procedures and clawback rules) shall not apply.

Portuguese law first enacted resolution measures in 2012 (the first version of the BRRD dates back to 2011), and the BRRD was fully implemented in Portugal by August 2015, although certain measures only entered into force on 1 January 2016.

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IV CONDUCT OF BUSINESS

Credit institutions operating in Portugal, whether domestic (i.e., those whose registered office is located in Portugal) or foreign entities providing cross-border services in Portugal (either through a branch or on a freedom to provide services basis), must comply with Portuguese law (including rules on banking secrecy, data protection and conflicts of interests), notably legal provisions governing the implementation of monetary policies and the reporting of information on their activity within the Portuguese territory, the decisions and measures taken on monetary, financial and foreign exchange policies, as well as those that must apply in the interest of the general good.

This concept of the general good is not crystal clear, and presents some difficulties regarding its interpretation. While Portuguese law does not provide a definition of the general good, it is generally acknowledged that the concept includes, inter alia, rules dealing with:

a protection of recipients of services;
b protection of workers;
c consumer protection;
d preservation of the good reputation of the national financial sector;
e prevention of fraud; and
f protection of intellectual property.

Furthermore, rules of general good must not have a discriminatory nature, and shall be mandatory to protect the general good, as well as proportionate to pursue that goal.

The above-mentioned institutions must also comply with legal requirements on marketing (i.e., the prohibition of misleading or subliminal advertising, aggressive commercial practices) and other consumer protection-related requirements.

According to Portuguese law, consumer protection rules are applicable to banks as regards information duties, marketing requirements, pricing and interest rates.

Banks are required to:

a provide detailed pre-contractual information;
b assess the creditworthiness of a consumer before granting a loan;
c provide specific information throughout the duration of the loan agreement;
d grant a mandatory cooling-off period; and
e allow for early repayment of the loan.

There are also specific rules applicable to mortgage credit, consumer credit, deposits and complex financial products.

Banks must inform the BOP about the pricing that applies to their services, which is publicly available on the supervisor's website.

Maximum interest rates on loan agreements entered into by banks and consumers are determined by the BOP and regularly updated.

Domestic credit institutions and foreign institutions carrying out their activity within the Portuguese territory through a branch are also subject to Portuguese legal requirements on anti-money laundering and the financing of terrorism.

In addition, credit institutions are required to establish several internal departments in respect of, for example, audit, risk management, complaints handling and compliance. In this context, they must have an internal organisation structure that is well defined,

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transparent and that may be perceptible, giving support to the pursuit of their activity; and must implement an internal compliance system that is adequate and effective in ensuring that the management and control of transactions carried out is done in a prudent manner.

The facts and elements concerning the contractual relationship between a credit institution and its clients are subject to secrecy (even if the holder of that data is no longer a customer of the institution). These facts and elements include, in particular and without limitation, clients' names, details of their bank accounts and respective movements further to other banking transactions. These elements may only be disclosed to third parties if the client has authorised disclosure (unless the third party is the BOP, the CMVM, the Deposits' Guarantee Fund or the Investors' Indemnity System, within the scope of their respective attributions or while assisting the tax or enforcement authorities).

V FUNDING

Portuguese credit institutions may fund their activities in different ways, including by gathering retail deposits from the public, debt issuance and other market instruments.

There are no restrictions on the issuance of such instruments, but they are subject to the securities market regulations and must be verified by the BOP to confirm they meet the conditions established by the bank solvency regulations.

On the one hand, the main funding source for Portuguese credit institutions continues to be the deposits taken from their customers, which remained stable in line with previous years by the end of the third quarter of 2018. On the other hand, the funding of Portuguese banks by the eurosystem (i.e., the ECB and the national central banks of the eurozone) registered a minor decreased by the end of 2018, reaching its lowest level since the first quarter of 2010.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

In terms of regulatory approvals, the acquisition of a significant stake in a Portuguese credit institution would entail the need to file several communications and obtain several authorisations (or non-objection decisions) by both the buyer and the seller, in line with the Acquisitions Directive, which has been implemented into Portuguese law by Decree-Law No.52/2010, of 26 May.

Under Article 2-A, Paragraph ee) of the RGICSF, a significant stake means a direct or indirect holding of at least 10 per cent of the share capital or voting rights of the target entity, which for any reason makes it possible to exercise a significant influence over the management of the target entity.

By the same token, prior notice must be given to the BOP, and approval must be granted by the regulator regarding acts that involve the increase of a qualified holding whenever the proportion of the voting rights or of the share capital held would reach or exceed, as applicable, 10, 20, 33 or 50 per cent of the share capital or voting rights in the target company, or as a consequence of which the credit institution would become an affiliate of the buyer (as defined by law).

The seller would need to notify the BOP of its decision to sell its stake in the Portuguese credit institution and the subsequent loss of control of the entity. This notification must be made once the decision to sell is made, and in any case prior to closing.

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The potential buyer, with cooperation from the seller, would have to obtain approval (a non-objection decision) from the ECB to acquire a significant stake in the Portuguese credit institution. This authorisation would be obtained through the following procedure:

a the application is submitted by the buyer to the ECB (through the BOP, the point of entry into the SSM);

b the BOP acknowledges receipt of the file within a maximum of two business days, and either confirms that the filing is complete or requests further information until it is satisfied with the level of disclosure of the buyer. The 60 business day term for the ECB to issue its non-objection decision will start once the filing is deemed complete;

c during this term, if additional information is requested by either the BOP or the ECB, the period for a decision may be suspended for up to either 20 or 30 business days, the latter if the applicant (the buyer) is not a financial regulated entity within the European Union;

d the BOP shall send the ECB a preliminary decision of objection or non-objection to the acquisition within 45 business days of the date it confirmed the filing was complete, and the ECB shall then either accept the preliminary decision of the BOP or reject and amend that decision, issuing a final decision within 15 business days of receiving the preliminary decision from the BOP, even if the BOP did not spend the full 45 business days it had to prepare the preliminary decision;

e in the event that the 60 business day period referred to above lapses without a decision being issued by the ECB, the ECB will be deemed to have granted its non-objection to the acquisition; and

f finally, as of the date of issuance of the non-objection decision (or the lapsing of the term for its issuance), and unless instructed otherwise therein (which may occur in an asset disposal carried out within a recovery scenario), the parties may complete the envisaged transaction within a period of up to one year.

The target Portuguese credit institution itself must then notify the BOP immediately after the transaction is closed.

The contents of the above-mentioned applications, including the information to be provided therein, are set out in BOP Notice No.5/2010.

In the event that the proposed acquisition triggers a change of control in the target credit institution or a control relationship is established, the proposed buyer must deliver a business plan containing, among other matters, information on the strategic development plan relating to the acquisition, forecasts (including provisional *pro forma* accounts of the target entity, on an individual and consolidated basis, for a period of three years, and details of the main changes to be introduced in the target credit institution. Antitrust authorisations may be also required, depending on the buyer.

The acquisition of a significant stake is also subject to special registration with the BOP, and the application for that registration should be filed within 30 days of the relevant regulatory authorisation for the acquisition being granted.

Failure to notify the BOP, carrying out the acquisition or increasing a qualifying shareholding during the decision period available to the BOP, or non-compliance with a refusal of the proposed transaction by the BOP, without prejudice to the application of other sanctions, may determine the blocking of the acquired voting rights.

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Furthermore, any acquisition of a holding equal to or higher than 5 per cent of the voting rights or of the capital of a credit institution is also required to be notified to the BOP within 15 days of the acquisition of that holding so that the BOP can assess whether it is to be considered a qualifying shareholding.

General statutory limitations, rules on financial assistance, capital maintenance and other similar principles established by Portuguese law may limit the ability of a Portuguese bank to grant security interests for the obligations of a purchaser to repay acquisition finance, or may require that the guarantee or security be limited to a specific amount.

ii Transfers of banking business

Under Portuguese law, there are essentially two options for the transfer of the business of a bank: a demerger or partial spin-off, or an asset deal or direct transfer (sale) of business. As explained below, the consent of customers or any other third party[3] (excluding shareholder approval) may not be necessary in the event of the transfer being structured pursuant to the first option.

Demerger or partial spin-off

Using this option, the bank would undergo a partial spin-off by demerger to segregate the business and incorporate it into another entity. The requirements and corporate procedure applicable to this demerger shall be governed by Portuguese law as the personal law of the Portuguese bank. The business to be transferred within the spin-off should constitute an autonomous business unit capable of pursuing a productive process.

As regards the need to obtain the consent of customers or any other third party in a spin-off, and although not on an indisputable basis, certain Portuguese scholars argue that the consent of the affected counterparties is not required for a business transfer following a demerger governed by Portuguese law. Following this line of reasoning, this alternative appears to be more attractive than the one described below, as it offers a simpler and more straightforward means of transfer from the perspective of the need to obtain the consent of customers or any other third party.

Asset deal or direct transfer (sale) of business

Under Portuguese law, if a business is transferred from one party to another as a stand-alone commercial establishment (thus integrating certain elements that form an autonomous business unit within the seller's activity capable of pursuing a productive process), the acquisition thereof shall be qualified as a transfer of business as a going concern.

A transfer of business as a going concern could be governed by a single master sales agreement governing the transfer of each of the assets and liabilities (or classes of assets and liabilities) of the business of the transferor bank to be transferred. Note, however, that a transfer of agreements with (or liabilities to) the customers and third parties of the Portuguese bank that are part of the transfer of business as a going concern shall require, as a general rule, the consent of the customers and contractual counterparties, except for certain particular situations (e.g., a transfer of employment contracts or the leased premises or equipment of the Portuguese bank).

3 References to a third party in this chapter do not include any kind of corporate approvals, such as shareholder approval.

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Pursuant to Portuguese law, a contractual position in any agreement with mutual undertakings (also named bilateral agreements, such as swaps, etc.) may only be assigned to a third party if the counterparty of the agreement consents to the assignment.

Although consent in these situations is mandatory, it may be granted either before (e.g., in the agreement itself concluded between the parties that is being assigned) or after the execution of the relevant assignment agreement. If this consent is granted prior to assignment, it shall only be deemed effective once the counterparty has been notified or the assignment is acknowledged as having occurred.

Consent for the assignment of a counterparty's contractual position in any agreement with mutual undertakings may be either explicit or tacit.

As a general rule, if no express objection is received, it may be construed that the relevant customer or third party has consented to the transfer whenever it has carried out certain actions that correspond in practice to an express consent (e.g., if any outstanding amounts due pursuant to the assigned agreement are paid by the transferee instead of the transferor).

In turn, whenever the assigned agreement does not have mutual undertakings but only one of the parties thereto is required to fulfil certain obligations or undertakings (e.g., the payment of a bank overdraft), the assignment of the other party may be carried out without that party's consent (this rule applies, for example, whenever an assignment of receivables is involved). Notwithstanding the validity of this assignment, notice would have to be given to the counterparty for the assignment to be enforceable against it.

If consent is required but not obtained (either the affected counterparty does not give explicit consent or does not engage with the transferee, thereby implying tacit consent), the transferor will remain formally and legally bound under Portuguese law, thus bearing the economic exposure towards the affected counterparty.

The foregoing is a general description of the legal regime under Portuguese law for the transfer of assets and liabilities. However, specific analysis of each asset and of the terms of each agreement to be transferred would still need to be carried out. By way of example, change of control provisions could be triggered as a result of a transfer of business. On the other hand, a transfer of real estate property or other movable assets subject to registration may determine the need to comply with certain formal requirements and to update the relevant registers. Issues relating to, inter alia, a transfer of direct debit mandates, bank guarantees issued by a bank and positions of such a bank in syndicated loans may also be triggered as a result of a transfer of business as a going concern.

VII THE YEAR IN REVIEW

Although still weak, the profitability of Portuguese banks continued along a recovery path, while non-performing loans (NPLs) declined further at a fast pace, the liquidity position remained within comfortable levels and the total capital ratio has improved. In addition, the structure of banks' funding is still improving, with a loan-to-deposit ratio close to 90 per cent, and banks benefiting from advantageous funding conditions from the ECB.

As previously mentioned, Portuguese banks are taking steps to enhance their capital ratios and are trying to attract fresh equity. State-owned Caixa Geral de Depósitos, Portugal's largest bank, concluded the process of increasing its equity base by €500 million through the

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issuance of securities representative of Tier 2 capital, after increasing its equity base, in the previous stages of this process (2017), by approximately €4 billion through various measures, including a share capital increase amounting to €2.5 billion.

In the context of banking law, of utmost importance was the implementation into Portuguese law of Directive 2014/65/EU of the European Parliament and of the Council, of 15 May 2014, on markets in financial instruments, by the publication of Law No. 35/2018, of 20 July, which amends, among others, the RGICSF.

Again regarding banking law, it must be stressed that Directive (EU) 2015/2366 of the European Parliament and of the Council, of 25 November 2015, on payment services in the internal market, was implemented into Portuguese law by means of Decree-Law No. 91/2018, of 12 November, which approves the new legal framework regulating payment services and electronic money.

In addition, the entry into force of Decree-Law No. 81-C/2017, of 7 July, implementing into Portuguese law Directive 2014/17/EU of the European Parliament and of the Council, of 4 February 2014, on credit agreements for consumers relating to residential immovable property, commonly referred to as the Mortgage Credit Directive, marked an important milestone for the banking sector, since it established the obligations of natural and legal persons seeking to carry on the activity of credit intermediation to be duly authorised and registered with the BOP.

Finally, with respect to the implementation of Directive (EU) 2015/849 of the European Parliament and of the Council, of 20 May 2015, on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, the Beneficial Owner Central Register online service was created through Ordinance No. 233/2018, of 21 August, in compliance with Law 89/2017, of 21 August, which approved the legal framework of the Beneficial Owner Central Register.

VIII OUTLOOK AND CONCLUSIONS

While the Portuguese economy has continued to recover for the sixth consecutive year, as substantiated in a decrease in risk premiums and the upgrades to sovereign debt rating, the country still remains vulnerable to shocks, namely those associated with changes in the risk perception of investors. Budgetary consolidation, high indebtedness levels, the banking sector itself and the implementation of structural reforms pose some downside risks to a sustainable recovery.

The banking system's main challenges remain weak asset quality, thin capital buffers, low profitability and relatively high exposure to Portuguese sovereign debt.

Nevertheless, the Portuguese economy have been going through a period of growth, with the first data from 2018 disclosed by the National Statistics Institute pointing to a growth in gross domestic product of around 2.1 per cent, which is 0.7 per cent less than it was in 2017. This evolution stemmed largely from the less pronounced contribution by foreign demand, a marked deceleration in private consumption, and a deceleration of exports of goods and services, reflecting a more modest growth in investment. Most public entities and analysts believe the recent slowdown will continue in 2019.

With regard to trends in the banking sector, there has been a notable intensification of the prudential banking requirements and supervision through the action of the SSM. We believe this trend will continue to set the pace of the Portuguese banking industry in coming years.

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Chapter 32

SINGAPORE

Francis Mok[1]

I INTRODUCTION

Singapore has a reputation as a key regional and global hub for companies to do business. It consistently ranks as one of the countries in the world with the best investment potential.[2] Singapore has also been ranked the world's second-easiest place to do business,[3] and the most transparent country in Asia which enjoys a stable business environment.[4]

In November 2013, an assessment under the Financial Sector Assessment Programme of the International Monetary Fund (IMF) found Singapore's financial sector to be well regulated and highly developed. The assessment by the IMF affirms Singapore's standing as a sound and stable financial centre.

The three local banks in Singapore – DBS Bank Limited, Oversea-Chinese Banking Corporation Limited and United Overseas Bank Limited – are on the list of the world's 50 safest banks in 2018 as compiled by Global Finance.

The Monetary Authority of Singapore (MAS) is banker and financial agent to the government and the central bank of Singapore. Following its merger with the Board of Commissioners of Currency on 1 October 2002, MAS has also assumed the functions of currency issuance. MAS's functions include:

a to act as the central bank of Singapore, including the conduct of monetary policy, the issuance of currency and the oversight of payment systems, and serving as banker to and financial agent of the government;

b to conduct integrated supervision of financial services and financial stability surveillance;

c to manage the official foreign reserves of Singapore; and

d to develop Singapore as an international financial centre.

MAS's approach is to utilise risk-based supervision, rather than to use prescriptive one-size-fits-all rules. MAS adopts a consultative approach in regulating the financial sector, actively seeking feedback from market practitioners and the public with a view to developing regulations that take into account market realities and industry practices.

1 Francis Mok is a partner at Allen & Gledhill LLP.

2 Business Environment Risk Intelligence Report 2017-I.

3 Doing Business 2019 Report.

4 Global Competitiveness Report 2018.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

Singapore-licensed banks come within the ambit of the Banking Act and the Monetary Authority of Singapore Act (MAS Act), and are supervised and regulated by MAS. Banks have to comply with the provisions in the Banking Act and the MAS Act and the subsidiary legislation issued thereunder, as well as with notices, circulars, guidelines, practice notes and codes issued by MAS from time to time.

There are three types of bank licences under the Banking Act: a full bank licence, a wholesale bank licence and an offshore bank licence.

Full banks may provide the whole range of banking business permitted under the Banking Act, which includes deposit taking, the provision of cheque services and lending. While a full bank may engage in the full range of both Singapore dollar and non-Singapore dollar-denominated banking business, foreign banks with full bank licences are restricted in the number of branches and automated teller machines (ATMs) that they may operate. However, a foreign bank with a full bank licence that has been conferred with qualifying full bank privileges may operate at more locations, share ATMs among themselves and relocate their sub-branches freely.

Wholesale banks may engage in the same range of banking business as full banks, except that they do not carry out Singapore dollar retail banking activities. They operate within the Guidelines for Operation of Wholesale Banks issued by MAS.

Offshore banks are subject to even stricter restrictions on Singapore dollar accounts as set out in the Guidelines for Operation of Offshore Banks issued by MAS. Offshore banks may, however, engage in the same activities as full banks and wholesale banks for businesses transacted through their Asian currency units (ACUs). The ACU is an accounting unit that the banks use to book all their foreign currency transactions conducted in the Asian dollar market. MAS's approval is required for the operation of an ACU. Banks' Singapore dollar transactions are separately booked in their domestic banking units.

Aside from the banking activities as outlined above, banks may also carry on any other business that is regulated or authorised by MAS (including capital market services, financial advisory services and insurance broking), or otherwise prescribed or approved by MAS. Banks are, however, prohibited from engaging in non-financial activities.

Besides the three categories of licensed banks, financial institutions may be approved by MAS to operate as merchant banks under the MAS Act. The operations of merchant banks are governed under MAS's directives to merchant banks. The scope of activities a merchant bank may undertake is generally narrower than that for licensed banks, but a merchant bank may also apply to MAS for approval to operate an ACU and thereby compete with licensed banks in the non-Singapore dollar banking market.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Banks are regulated and supervised by MAS. As a regulator, MAS aims to be business-friendly, adopting a consultative approach in developing regulations, typically through public consultation processes. MAS adopts risk-based supervision with the objective of fostering the safety and soundness of banks, and with promoting transparency and fair dealing in banks in relation to their customers and counterparties.

Under the risk-based approach, MAS employs the impact and risk model, which aims to reduce the risk and impact of the failure of banks or of inappropriate behaviour through

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increased supervision where it is appropriate and likely to be effective. The impact and risk model entails MAS evaluating and rating the impact and risk of a bank relative to other institutions. On combining the assessments of both impact and risk ratings, MAS is able to distinguish those banks that may pose a greater threat to the safety and soundness of the sector, and accordingly determine the level and intensity of supervision required.

MAS performs its supervisory responsibilities by checking on the quality of corporate governance, internal controls and risk management of the bank, and its dealings with its customers and counterparties. In this way, MAS hopes to encourage a system of sound management practices commensurate with the bank's type, scale and complexity of business activities, and their related risks.

MAS also reinforces the responsibilities of the board and senior management for the oversight and governance of the bank's activities and risk management and internal processes. As long as risks are adequately managed, MAS seeks to minimise the need to interfere with a bank's business operations.

ii Management of Singapore-incorporated banks

MAS places considerable emphasis on good governance and the quality of directors of Singapore-incorporated banks.

MAS' Guidelines on Corporate Governance for Financial Holding Companies, Banks, Direct Insurers, Reinsurers and Captive Insurers which are Incorporated in Singapore (Guidelines) comprise the Code of Corporate Governance 2012 for companies listed on the Singapore Exchange Securities Trading Limited (SGX-ST) and supplementary principles and guidelines from MAS. The Guidelines and the Banking (Corporate Governance) Regulations 2005 define what is meant by an independent director, and set out the requirements for the composition of the board of directors and board committees, such as the nominating committee, remuneration committee, audit committee and risk management committee. The Guidelines also set out, inter alia, the principle that there should be a clear division of responsibilities between the leadership of the board of directors of a bank and the executives responsible for managing a bank's business, as well as the principle that there should be a strong and independent element on the board of directors of a bank that is able to exercise objective judgement on corporate affairs independently, in particular, from the management of the bank and 10 per cent shareholders of the bank (as defined in the Guidelines). The Guidelines also encourage the separation of the roles of chair and chief executive officer and outline how this is to be applied. The Guidelines further set out the principle that the board of directors of a bank should ensure that the bank's related-party transactions are undertaken on an arm's-length basis.

Inter alia, the remuneration committee of a bank reviews and recommends to a bank's board of directors a general framework of remuneration for the board of directors and key management personnel. Recommendations are also made regarding remuneration packages for each director and key management personnel.

While there are no restrictions on bonus payments to management and employees of a bank, a Singapore-incorporated bank is required to adopt the Principles for Sound Compensation Practices and Implementation Standards issued by Financial Stability Board (FSB), which are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes.

Separately, MAS Notice 637 on Risk-Based Capital Adequacy Requirements for Banks Incorporated in Singapore (MAS Notice 637) stipulates that the board of directors and

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senior management of a Singapore-incorporated bank are responsible for mitigating the risks arising from remuneration policies. In this regard, the compensation practices and policies of the Singapore-incorporated bank must not be unduly linked to short-term accounting profit generation. Instead, they should be linked to longer-term capital preservation and the financial strength of the bank.

iii Regulatory capital and liquidity

Minimum capital requirements

The Banking Act prescribes minimum capital requirements for banks. Save where approved by MAS for wholesale banks, the minimum capital requirement for a Singapore-incorporated bank is S$1.5 billion.

Capital adequacy

MAS Notice 637 implements Basel III capital standards for Singapore-incorporated banks, and establishes the minimum capital adequacy ratios (CARs) for banks incorporated in Singapore and the methodology for calculating these ratios. MAS Notice 637 also sets out the expectations of MAS in respect of the internal capital adequacy assessment process of Singapore-incorporated banks under the supervisory review process, and specifies the minimum disclosure requirements for Singapore-incorporated banks in relation to their capital adequacy. MAS Notice 637 further sets out the data submission and disclosure requirements for assessing global systemically important banks.

MAS has imposed CAR requirements on a bank incorporated in Singapore at two levels:

a the bank standalone (solo) level CAR requirements, which measure the capital adequacy of a bank incorporated in Singapore based on its standalone capital strength and risk profile; and

b the consolidated (group) level CAR requirements, which measure the capital adequacy of a bank incorporated in Singapore based on its capital strength and risk profile after consolidating the assets and liabilities of its subsidiaries and any other entities that are treated as part of the bank's group of entities according to the applicable accounting standards (collectively called bank group entities), taking into account any exclusions of certain bank group entities or any adjustments pursuant to securitisation under MAS Notice 637.

In addition to complying with the CAR requirements in MAS Notice 637, a bank incorporated in Singapore should consider as part of its internal capital adequacy assessment process whether it has adequate capital at both the solo and group levels to cover its exposure to all risks.

Under MAS Notice 637, banks incorporated in Singapore that are designated by MAS as domestic systemically important banks (D-SIBs) are required to meet capital adequacy requirements that are two percentage points higher than the requirements of the Basel Committee on Banking Supervision (Basel Committee), namely a minimum Common Equity Tier 1 CAR of 6.5 per cent, a minimum Tier 1 CAR of 8 per cent and a minimum total CAR of 10 per cent. Other Singapore-incorporated banks are only required to maintain the minimum ratio in accordance with the Basel Committee's requirements.

In line with the Basel Committee's requirements, MAS introduced in MAS Notice 637 a capital conservation buffer of 2.5 per cent above the minimum capital adequacy

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requirements. The capital conservation buffer is met with CET 1 capital, and is currently 2.5 per cent. Including the capital conservation buffer, banks incorporated in Singapore that are designated by MAS as D-SIBs will be required to meet CET 1, Tier 1 and total CARs of 9, 10.5 and 12.5 per cent, respectively.

In addition, Singapore-incorporated banks are required to maintain a countercyclical buffer, which was phased in on 1 January 2016 and progressively increased until 2019. From 1 January 2019, the countercyclical buffer will range from zero to 2.5 per cent above the minimum CET 1, Tier 1 and total CARs, the actual magnitude being determined by the weighted average of the country-specific countercyclical buffer requirements that are being applied by national authorities in jurisdictions in which a Singapore-incorporated bank has private-sector credit exposures.

Leverage ratio

Under MAS Notice 637, Singapore-incorporated banks are also required to maintain at all times a minimum leverage ratio of 3 per cent, to be met with Tier 1 capital. This is consistent with the Basel standard and applies at both bank-group and bank-solo levels.

Capital liquidity

A bank is required to hold minimum liquid assets (MLA) as specified in Section 38 of the Banking Act and in accordance with the requirements under MAS Notice 649 on Minimum Liquid Assets and Liquidity Coverage Ratio (LCR) (MAS Notice 649).

Banks incorporated and headquartered in Singapore and banks notified by MAS to be D-SIBs must comply with the LCR framework under MAS Notice 649. Other banks in Singapore may elect to comply with either the MLA framework or the LCR framework.

The LCR framework implements the Basel III LCR rules, which are the global minimum standard for liquidity risk endorsed by the Group of Central Bank Governors and Heads of Supervision, and which require banks to hold sufficient high-quality liquid assets to match their total net cash outflows over a 30-day period. Banks in Singapore under the LCR framework must maintain at all times a Singapore dollar LCR of at least 100 per cent. Banks incorporated and headquartered in Singapore must maintain at all times an all currency LCR of 100 per cent. All other banks under the LCR framework must maintain at all times an all currency LCR of 50 per cent.

Banks in Singapore under the MLA framework must hold at all times a minimum of 16 per cent of its qualifying liabilities (as defined in MAS Notice 649) denominated in all currencies in liquid assets denominated in any currency, and a minimum of 16 per cent of its Singapore dollar qualifying liabilities in Singapore dollar liquid assets. A bank in Singapore under the MLA framework must also hold at all times at least 50 per cent of its liquid assets held for the purposes of meeting its MLA requirements in Tier 1 liquid assets.

In addition, MAS imposes the Basel Committee's net stable funding ratio (NSFR) standard on banks designated by MAS to be D-SIBs. The NSFR requires banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. Under MAS Notice 652 on Net Stable Funding Ratio (MAS Notice 652), D-SIBs incorporated and headquartered in Singapore are required to maintain an all currency NSFR of at least 100 per cent on an ongoing basis, at a banking group level, after excluding certain banking group entities. D-SIBS headquartered offshore are required to meet a minimum NSFR of 50 per cent at the entity level or at the country-level group basis (where approval has been obtained from MAS to comply on a country-level group basis).

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Separately, under Section 39 of the Banking Act and MAS Notice 758 on Minimum Cash Balance (MAS Notice 758), a bank in Singapore is also required to maintain, during a maintenance period, an aggregate minimum cash balance with MAS of at least an average of 3 per cent of its average qualifying liabilities (as defined in MAS Notice 758).

iv Recovery and resolution

Like any other company, the legislative framework for the insolvency of banks is found in the Companies Act. In addition, MAS has special powers over banks as set out in the Banking Act and the MAS Act. These special powers are designed for the protection of depositors in certain events, including where a bank becomes insolvent, is unable to meet its obligations, is going to suspend payments or is carrying on its business in a manner likely to be detrimental to the interests of its depositors or creditors. In these situations, under the Banking Act, MAS may require the bank concerned to take any action or refrain from doing an act. MAS may also appoint a statutory adviser to advise the bank on the proper management of its business. MAS may itself assume control of and manage the business of the bank, or appoint a statutory manager to do so.

Where a bank is incorporated outside Singapore, the advice given by the statutory adviser or control assumed by MAS or the statutory manager over the bank's business will only relate to the business or affairs of the bank carried on or managed in or from Singapore, or the property of the bank located in Singapore or reflected in the books of the bank in Singapore in relation to its operations in Singapore.

MAS also has broad supervisory powers under the resolution regime in the MAS Act. Apart from the provisions in the Companies Act, the MAS Act provides for additional grounds for the winding up of a bank. MAS may apply to the court for an order to claw back the salary, remuneration or other benefits of a director or executive officer in the past two years in certain circumstances, including where the director or executive officer has failed to discharge his or her duties, or has misapplied or retained, or become liable or accountable for, any money or property of a bank. The clawback period may be extended if the director or executive officer has acted recklessly, fraudulently or dishonestly. MAS is further vested with the power to issue directions to a bank's significant associated entities that are incorporated or established in Singapore under certain circumstances, as well as to share information with a foreign resolution authority if the information is intended to enable such authority to deal with the resolution of a financial institution.

The MAS Act also empowers MAS to direct the compulsory transfer of business of the bank, and in the case of a bank incorporated in Singapore, MAS further has the power to direct compulsory transfers of shares or compulsory restructuring of the share capital of the bank upon certain preconditions being satisfied.

There is currently no formalised bail-out regime in Singapore.

IV CONDUCT OF BUSINESS

The Banking Act and the regulations and notices issued thereunder set out the primary statutory duties and liabilities of a bank carrying out banking business in Singapore. Breaches of the Banking Act and related subsidiary legislation may result in criminal sanctions. Additional duties and liabilities may also be imposed by MAS through guidelines. In this

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regard, while contravention of the MAS guidelines does not constitute a criminal offence, the degree of observance of such guidelines may affect MAS's overall risk assessment of an institution.

In addition, banks in Singapore are guided by the Code of Consumer Banking Practice (Consumer Banking Code) and the Code of Conduct for Private Banking in Singapore (Private Banking Code). The Consumer Banking Code serves as a best banking practice guide for retail banks, while the Private Banking Code sets out standards of good practice on competency and market conduct expected of banks (including their staff) operating in Singapore that provide financial services to high-net-worth individuals. Neither the Consumer Banking Code nor the Private Banking Code have force of law, but arose from industry initiatives with the support of MAS.

Where a bank in Singapore carries on an activity that is regulated under the Securities and Futures Act (SFA) (e.g., advising on corporate finance, dealing in capital markets products or fund management) or the Financial Advisers Act (FAA) (e.g., providing financial advisory services), the conduct of business requirements under the SFA and the FAA, and the regulations, notices, circulars and guidelines thereunder, as the case may be, must be complied with. These requirements relate to various matters, including the appointment of representatives, keeping of books and, where applicable, the handling of customers' money and assets.

i Privacy of customer information

Licensed banks in Singapore are subject to statutory obligations to protect the privacy of customer information, as set out in Section 47 of the Banking Act, which provides that customer information shall not in any way be disclosed by a bank in Singapore or any of its officers (including a director, secretary, employee, receiver or manager, and liquidator) to any other person except as expressly provided in the Banking Act. A breach of Section 47 is an offence.

The Banking Act provides for exceptions to the general prohibition against disclosure in Section 47. The exceptions are divided into two categories: the first category where the recipient of the information is not prohibited from further disclosing the information to any other person (category 1), and the second category where the recipient of the information is prohibited from further disclosing the customer information to another person, except as authorised under the Banking Act or if required to do so by an order of any court of competent jurisdiction in Singapore (category 2).

Disclosures pursuant to the exceptions in category 1 include:

a disclosure permitted in writing by the customer;
b disclosure solely in connection with the insolvency of a customer;
c disclosure for the investigation and prosecution of certain criminal offences; and
d disclosure necessary for compliance with a garnishee order served on the bank attaching moneys in the customer's account.

Examples of permitted disclosures pursuant to the category 2 exemptions include disclosure solely in connection with the performance of duties as an officer of the bank or a professional adviser of the bank, and disclosure in connection with the outsourcing of the bank's operational functions.

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V FUNDING

Deposits form a significant funding base for banks in Singapore. The three local banking groups in Singapore are also listed on the SGX-ST and have issued securities to raise funds.

With respect to the management of liquidity in the Singapore banking system, MAS achieves this through daily money-market operations and liquidity facilities.

MAS carries out money-market operations every morning with a view to ensuring an appropriate amount of liquidity in the banking system to meet banks' demand for precautionary and settlement balances without being excessive. MAS carries out money-market operations exclusively with primary dealers in recognition of their roles as specialist intermediaries in the Singapore Government Securities market and money markets. MAS may supply more or less liquidity than is required to meet banks' demand for precautionary and settlement balances, depending on the economic climate and market conditions.

Banks in Singapore may also avail themselves of two liquidity facilities provided by MAS that complement the daily money market operations: the Intraday Liquidity Facility and the Standing Facility. While money-market operations provide for broad liquidity management, the liquidity facilities allow MAS to fine-tune the liquidity in the system and minimise intraday volatility in overnight interest rates.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Requirements relating to disclosure of substantial shareholding in voting shares are provided for in the SFA, and apply only in relation to a Singapore-incorporated company listed on the SGX-ST and foreign corporations with a primary listing on the SGX-ST (ListCo). Accordingly, only the listed entities in the three local banking groups are subject to the substantial shareholding notification regime.

Under this regime, a substantial shareholder is a person who has an interest in not less than 5 per cent of the total votes attached to all the voting shares (excluding treasury shares) of a ListCo. A substantial shareholder must notify the ListCo within two business days of becoming or ceasing to be a substantial shareholder, or when there is a change in the percentage level of the voting shares held.

In addition, a condition is typically found in the banking licence requiring the licensed bank to notify MAS of any changes or proposed changes in ownership or control over the bank that will result in a change in the entity or entities having effective control over the bank.

The Banking Act requires the prior approval of the Minister for Finance (Minister) to be obtained at three threshold levels:

a before a person becomes a substantial shareholder of a Singapore-incorporated bank or an approved financial holding company under the MAS Act (together referred to as a designated financial institution (DFI));

b before a person, alone or with his or her associates, holds not less than 12 per cent of the shares of, or controls not less than 12 per cent voting power in, a DFI; and

c before a person, alone or with his or her associates, holds not less than 20 per cent of the shares of, or controls not less than 20 per cent voting power in a DFI.

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The Minister's prior approval is also required before a person becomes an indirect controller of a DFI (i.e., being in a position to determine the policy of the DFI, or being a person whose directions, instructions or wishes the directors of the DFI are accustomed or under an obligation to act upon).

The Banking Act also requires prior written approval of the Minister before a Singapore-incorporated bank may be merged or consolidated with, or taken over by, another company.

Failure to obtain such prior written approval is an offence.

ii Transfers of banking business

Under the Banking Act, a bank in Singapore may transfer its business (including its non-banking business) to another bank in Singapore. The conditions for a voluntary transfer of the business of a bank are as follows:

a where the transferor is a bank incorporated in Singapore, the Minister has consented to the transfer or has certified that his or her consent is not required. The Minister will grant his or her consent to the transfer of business if:
- MAS is satisfied that the transferee is a fit and proper person, and the transferee will conduct the business of the transferor prudently and comply with the provisions of the Banking Act; and
- the Minister is satisfied that it is in the national interest to do so;

b where the transferor is a bank incorporated outside Singapore, the business to be transferred is reflected in the books of the transferor in Singapore in relation to its operations in Singapore;

c the transfer involves the whole or a part of the banking business of the transferor; and

d the Singapore High Court has approved the transfer.

Upon the Singapore High Court granting its order approving the transfer of business, the transferor's business will be transferred to and vest in the transferee (the transfer of any land being subject to the appropriate entries in the land registers).

VII THE YEAR IN REVIEW

Important regulatory developments affecting banks in Singapore in the past 12 months include the following.

i Amendments to the Banking Act

The Banking (Amendment) Act 2016 was gazetted on 23 May 2017 and came into force on 30 November 2018. The legislative changes are aimed at enhancing prudential safeguards, corporate governance and risk management controls in the banking industry. The changes include empowering MAS to remove key appointment holders and to require local incorporation of branches of foreign banks that have a significant retail presence in Singapore. In addition, the amendments codify MAS' expectation for banks to institute risk management systems and controls, and to obtain MAS' approval to establish new places of business where non-banking activities are conducted.

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ii Enhancement of resolution regime for financial institutions in Singapore

The Monetary Authority of Singapore (Amendment) Act 2017 was gazetted on 1 August 2017 and the provisions on the resolution of financial institutions have come into force. These enhancements take into account global developments, including the Key Attributes of Effective Resolution Regimes for Financial Institutions adopted by the FSB, and are aimed at promoting the orderly and effective resolution of distressed financial institutions. The Monetary Authority of Singapore (Resolution of Financial Institutions) Regulations 2018 was also promulgated. The Monetary Authority of Singapore (Resolution of Financial Institutions) Regulations 2018 set out, inter alia, definitions of key terms (including a pertinent financial institution, the types of instruments that are subject to the bail-in regime, and the rights and obligations during a compulsory transfer of business of a pertinent financial institution). In addition, MAS has issued MAS Notice 654 on Recovery and Resolution Planning, as well as the Guidelines to MAS Notice 654 on 30 January 2019. MAS Notice 654 and its accompanying Guidelines set out requirements that a bank which has been notified by MAS has to comply with. For example, the bank will have to prepare a recovery plan that must be reviewed and kept up to date.

VIII OUTLOOK AND CONCLUSIONS

The financial sector is an integral part of Singapore's ambition to be a Smart Nation. MAS is seeking to create a Smart Financial Centre where technology is used pervasively in the financial industry to increase efficiency, create opportunities, allow for better management of risks and improve lives.[5] In view of technological advancements as well as the increasing use of technology within the financial sector, MAS is looking to address the changing cyber-threat landscape with the following upcoming regulatory instruments.

i Consultation paper on the draft Notice on Cyber Hygiene

In September 2018, MAS issued a consultation paper on the draft Notice on Cyber Hygiene. The Notice on Cyber Hygiene prescribes a set of essential cybersecurity practices that financial institutions (including banks) must put in place to manage cyber threats, in view of the deepening cyber-threat landscape. MAS has referred to the cybersecurity guidance and regulations in other major jurisdictions to extract the most relevant and effective hygiene practices for financial institutions to adopt.

ii E-Payments User Protection Guidelines

MAS issued the E-Payments User Protection Guidelines on 28 September 2018. They were originally slated to come into force on 31 January 2019, but this has now been delayed until 30 June 2019. The E-Payments User Protection Guidelines set out MAS's expectations of any responsible financial institution (including banks) that issues or operates an account used for e-payments. It also aims to achieve the following: to set out the duties of financial institutions and users for secure e-payment transactions; simplifying error resolution processes when a user sends money to the wrong recipient; and apportioning liability between financial institutions and users for unauthorised transactions.

5 Accessed at http://www.mas.gov.sg/Singapore-Financial-Centre/Smart-Financial-Centre.aspx.

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Chapter 33

SOUTH AFRICA

Natalie Scott[1]

I INTRODUCTION

South Africa has an advanced banking system, backed by a sound legal and regulatory framework that aims to secure systemic stability in the economy, to ensure institutional safety and soundness, and to promote consumer protection.

Notwithstanding the turmoil experienced in international financial markets, the South African banking sector has remained sound and adequately capitalised, and new legislation is being promulgated to ensure the continuing stability of the financial sector. The South African Reserve Bank (SARB), which is the central bank in South Africa, is closely involved in international forums, particularly the G20. In addition, the SARB has maintained a greater focus on financial stability[2] in general.

The five largest banks in South Africa by total assets are Absa Bank Limited, FirstRand Bank Limited, Investec Bank Limited, Nedbank Limited and The Standard Bank of South Africa Limited.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The following primary statutes and regulations govern the banking industry:

a the Banks Act 94 of 1990 (Banks Act) and regulations published in terms thereof, providing for the regulation and supervision of the taking of deposits from the public;

b the South African Reserve Bank Act 90 of 1989, specifically regulating the SARB and the monetary system;

c the Financial Sector Regulation Act 9 of 2017 (FSRA), establishing a system of financial regulation by establishing the Prudential Authority (PA) and the Financial Sector Conduct Authority (FSCA), conferring powers on these entities to preserve and enhance financial stability in the RSA by conferring powers on the SARB, regulating and supervising financial product providers and financial services providers, improving market conduct in order to protect financial customers and providing for co-ordination, co-operation, collaboration and consultation among the SARB, the PA, the FSCA, the National Credit Regulator, the Financial Intelligence Centre and other organs of state in relation to financial stability and the functions of these entities;

1 Natalie Scott is a director at Werksmans Attorneys.

2 In its September 2018 Financial Stability Review, the SARB states that financial stability 'refers to a financial system that is resilient to systemic shocks, facilitates efficient financial intermediation and mitigates the macroeconomic costs of disruptions in such a way that confidence in the system is maintained'.

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d the National Payment Systems Act 78 of 1998 (NPS Act), providing for the management, administration, operation, regulation and supervision of payment, clearing and settlement systems in South Africa;

e the Inspection of Financial Institutions Act 80 of 1998, providing for the inspection of the affairs of financial institutions (such as banks) and of unregistered entities conducting the business of financial institutions;

f the Currency and Exchanges Act 9 of 1933 (Currency Act), regulating legal tender, currency, exchanges and banking. Exchange control regulations issued in terms of the Currency Act impose controls that regulate the expatriation of capital from South Africa;

g the Financial Intelligence Centre Act 38 of 2001 (FICA), establishing a Financial Intelligence Centre and a Money Laundering Advisory Council to combat money-laundering activities and the financing of terrorist and related activities, and imposing certain duties on institutions and other persons who might be used for such;

h the Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS), regulating the rendering of certain financial advisory and intermediary services to clients;

i the Electronic Communications and Transactions Act 25 of 2002, providing for the facilitation and regulation of electronic communications and transactions;

j the Prevention of Organised Crime Act 121 of 1998, introducing measures to combat organised crime, money laundering and criminal gang activities, and prohibiting certain activities relating to racketeering activities;

k the Home Loan and Mortgage Disclosure Act 63 of 2000, promoting fair lending practices, which requires disclosure by financial institutions of information regarding the provision of home loans;

l the Mutual Banks Act 124 of 1993 (Mutual Banks Act), providing for the regulation and supervision of the activities of mutual banks;

m the Co-operative Banks Act 40 of 2007, providing for the regulation and supervision of cooperative banks. The legislation acknowledges member-based financial services cooperatives as a separate tier of the official banking sector;

n the National Credit Act 34 of 2005 (NCA) regulating consumer credit and improved standards of consumer information. It also:

- prohibits certain unfair credit and credit-marketing practices and reckless credit granting;
- provides for debt reorganisation in cases of over-indebtedness;
- regulates credit information; and
- provides for the registration of credit bureaux, credit providers and debt-counselling services;

o the Consumer Protection Act 68 of 2008 (CPA), protecting certain fundamental consumer rights, and applying to the provision of banking services to consumers, unless exempted, except to the extent that any such service constitutes advice or intermediary services regulated by FAIS, or is regulated in terms of the Long-term Insurance Act of 1988 or the Short-term Insurance Act of 1988 (the provisions of which have been largely superseded by the Insurance Act 18 of 2017);

p the Financial Markets Act 19 of 2012 (FMA), providing for, inter alia, the regulation of financial markets and the custody and administration of securities, and prohibiting insider trading;

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q the Financial Institutions (Protection of Funds) Act 28 of 2001, providing for and consolidating the laws relating to the investment, safe custody and administration of funds and trust property by financial institutions; and

r the Protection of Personal Information Act 4 of 2013 (POPI), which will, once fully effective, regulate the minimum threshold requirements for the lawful processing of personal information, and which will be in harmony with international standards.

The following regulatory authorities are responsible for overseeing banks:

a the SARB, as the central bank, and more particularly the Registrar of Banks (Registrar), who is an officer of the SARB, are primarily responsible for overseeing banks.[3] The SARB, in terms of the NPS Act, also recognises the Payment Association of South Africa as a payment system management body with the object of organising, managing and regulating the participation of its members (i.e., banks) in the payment system;[4]

b the PA, the objective is which is to:
- promote and enhance the safety and soundness of financial institutions that provide financial products and securities services;
- promote and enhance the safety and soundness of market infrastructures;
- protect financial customers against the risk that those financial institutions may fail to meet their obligations; and
- assist in maintaining financial stability;

c the FSCA (previously known as the Financial Services Board (FSB)), established in terms of the FSRA, the objective of which is to:
- enhance and support the efficiency and integrity of financial markets;
- protect financial customers by promoting fair treatment of financial customers by financial institutions; providing financial customers and potential financial customers with financial education programmes; and otherwise promoting financial literacy and the ability of financial customers and potential financial customers to make sound financial decisions; and
- to assist in maintaining financial stability;

d the Financial Intelligence Centre, which monitors and provides banks with guidance as accountable institutions regarding the performance of their duties and their compliance with FICA;

e the National Credit Regulator (NCR), established in terms of the NCA, whose responsibilities include the registration of credit providers, and monitoring the consumer credit market and industry to ensure prohibited conduct is prevented, or detected and prosecuted;

f the National Consumer Commission, established in terms of the CPA, whose responsibilities include enforcement of the CPA; and

g the Information Regulator, which is to be established once POPI becomes effective. Its responsibilities will include monitoring and enforcing compliance with the provisions of the POPI.

3 Sections 3 and 4 of the Banks Act.

4 Section 3 of the NPS Act.

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III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The SARB, as the central bank of South Africa, is responsible for bank regulation and supervision in South Africa. It also has responsibility for promoting the soundness of the domestic banking system through the effective and efficient application of international regulatory and supervisory standards and for minimising systemic risk. The SARB issues banking licences to banking institutions, and monitors their activities in terms of either the Banks Act or the Mutual Banks Act.

On 21 August 2017, the FSRA was signed into law. The passing of the FSRA was the culmination of the collaboration on financial sector reform by the SARB, National Treasury and the FSB, and marked an important milestone in South Africa's journey towards a safer and fairer financial system that is able to serve all citizens.

The FSRA introduced three important changes to the regulation of the financial sector:

a it granted an explicit mandate to the SARB to maintain and enhance financial stability;

b it created a prudential regulator, the PA, which is responsible for regulating banks, insurers, cooperative financial institutions, financial conglomerates and certain market infrastructures; and

c it established a market conduct regulator – the FSCA – which is located outside of the SARB.[5]

The PA is a juristic person operating within the administration of the SARB and comprises four departments:

a the Financial Conglomerate Supervision Department;

b the Banking, Insurance and FMI Supervision Department;

c the Risk Support Department; and

d the Policy, Statistics and Industry Support Department.[6]

Banks are subject to inspection by the regulatory authorities listed in Section II. Official inspections may take various forms. Banks are requested and required by various statutes to submit, at regular intervals, specific financial and other reports, which are then analysed by the regulatory authorities with a view to identifying undesirable developments, such as potential default trends.

In addition, banks are subjected to on-site inspections, in which case the authorities undertake a type of external audit of the bank, but with specific reference to the prudential and conduct-of-business requirements. Regulatory bodies may also conduct inspections when complaints are received by the public. Informally, supervisors may also engage in presentations to and meetings with any bank's board of directors (board).

5 https://www.resbank.co.za/PrudentialAuthority/Pages/default.aspx accessed on 17 February 2019 at 08h37.

6 Ibid.

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ii Management of banks

The board of a bank is ultimately responsible for ensuring that an adequate and effective process of corporate governance, which is consistent with the nature, complexity and risk inherent in the bank's on-balance sheet and off-balance sheet activities, and which responds to changes in the bank's environment and conditions, is established and maintained.[7]

The process of corporate governance includes the maintenance of effective risk and capital management by a bank.[8] The overall effectiveness of the processes relating to, inter alia, corporate governance, internal controls, risk management, capital management and capital adequacy must be continually monitored by the bank's board.[9] The board of a bank, or a committee appointed by the board for that purpose, must at least once a year assess and document whether the processes relating to corporate governance, internal controls, risk management, capital management and capital adequacy implemented by the bank successfully achieve the objectives specified by the board; and at the request of the Registrar, provide the Registrar with a copy of the report compiled by the board or committee in respect of the adequacy of the processes relating to corporate governance, risk management, capital management and capital adequacy.[10]

In addition, the external auditors of a bank must annually review the process followed by the board in assessing its corporate governance arrangements, including the management of risk and capital, and the assessment of capital adequacy, and report to the Registrar whether any matters have come to their attention to suggest that they do not concur with the findings reported by the board, provided that when the auditors do not concur with the findings of the board, they provide reasons for their non-concurrence.[11]

Every director of a bank or controlling company is required to acquire a basic knowledge and understanding of the conduct of the business of that bank, and of the laws and customs that govern the activities of such an institution. Although not every member of the board of a bank or controlling company is required to be fully conversant with all aspects of the conduct of the business of a bank, the competence of every director of a bank must be commensurate with the nature and scale of the business conducted by that bank and, in the case of a director of a controlling company, as a minimum must be commensurate with the nature and scale of the business conducted by the banks in the group.[12]

In view of the fact that the primary source of funds administered and utilised by a bank in the conduct of its business are deposits loaned to it by the general public, it is further the duty of every director and executive officer of a bank to ensure that risks that are of necessity taken by such a bank in the conduct of its business are prudently managed.[13]

The board must establish, inter alia, a remuneration committee consisting only of non-executive directors of the bank or controlling company.[14] The functions of the remuneration committee include working closely with the bank or controlling company's risk and capital management committee in the evaluation of the incentives created by the

7 Section 60B(1) of the Banks Act.
8 Regulation 39(2).
9 Regulation 39(17).
10 Regulation 39(18).
11 Regulation 39(19).
12 Regulation 40(1).
13 Regulation 40(3).
14 Section 64C of the Banks Act.

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compensation system, and ensuring that performance measures are based principally on the achievement of the board-approved objectives of the bank or controlling company and its relevant functions.

iii Regulatory capital and liquidity

A bank must manage its affairs in such a way that the sum of its Common Equity Tier 1 capital, additional Tier 1 capital and Tier 2 capital, and its Common Equity Tier 1 unimpaired reserve funds, additional Tier 1 unimpaired reserve funds and Tier 2 unimpaired reserve funds in South Africa does not at any time amount to less than the greater of 250 million rand, or an amount that represents a prescribed percentage of the sum of amounts relating to the different categories of assets and other risk exposures of the bank, calculated as prescribed in the regulations relating to banks, where the business of the bank includes trading in financial instruments.

A bank must furthermore hold in South Africa liquid assets amounting to not less than the sum of amounts, calculated as prescribed percentages not exceeding 20 per cent, of such different categories of its liabilities as may be prescribed in the regulations relating to banks. A bank may not pledge or encumber any portion of these liquid assets. The Registrar is empowered to exempt the bank from this prohibition on such conditions, to such an extent and for such a period as he or she may determine.

A controlling company must further manage its affairs in such a way that the total of its Common Equity Tier 1 capital, additional Tier 1 capital and Tier 2 capital, and its Common Equity Tier 1 unimpaired reserve funds, additional Tier 1 unimpaired reserve funds and Tier 2 unimpaired reserve funds, does not at any time amount to less than an amount that represents a prescribed percentage of the sum of the amounts relating to the different categories of assets and other risk exposures, and calculated in such a manner as prescribed. In addition, the capital and reserve funds of any regulated entity included in the banking group and structured under the controlling company must not at any time amount to less than the required amount of capital and reserve funds determined in respect of the relevant regulated entity, in accordance with the relevant regulator responsible for the supervision of the relevant regulated entity.[15]

iv Recovery and resolution

The SARB has issued a directive that specifies the minimum requirements for the recovery plans of banks, controlling companies and branches of foreign institutions. The level of detail and range of recovery options must be commensurate with the risk profile of the relevant bank or institution. These requirements are in line with the international standard for resolution planning set by the Financial Stability Board in its 'Key attributes of effective resolution regimes for financial institutions' released on 4 November 2011.

The directive sets out the following governance requirements:

a the development, maintenance, approval and annual review of the recovery plan should be subject to an appropriate governance process with clearly assigned roles and responsibilities for operational staff, senior management and the board (or committee of similar standing in the case of a locally registered branch of a foreign bank);

15 See in general Section 70A and Section 72 of the Banks Act.

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b the board should express its view on the recoverability of the bank from severe financial stress based on the options identified in the recovery plan; and

c an overview of any material changes or updates made since the previous version of the bank's recovery plan needs to be included in the recovery plan.

If the Registrar is of the opinion that a bank will be unable to repay deposits made with it or will probably be unable to meet any other obligations, the Minister of Finance (Minister) may appoint a curator to the bank, if he or she deems it desirable in the public interest, by notifying the chief executive officer or chair of the board of that bank in writing.[16] If such an appointment is made, the management of the bank vests in the curator, subject to supervision by the Registrar, and those who until then were vested with its management are divested of it. The curator must recover and take possession of all the assets of the bank.[17] The appointment of a curator does not amount to the bank being wound up or liquidated.

Subject to the supervision of the Registrar, the curator must conduct the management of the bank in such a manner as the Registrar may deem to best promote the interests of the creditors of the bank concerned and of the banking sector as a whole, and the rights of employees in accordance with the relevant labour legislation.[18] The curator may dispose of all or part of the business of a bank to enable an effective resolution of a bank under curatorship.[19] If, at any time, the curator is of the opinion that there is no reasonable prospect that the continuation of the curatorship will enable the bank to pay its debts or meet its obligations and become a going concern, the curator must inform the Registrar in writing forthwith.[20]

The curator is empowered to cancel any guarantee issued by a bank prior to its being placed under curatorship, excluding a guarantee that the bank is required to make good within a period of 30 days of the date of the appointment of the curator. A claim for damages in respect of any loss sustained by or damage caused to any person as a result of the cancellation of a guarantee may be instituted against the bank after the expiry of a period of one year from the date of the cancellation.[21] A curator is further empowered to raise funding on behalf of the bank from the SARB, or any entity controlled by the SARB and, notwithstanding any contractual obligations of the bank, but without prejudice to real security rights, to provide security over the assets of the bank in respect of that funding. Any claim for damages in respect of any loss sustained by or damage caused to any person as a result of such security may be instituted against the bank after the expiry of a period of one year from the date of the provision of security.[22] A curator may also propose and enter into an arrangement or compromise between the bank and all its creditors, or all the members of any class of creditors, in terms of Section 155 of the Companies Act 71 of 2008 (Companies Act).[23]

16 Section 69(1) of the Banks Act.
17 Section 69(2A) of the Banks Act.
18 Section 69(2B) of the Banks Act.
19 Section 68(2C) of the Banks Act.
20 Section 69(2D) of the Banks Act.
21 Section 69(3)(i) of the Banks Act.
22 Section 69(3)(j) of the Banks Act.
23 Section 69(3)(k) of the Banks Act.

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Notwithstanding the foregoing, the Registrar has the right to apply to a court for the winding up of any bank under the Companies Act. The Registrar also has the right to oppose any such application made by any other party.[24] Only a person recommended by the Registrar may be appointed as provisional liquidator or liquidator of a bank.

The introduction of the FSRA provides for the establishment of an explicit deposit insurance scheme for banks.[25] Together, the resolution chapter of the FSRA and the Financial Sector Laws Amendment Bill of 2018 (FSLAB) provide that the resolution of designated institutions falls squarely within the ambit of the SARB as the resolution authority.

IV CONDUCT OF BUSINESS

Under Section 78 of the Banks Act, a bank is not permitted to:

a hold shares in any company of which the bank is a subsidiary;

b lend money to any person against security of its own shares or of shares of its controlling company;

c grant an unsecured loan or a loan against security that, in the opinion of the Registrar, is inadequate for the purpose of furthering the sale of its own shares;

d show bad debts, losses or certain costs as assets in its financial statements or returns;

e pay out dividends on its shares, or open any branch or agency, before provision has been made out of profits for any such bad debts, losses and certain costs;

f act as an agent for the purpose of a money-lending transaction between a lender and a borrower, except in terms of a written contract of agency that confirms that the bank acts as the agent of the lender, that the lender assumes all risks and related responsibilities, and that payment is not guaranteed by the bank;

g record in its accounting records any asset at a value increased by the amount of a loss incurred upon the realisation of another;

h conclude a repurchase agreement in respect of a fictitious asset or an asset created by means of a simulated transaction;

i purport to have concluded a repurchase agreement without the agreement being substantiated by a written document signed by the other party, and the details of the agreement being recorded in the accounts of the bank as well as in the accounts that may be kept by the bank in the name of the other party; and

j pay out dividends from its share capital without the prior written approval of the Registrar.

A bank must hold all its assets in its own name, excluding any asset that is *bona fide* hypothecated to secure an actual or potential liability; in respect of which the Registrar has approved in writing that the asset may be held in the name of another person; or falling within a category of assets designated by the Registrar as an asset that may be held in the name of another person.

24 Section 68(1) of the Banks Act.

25 A critical feature of the resolution framework is to establish an explicit deposit insurance scheme to ensure that depositors who are most exposed to an asymmetry of information and thus least likely to hedge or mitigate against financial loss in the event of a bank failure are protected against losses and hardship that may stem from a bank failure (Financial Stability Review, second edition, 2017, see page 28).

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A bank owes a duty of confidentiality and secrecy to its customers.[26] Banking secrecy is founded on legislation, contract and the protection of privacy.[27] The contractual foundation of banking secrecy is regarded as an express or implied term of a contract between a bank and its customer. However, contractual obligations are not the only foundation of bank secrecy, because a bank may also not reveal information concerning a prospective or a past customer. Banks are, in fact obliged to keep all confidential information secret, whether it relates to a customer or anyone else.[28] According to *Malan*, '[a] bank is obliged to keep all information concerning a customer confidential including the fact, it is submitted, that he is or was a customer'.[29]

This duty is not absolute, as certain circumstances may justify a bank disclosing confidential information. The following grounds of justification were identified in *Tournier v. National Provincial & Union Bank of England*:[30]

a where disclosure is under compulsion by law;[31]
b where there is a duty to the public to disclose;
c where the interests of the bank require disclosure; and
d where the disclosure is made by the express or implied consent of the customer.

The Code of Banking Practice (Code) issued by the Banking Association of South Africa (BASA) also recognises the duty to respect privacy and confidentiality. Although it is voluntary, all member banks of BASA abide by the Code. The Code applies to the relationships between personal and small business customers and their banks. The Code confirms that banks will treat all the personal information of a customer as private and confidential, and that, as a general rule, banks will not disclose any personal information about a customer or his, her or its accounts, including to other companies in any bank's group, even when that person is no longer a customer.

26 See *Tournier v. National Provincial & Union Bank of England* 1924 1 KB 461; *Abrahams v. Burns* 1914 CPD 452 456; *Cambanis Buildings (Pty) Ltd v. Gal* 1983 (2) SA 128 (NC) 137E-F; *GS George Consultants and Investments (Pty) Ltd v. Datasys (Pty) Ltd* 1988 (3) SA 726 (W); *FirstRand Bank Ltd v. Chaucer Publications (Pty) Ltd* 2008 (2) SA 592 (C).

27 *Malan on Bills of Exchange, Cheques and Promissory Notes*, Fifth Edition, FR Malan et al., LexisNexis South, Paragraph 223.

28 *Cambanis Buildings (Pty) Ltd v. Gal 1983* (2) SA 128 (N) at 137; *GS George Consultants and Investments (Pty) Ltd v. Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 736. *Malan on Bills of Exchange, Cheques and Promissory Notes*, Third Edition, FR Malan and JT Pretorius, LexisNexis South, Paragraph 212.

29 *Malan on Bills of Exchange, Cheques and Promissory Notes*, Fifth Edition, FR Malan et al., LexisNexis South, Paragraph 223.

30 1924 1 KB 461 at 473. See also *Cywilnat (Pty) Ltd v. Densam (Pty) Ltd* 1989 (3) SA 59 (W); *Densam (Pty) Ltd v. Cywilnat (Pty) Ltd 1991* (1) SA 100 (A); *FirstRand Bank Ltd v. Chaucer Publications (Pty) Ltd* 2008 (2) SA 592 (C).

31 See, for example, Section 371 of the Financial Intelligence Centre Act 38 of 2001, which provides in general that no duty of secrecy or confidentiality or any other restriction on the disclosure of information, whether imposed by legislation or arising from common law or agreement, affects compliance by an accountable institution such as a bank, or any other person with a provision of Parts 3 and 4 of Chapter 3 and with Chapter 4; and the Promotion of Access to Information Act 2 of 2000, which aims, inter alia, to give effect to the right of access to any information that is held by another person and that is required for the exercise or protection of any rights.

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V FUNDING

Banks are required to maintain a minimum reserve balance in accounts with the SARB.[32] The credit balance in those accounts must comply with certain prescribed percentages.

The Basel III liquidity framework requires banks to adhere to a new liquidity coverage ratio (LCR). The LCR was introduced in South Africa as a minimum liquidity requirement from 1 January 2015. The SARB has approved the provision of a committed liquidity facility (CLF) to commercial banks to assist them in meeting their LCR. The CLF essentially enables banks to unlock liquidity from otherwise illiquid, but nevertheless high-quality, assets. A number of directives have been issued by the SARB setting out requirements for compliance with the LCR, including national discretion as allowed for in the LCR framework and how compliance with the LCR should be measured.

In April 2018, the SARB issued Banks Act Directive 1/2018 pertaining to matters related to Pillar 3 disclosure requirements: a consolidated and enhanced framework wherein banks, branches of foreign institutions and controlling companies were directed to disclose their capital adequacy and leverage ratios on a quarterly basis, in accordance with Pillar 3 of the Basel III Capital Accord.

In August, the SARB issued Banks Act Directive 2/2018 pertaining to the materiality threshold in respect of exposure to a foreign jurisdiction in applying jurisdictional reciprocity in the countercyclical capital buffer calculation, which directed banks, branches of foreign institutions and controlling companies to apply a materiality threshold in the calculation of the bank's exposures to foreign jurisdictions in respect of which reciprocity must be applied.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

No entity other than a bank or institution that has been approved by the Registrar and that conducts business similar to the business of a bank in a country other than South Africa may exercise control over a bank, unless the entity is a public company and is registered as a controlling company in respect of such bank.[33] A person is deemed to exercise control over a bank if the bank is a subsidiary of the controlling company, or if that person, alone or together with his or her associates:

a holds shares in the bank of which the total nominal value represents more than 50 per cent of the nominal value of all the issued shares of the bank, unless he or she, or he or she together with his or her associates, is unable to influence decisively the outcome of the voting at a general meeting due to limitations on the voting rights attached to the shares;

b is entitled to exercise more than 50 per cent of the voting rights in respect of the issued shares of the bank; or

c is entitled or has the power to determine the appointment of the majority of the directors of that bank.[34]

32 See in general Section 10A of the South African Reserve Bank Act 90 of 1989.

33 Section 42(1) of the Banks Act.

34 Section 422 of the Banks Act.

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An application for registration as a controlling company must be made to the Registrar on the prescribed form. The Registrar may grant or refuse the application, or make the granting thereof conditional. The Registrar shall not grant an application for registration as a controlling company unless he or she is satisfied that:

a the registration of the applicant as a controlling company will not be contrary to the public interest;

b in the case of an applicant intending to control any bank, the applicant will be able to establish control;

c no provision of the memorandum of incorporation of the applicant and no interest that any person has in the applicant is inconsistent with the Banks Act;

d every director or executive officer of the applicant is a fit and proper person, and has sufficient knowledge and experience; and

e the applicant is in a financially sound condition.

Restrictions are also in place for shareholding in banks. In general, a shareholder may not acquire or hold more than 15 per cent of the shares of a bank or controlling company without the permission of the Minister or the Registrar. In considering the requisite permission, the Registrar or Minister may consult the Competition Commission, established and constituted in accordance with the provisions of the Competition Act 89 of 1998. The Registrar or the Minister must be satisfied that the proposed acquisition of shares will not be contrary to the public interest, or to the interests of the bank, its depositors or the controlling company.

A bank further requires the prior written approval of the Registrar to:

a establish or acquire a subsidiary within or outside South Africa;

b invest in a joint venture within or outside South Africa if the investment exceeds certain thresholds;

c establish, open or acquire a branch office or representative office outside South Africa;

d create, establish or acquire a trust outside South Africa of which the bank is a major beneficiary, or any financial or business undertaking outside South Africa under the bank's direct or indirect control;

e acquire an interest in any undertaking with a registered office or principal place of business outside South Africa; or

f create a division within or outside South Africa where another person conducts his or her business through that division.

Banks are also required to furnish the Registrar with particulars relating to its shareholding or other interest in its subsidiaries. Furthermore, no reconstruction of companies within a group of which a bank or a controlling company or subsidiary of a bank is a member may be effected without the prior written approval of the Registrar.

ii Transfers of banking business

The Minister must consent in writing, and convey through the Registrar, to any arrangement for the transfer of more than 25 per cent of the assets, liabilities, or assets and liabilities, of

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a bank to another person. The 25 per cent rate is calculated by aggregating the amount of the transferred assets, liabilities, or assets and liabilities, with any previous transfer of assets, liabilities, or assets and liabilities, within the same financial year of the bank concerned.[35]

In the event that only assets are transferred, and the amount of the transferred assets, with any previous transfer of assets within the same financial year, aggregates to an amount that is less than 10 per cent of the total on-balance-sheet assets of the transferring bank, no consent is required.

These provisions do not apply to the transfer of assets effected in accordance with a duly approved securitisation scheme.

VII THE YEAR IN REVIEW

In September, the SARB issued Banks Act Directive 3/2018 pertaining to cloud computing and the offshoring of data, which is required to be read with Guidance Note 5/2018. Banks are required, under Regulation 39 of the Regulations pertaining to Banks, to establish and maintain an appropriate process of corporate governance. The process includes the maintenance of effective risk management processes by banks and the continuous management of risk arising from the use of cloud computing and the offshoring of data.

In October 2018, the SARB issued Banks Act Directive 4/2018 pertaining to matters related to the promotion of sound corporate governance, and in particular to the appointment of directors and executive officers.

On 1 December 2017, the Portfolio Committee on Trade and Industry invited public comments on the proposed National Credit Act Amendment Bill of 2017 (NCAAB). Section 88F of the NCAAB allowed the Minister of Trade and Industry to 'prescribe a debt intervention measure for a significant exogenous shock to a group of people to alleviate household debt and address economic hardship' subject to the identification of the relevant exogenous shock and the gazetting thereof.

The Committee adopted the NCAAB on 29 August 2018, and the draft includes new provisions prescribing over-indebtedness as a requirement to qualify for debt intervention. The NCR, through an amendment to Section 15A of the NCA, is proposed as a facilitator of the debt intervention process by assisting affected consumers through the process of being declared over-indebted. Debt may be suspended in whole or in part for up to 24 months, and may be extinguished altogether if the financial circumstances of the applicant do not improve during the suspension period. According to the NCR, task team agreements (TTAs) are voluntary non-statutory measures put in place to address any operational and procedural weaknesses that may arise from the implementation of the debt review provisions of the NCA.

Another provision of the NCAAB is that magistrate courts, through an amendment of Section 87 of the NCA, will be empowered to set maximum interest rates, fees and other charges on credit agreements, as prescribed by the TTA, distinguishing between secured and unsecured credit.

As previously mentioned, the FSRA expanded the mandate of the SARB to include the monitoring and mitigation of systemic risk in the South African market. The FSLAB, which includes amendments to the FSRA to cater for the resolution of financial institutions and the establishment of an explicit depositor insurance scheme, was published on 25 September 2018.

35 See in general Section 54 of the Banks Act.

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The FSLAB gives effect to the proposals contained in the discussion document titled 'Strengthening South Africa's resolution framework for financial institutions' released on 13 August 2015 and the deposit insurance policy document titled 'Designing a deposit insurance scheme for South Africa released on 30 May 2017'.[36]

The proposed amendments to the FSRA aim to strengthen the ability of the SARB to manage the orderly resolution or winding down of a failing financial institution with minimum disruption to the broader economy. In addition, the amendments are designed to ensure that depositors' funds are protected in the event of a bank failure, and that depositors' funds will be paid out speedily to protect the most vulnerable customers, by means of a deposit insurance scheme that will be funded by the banking industry. These amendments apply to all South African banks, including mutual banks and cooperative banks, as well as other systemically important non-bank financial institutions.

On 9 February 2018, the Minister gazetted regulations in terms of the FMA to bring regulatory clarity and certainty to certain aspects of the regulatory framework for over-the-counter (OTC) derivatives trading and certain market infrastructures.[37] In the case of OTC derivatives transactions, the regulations specify requirements regarding the authorisation of OTC derivatives providers and their reporting obligations to a licensed trade repository (TR), and provide for the clearing of transactions. The FSCA, with the concurrence of the PA, will determine eligibility criteria for OTC derivatives transactions that will be subjected to mandatory clearing.

In the case of financial market infrastructures (FMIs), the regulations spell out the steps for the approval of an external central securities depository (CSD) as a participant of a local CSD, and requirements for establishing that external link, the assets and resource requirements for exchanges, CSDs, central counterparties (CCPs) and TRs. Chapter 6 of the regulations deals extensively with the licensing and prudential requirements for CCPs in particular. The requirements seeks to enshrine the Principles for Financial Market Infrastructures (PFMIs) in South African legislation, and include key aspects such as the legal basis, access and participation, governance and risk management, and capital requirements.

Following the global financial crisis of 2007 to 2009, the G20 agreed on a broad range of regulatory reforms to address the weaknesses revealed in the financial system. One of the key reform areas identified was the lack of transparency of the OTC derivatives markets, transactions and products as well as the systemic risks that these pose to financial stability. In the years since then, jurisdictions around the world have undertaken steps to address the identified weaknesses.

The FSB's Twelfth Progress Report[38] on the implementation of OTC derivatives market reforms observed that progress continued to be made across the OTC derivatives landscape, but nonetheless noted areas for potential improvement, including in the case of South Africa. While progress had been made in having consultations on trade reporting rules and mandated central clearing, jurisdictions were urged to have in place a framework that would enable the regular assessment of OTC derivatives markets that would, in turn, allow them to move transactions to organised trading platforms where appropriate, which would ensure this

36 Financial Stability Review, second edition, 2018.

37 This Government Gazette No. 41433 can be accessed at http://www.gpwonline.co.za/Search/Pages/Results.aspx?k=41433.

38 The report can be accessed at http://www.fsb.org/wp-content/uploads/P290617-2.pdf.

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element of the G20 commitment is implemented. This was the case even where authorities did not consider that market conditions currently, or for the foreseeable future, warranted specific trade execution requirements being in place.

While South Africa has no domestically licensed authorised CCPs to clear OTC derivatives products, it is taking steps to review its incentives-based approach to central clearing of the market and to determine further regulatory standards to assess which products can be mandated for central clearing.

The finalisation of the FMA Regulations brings regulatory certainty to aspects of OTC derivatives trading and other FMIs.

Furthermore, the FSCA has issued a joint standard[39] that prescribes the requirements and additional duties of a trade repository as per the applicable sections of the FMA.

In the South African context, the FMA regulations are a step in the right direction towards the full implementation of the Committee on Payments and Market Infrastructures (CPMI)–International Organization of Securities Commissions (IOSCO) PFMIs, which aim to limit systemic risk, foster financial stability, and enhance the safety and efficiency of payment, clearing, settlement and recording arrangements.

In July 2018, the CPMI and IOSCO published the fifth update to the Level 1 assessment report monitoring the implementation of the PFMIs. The fifth update report is based on self-assessments by individual jurisdictions of how they have adopted the PFMIs and the four responsibilities for authorities included in the PFMIs. South Africa reported achieving full implementation of the payment system, CSD, and securities settlement systems as well as the CCPs. However, it currently has a rating of two for trade repositories. Final implementation measures for trade repositories will have to be in force for South Africa for the country to report a rating of four (i.e., full adoption of the PFMIs).

South Africa has also committed to undergo a CPMI-IOSCO Level 2 assessment, which aims to determine whether the legislation, regulations and policies that have been implemented are complete and consistent with the 24 PFMIs and the four responsibilities for authorities. FMIs are critical to maintaining financial system stability, and the regulatory authorities continue to strive towards ensuring the resilience and robustness of these infrastructures.

In 2012, National Treasury formed the Bond Market Development Committee (BMDC), an industry-wide committee whose mandate was to consider the developmental issues facing the South African bond market. The BMDC comprises representatives of key industry stakeholders, including the Johannesburg Stock Exchange Limited (JSE), Strate, the Association for Savings and Investments South Africa, the FSCA, the Primary Dealer Association and the SARB.

On 29 August 2018, National Treasury and the JSE launched the electronic trading platform (ETP) for government bonds. This was a culmination of efforts to enhance transparency in the South African bond market and to enable National Treasury to more accurately monitor the activities of primary dealers in government bonds. The platform went live on 18 July 2018, with the full spectrum of bonds phased in and all nine primary dealers commencing trading on the platform on 22 August 2018.

39 The joint standard is available at https://www.fsca.co.za/Notices/FMA%20Joint%20Standard%201%20of%202018%20%20Requirements%20and%20Additional%20Duties%20of%20a%20Trade%20Repository.pdf.

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An ETP Market Committee, chaired by National Treasury, has been established as the frontline governance structure of the market. It is responsible for the ETP, for determining the operating model for this market, and for defining the core functional and other requirements of the ETP. As was noted in the March 2015 edition of the Financial Stability Review, the ETP is aligned with the European model and with IOSCO's Objectives and Principles of Securities Regulation (OPSRs). As they relate to the secondary market, these OPSRs mandate, among other things, that the systems for the clearing and settlement of securities transactions should be subject to regulatory oversight to reduce systemic risk.

On 31 January 2019, the SARB announced that, as part of the SARB's journey to support responsible financial innovation for the benefit of all South Africans, it has become a member of the Global Financial Innovation Network (GFIN).[40] The GFIN, as a network, provides an efficient conduit for innovative firms to interact with regulators and to help them navigate between countries as they look to scale new ideas in the interest of consumers. Joining the GFIN will provide the SARB with the opportunity to share and gain from insights of its fellow regulators on experiences in enabling innovation.[41]

The following key areas were also considered by the SARB in 2018:

a increased protectionism;[42]

b shadow banking;[43]

c International Financial Reporting Standard 9;[44] and

d financial technology, and its implications for financial stability from an emerging market perspective.[45]

VIII OUTLOOK AND CONCLUSIONS

In its Financial Stability Review published in September 2018, the SARB confirmed that the outcome of a common scenario stress test of the local banking sector to evaluate its resilience to macroeconomic scenarios was that banks were adequately capitalised to withstand several plausible and severe stress scenarios designed to simulate additional credit, market and liquidity risks within the banking sector.

In the closing paragraph of the second edition of the Financial Stability Review, the SARB stated that:

> *Overall, the financial sector remains strong and stable, even with some headwinds from a challenging low domestic economic growth environment, persistent fiscal challenges, and increased policy uncertainty. The South African financial sector is also characterised by well-regulated, highly capitalised, liquid and profitable institutions, supported by a robust regulatory and financial infrastructure.*[46]

40 https://www.resbank.co.za accessed on 17 February 2019 at 09h03.

41 Ibid.

42 Financial Stability Review, first edition, 2018 at page 29.

43 Ibid. at page 30.

44 Ibid. at pages 36 and 37.

45 Ibid. at page 38.

46 See page 2.

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According to Guidance Note G2/2019 issued by the Deputy Governor and CEO of the Prudential Authority on 1 April 2019, meetings to be held by the SARB during 2019 with the boards of directors of executive management of branches of foreign institutions will include a discussion on 'Effective capital and liquidity risk management practices in foreign branches', Guidance Note G3/2019 issued by the Deputy Governor and CEO of the Prudential Authority on 1 April 2019, meetings to be held with the executive management of all South African banks with an asset value of less than 50 billion rand will include a discussion on 'Life cycle of Outsourcing' and Guidance Note G4/2019 issued by the Deputy Governor and CEO of the Prudential Authority dated 1 April 2019, meetings to be held with the boards of directors of banks with an asset size in excess of 50 billion rand will include a discussion on 'The creation and institutionalisation of a culture of ethics and awareness'.

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Chapter 34

SPAIN

Juan Carlos Machuca and Joaquín García-Cazorla[1]

I INTRODUCTION

Spain boasts a diversified modern financial system that is fully integrated with international and European financial markets. The Spanish banking regulator, Banco de España, joined the European System of Central Banks (ESCB) on 1 January 1999. As a result, the definition and implementation of the country's monetary and exchange rate policy, the management of official currency reserves, the efficiency of the payment systems and the issuing of banknotes are now controlled by the ESCB.

Also as a consequence of integration, the Spanish regulatory system governing credit institutions largely mirrors the legal framework in other EU Member States. As such, credit institutions from other EU Member States may provide banking services in Spain, and vice versa, without the need to establish a branch or a subsidiary.

After a number of years during which Spanish regulatory activity followed EU-wide requirements to a great extent, the outbreak of the Spanish financial crisis and, mainly, the return of the Spanish economy to technical recession at the end of 2011, triggered a revolution in the Spanish banking system that started in 2012 and lasted until 2016.

One of the main triggers of the revolution was the nationalisation in May 2012 of Bankia, the fourth-largest Spanish banking institution at the time, through the acquisition by the Fund for Ordered Bank Restructuring (FROB) of a majority stake in the entity's share capital, as it resulted in the government requesting financial assistance from the EU for the recapitalisation of certain Spanish financial institutions, which led to the signing of the memorandum of understanding (MOU) of 20 July 2012 between the Spanish and European authorities, with the participation of the International Monetary Fund (IMF). According to the MOU, the Spanish banking sector would be provided with up to €100 billion in financial assistance under a programme that would cover a period of 18 months. The MOU comprised several specific conditions designed to identify the capital needs of Spanish credit institutions, implement plans to address any capital shortfalls so identified, and reform the regulatory and supervisory framework of the financial sector.

Additionally, the terms of the MOU provided for those banks receiving public funding support to segregate their problematic assets related to real estate development and their foreclosed assets into the external Asset Management Company for Assets Arising from

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the Bank Restructuring (SAREB). The design, incorporation and performing of SAREB constitutes one of the major achievements derived from the restructuring of the Spanish financial system, as it is now one of the main players of the Spanish real estate sector.

SAREB's share capital is 55 per cent privately owned (mainly by banks and insurance companies) and 45 per cent is owned by public authorities. SAREB has the mandate to divest the assets over 15 years, optimising levels of recovery and value preservation, and minimising negative effects on the real estate market and economy and the costs to taxpayers.

The EU financial assistance programme for certain Spanish financial institutions was successfully ended on 22 January 2014 (as scheduled). Such termination led to a new supervision post programme that will be in place until Spain repays at least 75 per cent of the funds provided, which is expected to occur no earlier than in 2026.

As a consequence of the reforms resulting from the aforementioned EU financial assistance programme, and the transposition of the relevant pieces of EU legislation enacted during the period from 2013 to 2015, the current legal framework of the Spanish banking sector is now mainly gathered in the following two sets of legislation, which implement in Spain the CRR/CRD IV package[2] and the EU legal framework on recovery and resolution of credit institutions,[3] respectively:

a the Credit Institutions Solvency Law;[4] Royal Decree 84/2015, of 13 February, developing the Credit Institutions Solvency Law (RD 84/2015); Circular 2/2016 of the Banco de España, of 2 February, to credit institutions on supervision and solvency and completing the adaptation of the Spanish legal system to Directive 2013/36/EU and Regulation (EU) No. 575/2013 (Circular 2/2016); and Royal Decree-Law 14/2013, of 29 November, on urgent measures for the adaptation of the Spanish law to the EU rules and regulations on supervision and solvency of financial entities (RDL 14/2013), which jointly set forth the Spanish legal regime on supervision and solvency of credit institutions and have repealed and combined the numerous and diffuse rules on the organisation and discipline of credit institutions that existed previously (Credit Institutions Solvency Law, RDL 14/2013, RD 84/2015 and Circular 2/2016, jointly, the Credit Institutions Solvency Regulations); and

b the Recovery and Resolution Law[5] and Royal Decree 1012/2015, of 6 November, developing the Recovery and Resolution Law and amending Royal Decree 2606/1996, of 20 December, on deposit guarantee funds (jointly with the Recovery and Resolution Law, the Recovery and Resolution Regulations).

2 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (applicable since 1 January 2014) (CRR); and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV).

3 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amendingCouncil Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EEC, 2007/36/EEC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council (Recovery and Resolution Directive).

4 Law 10/2014, of 26 June, on the organisation, supervision and solvency of credit institutions.

5 Law 11/2015, of 18 June, on the recovery and resolution of credit institutions and investment firm.

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It is noteworthy that the resolution framework established by the Recovery and Resolution Regulations was tested on the occasion of the resolution in 2017 of Banco Popular Español, SA (Banco Popular), the fifth-largest bank in Spain at the time and listed in the Spanish Stock Exchange, which ended up with its sale to Banco Santander, SA (Banco Santander) as part of the resolution tool involving the sale of the entity's business for a total consideration of €1. The implementation of this resolution tool derived from the execution of the resolution of the FROB Steering Committee of 7 June 2017 (FROB Resolution), which, in turn, adopted the measures required to put in place the Decision of the Single Resolution Board (SRB) of the same date concerning the adoption of the resolution scheme in respect of Banco Popular, in compliance with Article 29 of Regulation (EU) No. 806/2014[6] (Regulation 806/2014).

As regards the background of Banco Popular's resolution, on 6 June 2017, the European Central Bank (ECB) informed the SRB that the entity was failing or likely to fail under the circumstances described in Article 18.4.c) of Regulation 806/2014. Based on the ECB's judgement, the SRB agreed to put Banco Popular under resolution, approved the resolution scheme containing the resolution mechanisms to be applied and instructed the FROB, as the executive resolution authority for Banco Popular, to take the measures required to apply the resolution scheme. The resolution scheme envisaged the writing down or conversion of shares and other capital instruments of Banco Popular that were eligible for resolution purposes and the sale of all the outstanding shares after those measures were implemented. Pursuant to the applicable EU rules and regulations on the resolution of credit institutions, prior to deciding on the resolution of Banco Popular, the SRB obtained the required valuation of the entity from an independent expert, which estimated a negative economic value of Banco Popular amounting to minus €2 billion, in the baseline scenario, and minus €8.2 billion, in the most adverse scenario.

On the basis of the foregoing, and in compliance with the SRB's instructions, the FROB Resolution was adopted. Pursuant to that:

a Banco Popular share capital outstanding prior to the date of the FROB Resolution was written down to create a non-distributable voluntary reserve;

b a capital increase was made without pre-emptive subscription rights to convert all the Additional Tier 1 capital instruments of Banco Popular into share capital;

c share capital was reduced to zero through the write-down of the shares deriving from the conversion described in point (b) to create a non-distributable voluntary reserve;

d a capital increase without pre-emptive subscription was agreed to convert all the Tier 2 capital instruments into newly issued Banco Popular shares; and

e all the newly issued Banco Popular shares deriving from the conversion described in point (d) were transferred to Banco Santander for a total price of €1.

It is worth noting that this whole process took place in a single day, and in particular that the implementation of the resolution scheme was carried out during the night of 6 to 7 June, so that when the Spanish markets opened on 7 June, the resolution of Banco Popular and its sale to Banco Santander had already been made public.

6 Regulation (EU) No. 806/2014, of the European Parliament and Council of 15 July 2015, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010.

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As regards the legislative developments in connection with banks, saving banks and other financial institutions in 2018, the following pieces of legislation and secondary legislation have been enacted:

a Royal Decree-Law 22/2018, of 14 December, establishing certain macroprudential tools that, inter alia, amends the Credit Institutions Solvency Law to broaden the macroprudential tools available to Banco de España. In particular, Banco de España is granted powers to increase the capital requirements applicable to specific risk exposures, limit the aggregate exposure of all of the credit institutions or of a subgroup of them to specific economic sectors, or to establish limits or specific conditions in connection with the granting of loans or the acquisition of certain financial products;

b Royal Decree-Law 19/2018, of 23 November, of payment services and other urgent measures on financial matters, which transposes into Spanish law Directive (EU) 2015/2366 of the European Parliament and of the Council of 23 November 2015 on payment services in the internal market, establishing the new regime applicable for the rendering of payment services in Spain. In addition, Royal Decree-Law 19/2018 amends the Credit Institutions Solvency Law in order to, inter alia, foresee the setting up by Banco de España of a communication channel through which credit institutions' breaches of their prudential obligations can be communicated to Banco de España, with appropriate safeguards for those submitting such communications;

c Circular of Banco de España 2/2018, of 29 December, amending Circular of Banco de España 4/2017, of 4 November, to credit institutions in connection with rules on public financial information and financial statements templates, to adapt it to Commission Regulation (EU) 2017/1986 of 31 October amending certain pieces of EU regulation as regards International Financial Reporting Standard 16 relating to lease contracts; and

d Circular of the National Securities Market Commission (CNMV) 1/2018, of 12 March, on warnings in connection with certain financial products (Circular 1/2018 of CNMV), which sets forth certain reinforced transparency duties applicable to, among others, credit institutions when marketing and distributing certain financial products and services to retail customers. Among other matters, Circular 1/2018 of CNMV sets forth the warnings that retail customers need to be provided with if they are willing to subscribe financial instruments that, pursuant to the credit institution solvency regulations, qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2, or instruments that are equivalent to those in third countries, and imposes the obligation of gathering their handwritten statements as to their acknowledgement of the relevant financial product not being advisable for retail customers. Circular 1/2018 of CNMV also imposes additional transparency obligations for the marketing of instruments that are eligible for amortisation or conversion in a credit institution resolution scenario (see Section III.iv).

A new institutional and legal framework for the Spanish banking system has been established in a multi-stage procedure that commenced in 2012, which developed intensely between 2013 and 2015 and considerably slowed since 2016. Within this process, a number of measures have been taken with the aim of improving bank transparency, regulation and supervision, and speeding up the recovery of the Spanish financial system within the context of a more propitious economic environment.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

The Spanish regulatory regime for credit institutions is currently set out in the Credit Institutions Solvency Regulations, Law 26/2013, of 27 December, on savings banks and banking foundations (Savings Banks and Banking Foundations Law) and its regulations, and Law 13/1989, of 26 May 1989, on credit cooperatives.[7] This regulatory framework may be supplemented by the circulars, rules and guidelines issued, from time to time, by Banco de España or by the ECB.

A credit institution is defined under Spanish law as a company duly authorised to receive from the public deposits or other forms of repayable funds, and grant credits for their own account. Spanish credit institutions may therefore primarily engage in a number of retail banking services.

Credit institutions must be recorded in a register maintained by Banco de España before they commence banking activities.

There are other types of regulated entities that play an important role in the Spanish market for financial services, among which financial credit establishments, electronic money entities and payment service entities are especially noteworthy.

i Credit institutions: banks, savings banks and credit cooperatives

Credit institutions consist of banks, savings banks, credit cooperatives and the Official Credit Institute (ICO), which is the country's financial agency. Excluding the figures relating to the ICO, banks represent 44.83 per cent of all Spanish credit institutions, credit cooperatives represent 53.45 per cent and savings banks the remaining 1.72 per cent.[8] Banks are nevertheless by far the most important category of credit institution in Spain, as the value of their assets represents 95.44 per cent of the sector, while credit cooperatives' represent 4.5 per cent and savings banks 0.07 per cent.[9]

The raising of funds from the general public, except through activities subject to the securities markets regulations, is reserved for credit institutions.

Based on the foregoing figures, banks have a central role in the financial system because of the sheer volume of their business and their involvement in every segment of the Spanish economy. Most Spanish banks provide a full range of services for corporate and private customers, including collection and payment services outside Spain through foreign branches. Banks have the legal form of public limited companies, and are therefore subject to general principles of company law as well as banking regulations.

Savings banks are a specific type of credit institution that until recently accounted for nearly half of the Spanish financial sector. Savings banks tended to be locally oriented entities of variable (but generally limited) size with strong economic and social ties to their home region. Although savings banks fully participated in the market, they were a special category within the financial services industry, as they were structured as foundations rather than

7 As regards credit cooperatives, certain matters and rules are also regulated at regional level.

8 Amounts obtained from Banco de España's registry of institutions as of 6 March 2018.

9 Approximate and estimated figures calculated on the basis of the data publicly available on the websites of the AEB (the Spanish banking association), UNACC (the Spanish national union of credit cooperatives), Caixa Pollença and Caixa Ontinyent (the only two savings banks currently in existence).

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companies and governed by representatives of collective shareholders: mainly depositors, employees and local authorities. Any positive result was allocated to social welfare and cultural projects.

The corporate model of savings banks has completely changed in recent years. After a number of partial reforms during 2011 and 2012 (as a consequence of which most of the Spanish savings banks were transformed into banks through different integration processes), a comprehensive revolution of their legal regime was put in place in December 2013 when the Savings Banks and Banking Foundations Law was passed. That regulatory revolution considerably deepened in 2015 and 2016 as a result of the approval of various pieces of ancillary legislation developing the Savings Banks and Banking Foundations Law.[10]

Since 2010, 43 of the 45 savings banks (99.39 per cent of the aggregate average assets of the sector) have been part of a consolidation process, which has resulted in seven banking groups now operating. The number of branches has been reduced by 46.8 per cent and the workforce by 40.6 per cent since late 2008.[11] In the light of these radical changes to the sector, the Savings Banks and Banking Foundations Law aims to limit the role of savings banks in the credit institutions sector (capping the balance sheets, market share and geographical scope of banking activities), clarifying the role of former savings banks in their capacity as shareholders of credit institutions, and strengthening incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Some of the main features of the new regime are as follows:

a savings banks will only be entitled to engage in the solicitation of repayable deposits from the public and the granting of credits within the territory of one autonomous region or a maximum of 10 neighbouring provinces;

b savings banks need to be engaged mainly in the deposit-taking and lending business;

c any person holding an executive position in a political party, trade union or professional association, elected representatives in public administrations, senior officers in such public administrations and those who have held any of the foregoing positions during the past two years, will not be allowed to be a member of a management body of a savings bank. This is a breakthrough on the prior regime that aims to avoid previous failures in the management of savings banks;

d any savings bank holding assets in excess of €10 billion or with a market share in relation to the deposits in its autonomous region of more than 35 per cent shall transfer

10 Royal Decree 877/2015 of 2 October (as amended by Royal Decree 536/2017), which, inter alia, develops the Savings Banks and Banking Foundations Law in connection with the reserve fund to be created by specific banking foundations; Ministerial Order ECC/2575/2015 of 30 November, establishing the content, structure and disclosure requirements for the annual corporate governance report of certain banking foundations; National Securities Market Commission Circular 3/2015 of 23 June on the technical and legal specifications and information requirements for websites of listed companies and savings banks that issue securities on official secondary securities markets; and Banco de España Circular 6/2015 of 17 November to savings banks and banking foundations on specific matters pertaining to remuneration and the corporate governance reports of savings banks that do not issue securities admitted to listing on official secondary securities markets and on the obligations of specific banking foundations derived from stakes in credit institutions (collectively, the Savings Banks and Banking Foundations Developing Regulations).

11 Presentation on the status of the regulatory and financial outlook of the savings banks sector issued by the Spanish Confederation of Savings Banks on 26 February 2018.

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its financial activity to a credit entity and become a banking foundation or a regular foundation, depending on the stake it holds in the entity receiving its financial activity; and

e banking foundations are those foundations with a (direct or indirect) holding in a credit entity of at least 10 per cent of its share capital or voting rights, or such other percentage allowing the appointment or removal of at least one member of the board. These entities shall have the purpose of managing their stake in the relevant credit institutions and pursuing their social project or corporate responsibility programme. Depending on the stake of the banking foundation in the credit entity (the relevant thresholds being 10, 30 and 50 per cent), a number of internal rules and protocols shall be in place. Additionally, the dividend distribution of credit institutions controlled by banking foundations shall be subject to a minimum voting majority of two-thirds.

Credit cooperatives are private institutions whose corporate purpose is to attend to the financial needs of members and those of third parties by means of the development of those activities that are also carried out by credit institutions. Their current regime is contemplated in Law 13/1989, of 26 May 1989, on credit cooperatives as its developing regulation, as approved by Royal Decree 84/1993 of 22 January.

ii Other types of regulated entities that do not qualify as credit institutions under Spanish law

Financial credit establishments

Financial credit establishments (EFCs) are a special type of regulated entity that do not qualify as credit institutions (although they did until the Credit Institutions Solvency Law was approved) and that carry out, in a professional manner, one or more of the following activities:

a granting of loans and credits, including consumer loans and mortgage-backed loans;
b factoring, with or without recourse, and other ancillary activities;
c leasing;
d granting of security interests; and
e granting of reverse mortgages.

The legal framework governing EFCs is established in Law 5/2015, of 27 April, on promoting corporate financing (Law 5/2015), the main features of which include the following:

a the creation of EFCs requires authorisation from the Ministry of Economy, which, in turn, requires the issuance of a mandatory prior report by Banco de España;
b Law 5/2015 regulates the existence of hybrid institutions (i.e., EFCs that also provide payment services or issue electronic money); and
c a significant portion of the obligations applicable to credit institutions on solvency, conduct of business, control of major shareholdings and transfer of business, and corporate governance are also applicable to EFCs.

Finally, in October 2015, the Ministry of Economy made public a draft regulation aimed at developing the legal framework of EFCs. The draft regulation has not yet been approved.

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Electronic money entities

Electronic money entities (EDEs) are recognised as a special type of regulated entity that issues electronic money. The legal regime for EDEs was established in 2008 and amended in 2011 by a law regulating the issuing of electronic money and the legal regime of EDEs, partially implementing Directive 2009/110/EC. Secondary legislation was approved by Royal Decree-Law 778/2012, of 4 May, developing the legal framework of EDEs, clarifying the definition of e-money and the scope of the applicable Spanish regulations, and establishing the requirements for the setting up and running of EDEs, since their supervision and sanction regime is very similar to that applicable to credit institutions. Royal Decree-Law 778/2012 fully implemented Directive 2009/110/EC.

Payment services entities

Payment service entities are entities regulated by Banco de España that are engaged, in a professional manner, in the rendering of payment services, as defined in point (3) of Article 4) of Directive (EU) 2015/2366 of the European Parliament and of the Council of 23 November 2015 on payment services in the internal market. The legal regime in connection with the rendering of payment services is set forth in Royal Decree-Law 19/2018, of 23 November, of payment services and other urgent measures on financial matters.

III PRUDENTIAL REGULATION

Given its participation in the Single Supervisory Mechanism (SSM), Banco de España qualifies as a national competent authority (NCA), which implies that credit institutions considered as significant are supervised by the ECB, while less significant institutions are directly supervised by Banco de España and, indirectly, by the ECB. Of the 117 significant institutions supervised by the ECB, 12 are Spanish (as at 2 January 2019). These 12 significant institutions represent more than 90 per cent of deposit assets in Spain.

i Relationship with the prudential regulator

Banco de España no longer sets the country's monetary and exchange rate policy, except in its role as a member of the ESCB, but it remains in control of, inter alia, the following functions:

a management of currency and precious metal reserves not transferred to the ECB;
b supervision of the solvency and behaviour of credit institutions (pursuant to the distribution of competencies set forth by the SSM);
c promotion of the stability of the financial system and of national payment systems, without prejudice to the functions of the ECB; and
d minting and circulation of coins and other types of legal tender.

Banco de España continuously monitors and analyses credit institutions, assesses the reports and regular information received from them, and conducts on-site inspections. There is close interaction between Banco de España and the entities subject to its supervision. Provisioning rules are straightforward, transparent and verified by Banco de España.

Banco de España's responsibilities include the verification of maximum rates and charges for banking services rendered by credit institutions. It also verifies the customer protection rules and keeps several registries of public banking information, including the register of institutions, registers of senior officers and shareholders, auditors' reports and a special

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registry of the articles of association of supervised institutions. It also receives confidential information from institutions on their financial situation and their shareholders.

Banco de España may issue general or specific recommendations to and requirements of entities (i.e., requiring adequate provisioning for less solvent obligors and improvements in the quality control over assets). It may also initiate disciplinary proceedings against institutions and their boards of directors or managers, or may even intervene and replace directors to remedy deficiencies or non-compliance.

Banco de España has powers to enforce compliance with the organisational and disciplinary regulations applicable to credit institutions operating in the Spanish financial sector. These powers are exercised not only over credit institutions and other financial institutions subject to its oversight, but also over directors and managers, who can be penalised for very serious or serious infringements when they are attributable to wilful misconduct or negligence. Sanctions can also be imposed on the owners of significant shareholdings in credit institutions and on Spanish nationals who control a credit institution in an EU Member State.

Additionally, as a consequence of the CRR/CRD IV package and the entry into force of RDL 14/2013, the supervisory powers of Banco de España and CNMV have been widened and strengthened to ensure appropriate enforcement of the new banking and supervisory discipline. Likewise, RDL 14/2013 has amended Law 13/1994, of 1 June 1994 (the rule setting out the competences and regime applicable to Banco de España) to allow it to issue technical guidelines and answer binding questions on supervisory regulation.

Finally, according to the regime set forth by the Recovery and Resolution Regulations, Banco de España is the pre-emptive resolution authority, while executive resolution powers are vested in the FROB (see Section III.iv).

ii Management of banks

The board of directors of a credit institution (with at least five members) has prominent powers to administer and manage the operations and financial matters of the entity. Members of the board and senior management must have good commercial and professional reputations, appropriate experience and the ability to carry out proper governance of the entity.

A new suitability regime was established in 2014. Although it was in line with the regime applicable up to then (which was repealed), the new regime brought some novelties. For instance, Banco de España is entitled under the Credit Institutions Solvency Law to determine the maximum number of positions that may be held simultaneously by a director, general manager or the holder of a similar position in view of the particular circumstances of an institution and the nature, size and complexity of its activities. Save in the case of directors appointed pursuant to a replacement measure, directors, general managers and holders of similar positions in institutions that are significant in size, or that are more complex or of a special nature, may not hold more than four non-executive positions simultaneously, or one executive position at the same time as two non-executive positions (for these purposes, the positions held within the relevant credit institution's corporate group are counted as one).

The Credit Institutions Solvency Law obliges credit institutions to put corporate governance arrangements in place that are sound and proportionate in view of the risks taken by the institution. In addition, the following obligations are established:

a the board of directors may not delegate functions related to corporate governance arrangements, the management and administration of the institution, the accounting and financial reporting systems, the process for the disclosure of information and the supervision of senior management;

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b the chair of the board of directors must not hold the position of managing director simultaneously, unless this situation is justified by the institution and authorised by Banco de España;

c a website must be maintained on which the information required by the Credit Institutions Solvency Law is published and on which the institution explains how it complies with its corporate governance obligations;

d the obligation to draft and keep an up-to-date general viability programme that considers all the measures that will be taken to restore the viability and financial soundness of institutions in the event that they suffer any significant damage;

e the obligation to establish a nomination committee comprising non-executive directors and in which, at a minimum, one-third of its members, and in any case its chair, are independent directors. This committee must decide on a target figure for the representation of the gender currently underrepresented on the board of directors;

f the board must actively participate in the management and valuation of the assets, and regularly approve and review the risk policies and strategies of the institution; and

g Banco de España will be entitled to determine which institutions must establish a risk committee or, as the case may be, those institutions that may establish combined audit and risk committees to perform the functions of the risk committee.

Significant time has been devoted to Spanish remuneration policies during the past few years, as has been the case at both European and international levels. In particular, the Credit Institutions Solvency Law includes the provisions of the CRR/CRD IV package relating to the obligation for credit institutions to put in place remuneration policies that are consistent with their risks. In a nutshell, these provisions relate to:

a the obligation to make a clear distinction between the criteria used for setting fixed remuneration and variable remuneration;

b the obligation that the remuneration policy applicable to members of the board of directors of a credit institution is subject to the approval of the general shareholders' meeting or equivalent body under the same terms as those applicable to listed companies;

c the principles that will apply to variable elements of remuneration (inter alia, the variable component must not exceed 100 per cent of the fixed component save in cases of approval of the general shareholders' meeting granted in accordance with the procedure laid down in the Credit Institutions Solvency Law, in which case, it may reach up to the 200 per cent; at least 50 per cent of the variable remuneration is awarded in instruments; at least 40 per cent of the variable remuneration (either paid in cash or in instruments) is deferred for a period of between three and five years; the variable remuneration is paid or vests only if it is sustainable according to the financial situation and results of the institution; or 100 per cent of the variable remuneration is subject to explicit *ex post* risk adjustments – *malus* and clawback arrangements), with special attention in this regard to credit institutions that benefit from public financial assistance; and

d the obligation to establish a remuneration committee or, if Banco de España so determines, a joint nomination and remuneration committee.

Finally, as previously mentioned, credit institutions (other than credit cooperatives and savings banks) are incorporated as banks and have the legal form of limited liability companies. As such, general corporate rules will fully apply to them (i.e., they must have a suitable

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structural organisation, compliance and internal audit functions and risk assessments, and certain separate and delegated committees within the board, including an internal audit committee). These rules are primarily contemplated in Royal Legislative Decree 1/2010, of 2 July, approving the Spanish Companies Law.

iii Regulatory capital and liquidity

Spain's capital and liquidity requirements legislation has traditionally incorporated capital adequacy requirements in line with international standards as set out by the Basel Committee on Banking Supervision. According to these, a banking group should be adequately capitalised overall (in terms of both volume and capital quality), and there should be an adequate distribution of capital and allocation of risk, with sufficient buffers to allow ordinary growth.

Several laws, decrees and regulations on own funds, capital requirements and liquidity of individual credit institutions and consolidated groups have been approved through the years, most of them to implement the Basel I, Basel II and Basel III Accords. These regulations have been followed by specific circulars and guidelines issued by Banco de España determining the technical specifications and control of minimum funds.

Nonetheless, the entry into force of the CRR/CRD IV package and of the Credit Institutions Solvency Regulations has led not only to a deep change (at both the European and the Spanish level) in the regulation of solvency and liquidity of credit institutions but, more generally, to a fundamental step forward in the creation of the banking union. Since 1 January 2014, the nuclear regime for credit institutions solvency is condensed in the CRR (which is directly applicable in EU Member States). Where needed, the Credit Institutions Solvency Regulations supplement this regime in Spain.

One of the most interesting changes deriving from the entry into force of the Credit Institutions Solvency Law is the inclusion of capital buffers (i.e., additional capital requirements to those envisaged under the CRR), the regime of which is further developed by RD 84/2015 and Circular 2/2016. Failure to comply with capital buffers entails restrictions on distributions and payments relating to components of Common Equity Tier 1 (such as shares) or Additional Tier 1 capital (such as contingent convertible bonds) and on the payment of variable remuneration, and the obligation to submit a capital conservation plan that must be approved by the competent supervisor.

In particular, the various capital buffers provided for in the Credit Institutions Solvency Regulations are as follows:

a capital conservation buffer (2.5 per cent of the institution's risk exposure): a non-discretionary buffer, the application of which has been phased in from 1 January 2016 to 31 December 2018, and that from 1 January 2019 is set at its fully loaded level of 2.5 per cent;

b countercyclical capital buffer: a specific buffer for each institution or group, which is calculated as the weighted average of the countercyclical buffer percentages applicable in each of the territories in which an institution has exposures. The percentage applicable to risk exposures in Spain is set by Banco de España and ranges between zero and 2.5 per cent. Banco de España has decided to maintain the countercyclical buffer applicable to risk exposures in Spain for the first quarter of 2019 at zero per cent (as it was set up for the immediately preceding quarters);[12]

12 Banco de España press release dated 20 December 2018, available at https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/18/presbe2018_69en.pdf.

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c buffers for global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs): buffers specifically applicable to certain institutions by reason of their systemic importance. The identification of institutions as G-SIIs or O-SIIs is decided by Banco de España, which must annually review the classification it has carried out. Banco de España also has to set the buffer to be maintained by each type of institution, which in the case of G-SIIs will range from 1 to 3.5 per cent, and which in the case of O-SIIs may not exceed 2 per cent. These buffers are applicable from 1 January 2016, although in the case of both G-SIIs and O-SIIs, they must be fulfilled in tranches in the following four years. The only credit institution identified by Banco de España as a G-SII for 2019 is Banco Santander, which belongs to Subcategory A. The capital buffer it needs to meet in 2019 is equivalent to 1 per cent of its total risk exposure (on a consolidated basis). Besides this, Banco de España has already confirmed that Banco Santander will maintain its status as a G-SII for 2020, and that the G-SII capital buffer applicable to the entity in that year will amount to 1 per cent of its total risk exposure on a consolidated basis. The following credit institutions have been classified as O-SIIs by Banco de España for 2019: Banco Santander, BBVA, CaixaBank, Bankia and Banco Sabadell;[13] and

d systemic risk buffer: a buffer that may be set by the Banco de España to cover non-cyclical systemic or macroprudential risks where there is a risk of disruption in the financial system with the potential to have serious negative consequences for the financial system and the real economy.

Regarding liquidity, the Credit Institutions Solvency Law states that Banco de España will assess business models, corporate governance procedures and systems, supervision and evaluation findings, and all systemic risks.

iv Recovery and resolution

The Recovery and Resolution Regulations have updated the Spanish legislation on the recovery and resolution of credit institutions that was introduced in 2012 with the entry into force of Law 9/2012[14] to adapt it to the EU legislation on this matter.

The Recovery and Resolution Regulations foresee three phases (as described below) that correspond to the various stages in the deterioration of an institution's financial situation. The rules governing each of these phases are based upon the following two main principles:

a the separation of supervisory and executive resolution functions. The resolution powers in the pre-emptive resolution phase are entrusted to Banco de España as regards credit institutions, and the CNMV as regards investment firms, while the FROB holds the resolution powers in the executive phase; and

13 Banco de España press release on the setting of the capital buffers for systemic institutions for 2019, dated 21 November 2018, available at https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/18/presbe2018_63en.pdf.

14 Law 9/2012 of 14 November, on the framework for the restructuring and resolution of financial institutions (Law 9/2012), which was approved as a consequence of the subscription of the MOU and which was a major achievement in the Spanish regulatory landscape. The Recovery and Resolution Regulations constitute a continuation of the regime established by Law 9/2012 as they share the same principles and replicate, to a great extent, its structure and sections. This notwithstanding, the Recovery and Resolution Regulations have broadened the scope of the Spanish recovery and resolution legislation as it applies to investment firms, which were not included in the scope of Law 9/2012.

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b public resources cannot be used to fund recovery and resolution proceedings, the cost of which must be borne first by the shareholders of the institution under resolution, second by certain creditors, and finally by the credit institutions and investment firms sector (if needed).

Early intervention phase

Prior to any breach of the solvency, regulatory or disciplinary rules, or the declaration by the competent authority of any of these three phases, an institution must draw up and periodically update a recovery plan elaborating on the measures and actions to be taken to restore its financial position should it deteriorate significantly. The plan must be approved by the institution's board of directors and reviewed by the relevant supervisor.[15]

Early intervention measures can be adopted by the relevant supervisor when an institution or a parent of a consolidated group of institutions breaches, or is likely to breach, solvency, regulatory or disciplinary rules, provided that it is foreseeable that the institution will be able to overcome the situation by its own means. These measures include requiring the removal of one or several members of the governing body of the institution, convening a general meeting and proposing items on its agenda, or requiring the board of directors of the institution to draw up a plan for restructuring the institution's debt or requiring changes to be made to its business strategy.

Pre-emptive resolution phase

The pre-emptive resolution authority must draw up, approve and maintain a resolution plan for each individual institution or consolidated group that falls under its remit. Among other measures, it must consult the resolution authorities from those jurisdictions in which an institution or group has established a significant branch.

When drawing up the report, the pre-emptive resolution authority must determine whether the individual institution or consolidated group is resolvable (as this term is defined in Article 15.1 of the Recovery and Resolution Directive). Should any obstacles to the resolution of the institution be identified, the 'non-resolvable' institution must propose measures to remove them. These measures have to be approved by the relevant pre-emptive resolution authority. If it does not consider the proposed measures to be sufficient, it may request the relevant institution to adopt alternative measures (in particular, any of those foreseen in Article 17.5 of the Recovery and Resolution Directive as transposed into Spanish law).

Executive resolution phase

An institution will be resolved when all of the following circumstances have been met:

a it is non-viable (as this term is defined in the Recovery and Resolution Law, mirroring the definition included in the Recovery and Resolution Directive) or it is reasonably foreseeable that it will become so in the near future;

15 The Recovery and Resolution Regulations entrust powers to the relevant supervisor (Banco de España or the ECB for credit institutions, and the CNMV for investment firms), which will play a major role in the early intervention phase; the pre-emptive resolution authority (Banco de España or the CNMV, as applicable); and the executive resolution authority (FROB).

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b there is no reasonable prospect that private sector measures, supervisory measures (such as the early intervention measures), or the conversion or redemption of capital instruments[16] will prevent the institution from becoming non-viable within a reasonable period of time; and

c for reasons of public interest, it is necessary or advisable to proceed with the institution's resolution rather than liquidating it or winding it up in the applicable insolvency proceedings.

The FROB has the power to initiate the resolution process. The opening of the execution phase of the resolution will normally entail the replacement of the institution's board of directors, managing directors or similar officers (although the FROB may maintain them) with the person or persons appointed by the FROB to manage the institution under its supervision. The resolution tools available to the FROB are:

a the sale of the institution's business;

b the transfer of assets or liabilities to a bridge entity;

c the transfer of assets or liabilities to an asset management company; and

d internal recapitalisation (the Spanish bail-in tool).

In contrast to Law 9/2012, the use of a bail-in as a resolution tool is now specifically envisaged in the Recovery and Resolution Law. Moreover, the scope of this tool has been broadened in comparison to that of the measure that was foreseen in Law 9/2012 (the redemption or conversion of subordinated debt instruments). The Spanish bail-in tool, which came into force on 1 January 2016, allows all an institution's liabilities (including senior debt) not expressly excluded by the Resolution and Recovery Law (or by an express decision of the FROB)[17] to be amortised or converted into capital to recapitalise the institution. This tool may be used to recapitalise the institution so that it resumes its activities and market confidence in it is restored, or to convert into capital or reduce the principal amount of the credits or debt instruments transferred through the use of the resolution tools referred to previously. When using the Spanish bail-in tool, the FROB will require the body, or person or persons in charge of the management of the institution under resolution to submit an activities reorganisation plan containing the necessary measures to restore the long-term viability of the institution, or of a portion of its business, within a reasonable time frame.

Finally, the Recovery and Resolution Law has created a National Resolution Fund financed by the credit institutions and investment firms themselves which, under certain circumstances, will finance the resolution measures adopted by the FROB (briefly, when there are losses arising from a resolution process that have not been covered entirely by the eligible liabilities).

16 The Recovery and Resolution Law foresees that the FROB may agree to the redemption or conversion of certain capital instruments, which will be done either separately from the use of any resolution tool (including internal recapitalisation) or with any of the available resolution tools (provided that the circumstances triggering the resolution process are met).

17 The excluded liabilities set forth in the Recovery and Resolution Law are those listed in Article 44.2 of the Recovery and Resolution Directive.

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IV CONDUCT OF BUSINESS

i Conduct of business rules

According to the Credit Institutions Solvency Law, credit institutions rendering services in Spain, whether domestic entities or foreign entities authorised in another Member State that open a branch or provide cross-border services in Spain, must observe the applicable rules setting out the discipline of credit institutions, as well as those enacted in the interest of the general good, whether they are dictated by the state, autonomous communities or local entities.

The general good includes, inter alia, protection of the recipients of services, protection of workers, consumer protection, preservation of the good reputation of the national financial sector, prevention of fraud and protection of intellectual property.

Some conduct of business rules relate to compliance with regulations on advertising (i.e., a prohibition of misleading or subliminal advertising, aggressive commercial practices), or to conduct that may injure or is likely to injure a competitor, and to consumer-related matters. Credit institutions are subject to Spanish regulations protecting financial services users, and they must establish consumer services departments and a customer ombudsman to handle complaints about individuals or legal persons who are deemed users of their financial services.

Further, a credit institution must make certain information available to customers, including:

a the existence of a customer service department and of a customer ombudsman, as the case may be, including postal and email addresses;
b its obligation to serve and resolve customers' complaints within two months;
c the existence and contact information of Banco de España's complaints service;
d its internal customer service regulations; and
e references to the legislation in force on transparency and protection of financial services customers.

In addition, there are rules on the delivery of contracts and a number of specific provisions regarding the valid incorporation of terms into consumer contracts (some of which are currently the subject of legal debate after several recent Supreme Court decisions declaring null and void certain terms traditionally used by Spanish banks).

In addition to the foregoing, a number of rules regarding the protection of consumers of investment services apply to credit institutions (categorisation of investors, delivery of appropriate and comprehensible information on the financial instruments and investment strategies offered to the customer, etc.), including rules to check that the conduct of credit institutions is sufficiently diligent, and guidelines issued by the CNMV that should be followed by credit institutions. In this regard, Ministerial Order ECC/2316/2015 of 4 November on information obligations and the classification of financial products and Circular 1/2018 of CNMV are especially noteworthy, as they establish certain information and classification obligations that must be observed by institutions that market specific financial products. Credit institutions are specifically included within the subjective scope of these pieces of secondary legislation.

New legislation approved since 2012 on consumer protection and on evictions in cases of mortgage default is aimed at reinforcing the protection of some vulnerable mortgage debtors. The main pieces of legislation in connection with this matter are:

a Royal Decree Law 6/2012, of 9 March, on urgent measures to protect mortgage debtors without resources (RDL 6/2012), as amended by RDL 5/2017, which provides

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for a series of mechanisms to protect mortgage debtors at risk of social exclusion, the main pillar of which is the creation of a code. This code – which, although it provides for voluntary accession, has been signed by the vast majority of credit institutions operating in Spain – envisages three consecutive stages of action with the purpose of accomplishing the restructuring of the relevant mortgage debt;

b Law 1/2013, of 14 May, on measures to reinforce the protection of mortgage debtors, the restructuring of debt and social renting, which established a four-year moratorium from 15 May 2013 on evictions on mortgagors in a situation of extreme difficulty from their principal resident (which has been extended for three more years by RDL 5/2017); and

c Law 25/2015, of 28 July, on a second chance mechanism, diminishing the financial burden and other socially related measures, which, inter alia, sets out a number of protections for debtors within their insolvency proceedings (including the possibility of release from all debts in cases where the debtor's assets do not cover his or her aggregate debts), improves the Code of Good Practices in relation to mortgage debtors without resources, as approved by RDL 6/2012, and broadens the scope of the application of the Code so that a greater number of debtors can benefit from it.

In this regard, a new law on real estate loans, Law 5/2019, of 15 March regulating real estate loans (Law 5/2019), the original draft of which was approved in 2017, underwent negotiations in Parliament throughout 2018, and was finally approved on 22 February 2019. It will enter into force during the course of 2019. Law 5/2019, which implements in Spain Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immoveable property, and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No. 1093/2010, is very likely to heavily impact real estate lending, which constitutes one of the major sources of business for credit institutions in Spain.

ii Spanish banking secrecy

The duty of credit institutions to keep their clients' information confidential from third parties other than the supervisory authorities has traditionally been a feature of the Spanish banking system and is codified in law. Credit institutions, their managers and directors, and significant shareholders and their managers and directors, must safeguard and keep strictly confidential all information relating to balances, operations and any other customer transactions unless required to disclose the same by an applicable law or the supervisory authorities. In these exceptional cases, the delivery of confidential data must comply with the instructions of the client or with those provided by the applicable law.

The sharing of confidential information between credit institutions within the same consolidated group is not subject to these restrictions.

Any breach of the aforementioned regulations will be deemed a serious offence, which may be punished according to the ordinary sanctions procedure provided under Spanish banking regulations.

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V FUNDING

The main funding for Spanish credit institutions is based on deposits made by their customers. However, according to Banco de España, the global number of deposits taken from the private sector has decreased during the past few years.

Both capital and debt issuance have also been sources of funding. These instruments include (in addition to common shares) perpetual contingent convertible debt (which will normally qualify as Additional Tier 1 for solvency purposes), the newly created senior non-preferred debt (which is set forth in the Recovery and Resolution Law, as amended by Royal Decree-Law 11/2017, of 23 June, on urgent actions on financial matters, and which is a type of debt eligible for the minimum requirement for own funds and eligible liabilities, and for total loss-absorbency capacity purposes and subordinated debt. These types of debt instruments must be verified by the relevant supervisor to confirm they meet the conditions established by the bank solvency regulations, and their issuance is subject to the securities market regulations. In this regard, the Securities Market Law imposes relevant restrictions on the conditions of issuance of these instruments when they are to be marketed to retail investors. In a nutshell, a tranche of the issuance, which shall amount to at least 50 per cent of its total value, has to be addressed to qualified investors, and the face value of the issued instruments cannot be lower than a certain amount (which varies depending on the specific features of the instrument and the nature of the issuer).

In recent years, mistrust in Spanish public finances and the financial system resulted in a substantial increase in funding costs and difficulties in gaining access to wholesale markets, which had a considerable effect on sovereign debt during the summer of 2012. Additionally, as already mentioned, the Recovery and Resolution Regulations have introduced a number of instruments that are eligible for the recapitalisation of credit institutions within a resolution scenario, as well as specific FROB powers.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The Spanish regime for the prudential assessment of Banco de España regarding acquisitions and increases of holdings in Spanish credit institutions is contemplated in the Credit Institutions Solvency Regulations. The regime set forth therein must be construed in light of the entry into force of the SSM and the distribution of competencies between the ECB and the NCAs set out in the SSM Regulations.[18]

According to the regime established on the occasion of the entry into force of the SSM, the acquisition of a significant holding is subject to a mandatory pre-acquisition non-opposition from the ECB. The corresponding application shall be notified through Banco de España. A significant holding is defined as the direct or indirect holding (taking into account conditions regarding aggregation laid down in the Spanish regulations) of shares in the issued share capital or voting rights of a Spanish credit institution in excess of 10 per

18 Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and Regulation (EU) No. 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation).

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cent, as well as any holding below that threshold that allows the holder to have a notable influence on the corresponding credit institution. In accordance with Article 23 of RD 84/2015, notable influence shall be deemed to exist when there is the capacity to appoint or dismiss a board member of the corresponding credit entity.

A similar prior control procedure shall be carried out if the owner of a significant holding intends to increase that holding up to or above 20, 30 or 50 per cent of the issued share capital or voting rights of a Spanish credit entity; or if, as a consequence of a potential acquisition, the relevant shareholder could acquire control of the Spanish credit institution.

The disposal of a significant shareholding in a Spanish credit entity, the reduction of a significant shareholding below 20, 30 or 50 per cent of the issued share capital or voting rights of a Spanish credit entity, or the loss of control of a Spanish credit entity require prior notification to the competent supervisory body.

Likewise, immediate written notification to both the competent supervisor and the relevant credit entity is required if, as a result of the acquisition, the acquirer would hold, either on its own or in concert with other entities, directly or indirectly, 5 per cent or more of the issued share capital or voting rights of a Spanish credit entity.

The obligation to seek non-opposition for a proposed acquisition or increase of qualifying shareholding falls on the acquirer. However, the Spanish bank whose shareholding may be acquired must notify the competent supervisor as soon as it becomes aware of the proposed acquisition.

Within the framework of the assessment of the suitability of a potential acquirer and the financial strength of the proposed acquisition, a report from the Commission for the Prevention of Money Laundering and Monetary Infractions is needed, the aim of which is to ensure that the relevant credit entity is managed in a prudent manner taking into account the influence that may be exercised by the acquirer.

ii Transfers of banking business

The Spanish financial system has recently moved towards greater consolidation, mainly for efficiency and profitability, in an increasingly mature financial market and as a consequence of the restructuring of the Spanish banking system. The need to strengthen solvency is also a key driving factor. Naturally, the same factors apply to transfers of banking business, particularly considering the crucial importance of size in gaining access to wholesale capital markets.

The transfer of banking business by virtue of mergers, total and partial spin-offs, or assignments of assets and liabilities, any legal or economic arrangement analogous to any such transaction, and any structural modification deriving from the foregoing, is subject, in addition to general corporate law, to regulatory approval from the Ministry of Economy, Industry and Competitiveness as set forth in the Credit Institutions Solvency Law and the Credit Institutions Solvency Regulations.

Special regimes for the transfer of banking businesses are set out in the Recovery and Resolution Regulations (see Section III.iv).

VII THE YEAR IN REVIEW

2018 marked another volatile year for the Spanish economy, as geopolitical uncertainty (both domestically as a result of the political crisis in Catalonia, and the motion of confidence that resulted in the ousting of the Partido Popular government; and internationally, due mainly to the development of the negotiations in connection with the United Kingdom's exit

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from the EU) dominated the landscape and impacted on the development of the Spanish GDP, the growth of which (by 2.5 per cent) slowed down with respect to previous years. Notwithstanding the foregoing, the Spanish economy has remained solid, and avoided stagnation during 2018; in particular, job creation has continued at a rate of approximately half a million jobs per year (the unemployment rate decreased from 17 to 16 per cent in 2018).

This trend of sustained economic growth positively affected the performance of the Spanish banking sector during 2018. In this regard, the quarterly earnings obtained in the third quarter of 2018 (the latest consolidated data available at the time of writing) were at their highest level since the third quarter of 2009, although this was mainly triggered by controlling operating costs and a reduction of provisions. Weakness in revenue continued, especially the margin of interests, although this constitutes a key concern for the wider eurozone banking sector. Banking activity continued to contract: total assets fell by 2.9 per cent, therefore remaining at a volume similar to that seen in 2006. The number of staff and banking branches followed a similar trend in 2018, dropping by 31 and 42 per cent, respectively, compared with the maximum numbers of both seen in 2008. The inventory of lending to the private sector continued to decline, falling by 3.9 per cent year on year. Finally, the sector's 2018 non-performing loan (NPL) rate was especially noteworthy: it experienced a 25.3 per cent decline in comparison to the 2017 figure. The NPL rate reached its peak in December 2013, and has continuously decreased, falling by approximately 64 per cent in the period up to the end of 2018.[19]

On the regulatory side, although legislative production slowed considerably in 2018, reforms were approved that are likely to affect the activity of credit institutions (see Section I).

VIII OUTLOOK AND CONCLUSIONS

Spanish credit institutions were deeply affected by the outbreak of the 2007 financial crisis, which gave rise to an incredibly sharp increase in the level of impaired assets (both non-performing loans and foreclosed real estate assets) and an abrupt slump in entities' profitability. To address these problems, an intense process of recapitalisation and restructuring of the sector took place, which was accompanied by the setting up of a new regulatory framework enacted to enable the implementation of the sought recapitalisation and restructuring measures. As a consequence, the Spanish credit institution sector has notably concentrated and the solvency position of its actors has considerably improved, while at the same time the regulatory landscape applicable to credit institutions has changed notably. Thus, Spain's banking sector is now made up of fewer banks with adjusted risk profiles and improved corporate governance.

The outbreak of the financial crisis revealed excessive and careless risk taking in certain credit institutions, as well as a lack of compliance with the applicable rules of conduct as to the rendering of banking services, all of which resulted in profuse consumer litigation against credit institutions and a profound crisis of reputation. Although measures have been put in place to deal with these negative outcomes, they have not been as successful as those designed to restore credit institutions to a position of solvency and profitability.

19 Figures obtained from the BBVA Research Banking Outlook Report as of March 2019, available at https://www.bbvaresearch.com/wp-content/uploads/2019/03/Banking-Outlook-4Q18.pdf.

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As a consequence, and despite a significant improvement in financial position, the Spanish credit institution industry faces important challenges, the most notable of which are the following:

a a low interest rate environment in the eurozone, which is likely to persist until the second half of 2020, and which notably impacts the profitability of credit institutions;

b increasingly demanding solvency requirements applicable to credit institutions;

c the fast-growing competitive environment that surrounds banking services, characterised by the emergence of new actors that differ from traditional credit institutions (e.g., fintech entities); and

d the need to restore consumer confidence in credit institutions.

All such challenges will have to be faced in a context of political uncertainty, both domestically (national, regional and local elections will take place in the second quarter of 2019) and internationally (mainly due to developments in negotiations in connection with the UK's exit from the EU).

As regards regulatory developments, some legislation was approved in the first months of 2019, with further legislation being expected to be approved throughout the year, that is likely to impact credit institutions' business: namely, Law 5/2019, of 15 March, regulating real estate lending and its implementing regulations (the draft text has already been disclosed and is expected to enter into force in 2019), and Royal Decree-Law 5/2019, of 1 March, adopting contingency measures in connection with the withdrawal of the UK and Northern Ireland from the EU without reaching agreement as foreseen in Article 50 of the Treaty on European Union. In particular, the latter's main purpose is to adopt measures aimed at adapting the Spanish legal system in the event that the UK exits the EU without an agreement materialising, which will only enter into force on the day on which EU treaties cease to apply in the UK, and insofar as no withdrawal agreement being reached between the EU and the UK prior to such date (if an agreement is reached, Royal Decree-Law 5/2019 will never enter into force).

Moreover, it is worth noting the approval on 22 February 2019 of a draft law aimed at promoting the adaptation of the financial regulatory and supervisory framework in the new digital context, which foresees, among other things, the creation of a regulatory sandbox. Although this ambitious legislative project is likely to be postponed (at least until the elections have taken place and a new government has been formed), it is, without a doubt, an interesting and challenging initiative in terms of financial regulation.

In any event, the general economic environment, and numerous and well-targeted advances in the restructuring of the credit institution system, lead us to look at the future with reasonable confidence, and to believe that credit institutions will be able to overcome these demanding challenges.

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Chapter 35

SWEDEN

Fredrik Wilkens and Henrik Schön[1]

I INTRODUCTION

Swedish banks, which represent the larger part of the Swedish financial market and can provide all types of financial services, are usually categorised as universal banks. These consist of SEB, Swedbank and Handelsbanken, with Nordea as the largest foreign lender in Sweden (Big Four).[2] It should be noted, however, that Nordea decided in March 2018 to move its headquarters from Stockholm to Helsinki, Finland.

	Number of employees	Lending to the public	Balance sheet total
Nordea	30,399	€310 billion	€581.6 billion
SEB	15,804	1.485 billion kronor	2.559 billion kronor
Handelsbanken	11,832	2.065 billion kronor	2.767 billion kronor
Swedbank	14,588	1.535 billion kronor	2.212 billion kronor

Furthermore, Sweden has witnessed exuberant activity within the payments and fintech sectors in recent years, in which many firms have sought to obtain a licence to conduct banking or financing business, an aspiration that materialised for the Swedish unicorn Klarna AB (a credit institution focused on payment services), which obtained a full banking licence in June 2017.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i The Swedish Banking and Financing Business Act

Entities wishing to conduct business that is regulated under the Swedish Banking and Financing Business Act (BFBA) (namely, a combination of accepting repayable funds from the public and lending) can choose to apply for either a banking business licence or a credit market company licence, depending on the types of activities contemplated. Both types of licence are granted by the Swedish Financial Supervisory Authority (SFSA), and are passportable into other EEA jurisdictions in accordance with the Capital Requirements Directive (CRD) as implemented through the BFBA. Upon obtaining a banking or credit market company licence, the relevant entity would qualify as a Swedish credit institution pursuant to the CRD and the Capital Requirements Regulation (CRR).

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2 The annual report for 2017 of each bank.

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ii Forms of banks

Most Swedish credit institutions are formed as limited liability companies. However, the Swedish banking market also consists of cooperative banks, which are economic associations that have as their purpose the provision of banking services to their members. There are also savings banks, which do not have any actual owners. Instead, their business is conducted under the supervision of several principals who appoint the bank's board of directors, and dividends may only be distributed in accordance with instructions provided by the original founders or reinvested in the bank's business.

iii Branches of foreign credit institutions

Foreign non-EEA credit institutions must establish a Swedish subsidiary or branch and obtain a Swedish banking licence from the SFSA to provide their services in Sweden. However, such activities will only be licensable if considered to be carried out in Sweden and outside the *de minimis* exemption. It is not clear at which point a certain activity would be considered to be carried out in Sweden, as an assessment would be made by the SFSA for each case. It is clear, however, that a number of factors are taken into account, and that the SFSA will judge each case on its own merits. The SFSA would consider, inter alia:

a whether the foreign bank had taken the initiative in contacting a prospective client;
b whether the foreign bank operated from fixed (or frequently used) facilities in Sweden;
c the number of contacts in Sweden;
d the type and number of Swedish clients; and
e whether the foreign bank acted through a permanent representative in Sweden (such as an agent).

EEA credit institutions may provide their services in Sweden on a cross-border basis after having obtained a Swedish cross-border passport pursuant to the CRD. Should they wish to provide their services from inside Sweden, they will be required to set up a Swedish branch and apply for a Swedish branch passport pursuant to the CRD.

iv Supervisory architecture

The SFSA and the Swedish Central Bank (SCB) have the main responsibility for monitoring Swedish credit institutions' compliance with the applicable laws and regulations. The SFSA has a direct responsibility to supervise Swedish credit institutions, whereas the SCB has overall responsibility to promote the stable functioning of the Swedish financial system.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Types of supervision and supervisory approach

The SFSA mainly applies three types of supervision: ongoing supervision, investigations and event-driven supervision.

Ongoing supervision is conducted regularly and, to a certain extent, routinely, and consists of monitoring risk development and verifying that firms and market transactions meet set rules and requirements. The basis consists of both the regular reporting of financial and other data that participants are legally obliged to submit to the SFSA, and of the analysis performed by the SFSA based on that material. More thorough supervision

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comes in the form of investigations, which are used by the SFSA to dig deeper into a firm, area or certain activity, and to find information that does not usually emerge in ongoing supervision or reporting. This can be a case of assessing, for instance, the quality of a firm's internal governance, its control or risk management, or its compliance with and procedures relating to anti-money laundering. Event-driven supervision relates to risks that have already manifested themselves in different ways (i.e., reactive supervision); for example, a firm facing acute difficulty, consumers being affected by dubious advice, or the detection of some sort of market abuse.

On a more general level, the SFSA applies risk-based supervision, which stands on two pillars: a risk assessment process and a risk classification process. The risk assessment process identifies and ranks the biggest risks, while the risk classification process ranks firms based on where the problems are considered to have the greatest potential to produce negative consequences for consumers or the national economy. However, despite this risk-based approach, the SFSA's goal is that each firm operating on the basis of an authorisation from the SFSA shall, over a period of three years, be subject to at least one supervisory activity. The reasoning behind this goal is that rules for a certain type of financial operation must apply equally to all and must be respected by all, and that equal conditions for competition must apply between different participants. Prioritising according to risk thus does not mean that supervisory resources shall be exclusively allocated to firms or factors that in each situation are deemed to pose the greatest risks.

Supervision of the banking industry

The SFSA's supervision within the banking industry has a clear emphasis on financial stability in general and the stability of the system in particular. The Big Four are, according to the SFSA, systemically important owing to their predominant position in the Swedish market, their complex business models and their extensive cross-border operations (following Nordea's re-location to Finland, Nordea is no longer subject to the primary supervision of the SFSA, but Nordea Hypotek AB, a company within the Nordea group, has been classified as systematically important by the SFSA). They are therefore thoroughly supervised and constitute Category 1 firms. The SFSA is in close dialogue with each Category 1 firm's board and management. A specific supervision plan is usually prepared for these firms, engaging a high number of employees in different types of activities, and a contact person for the firm bears responsibility for the cohesion and coordination of the work of the team of risk specialists participating in supervising the firm.[3] In this respect, the SFSA has stated that it will continue to maintain its view of Nordea as a systemically important institution after its relocation to Helsinki.

ii Management of banks

Board of directors

The board of directors of a Swedish credit institution must consist of at least three members, and the majority of the board members may not be employed by the institution or an undertaking that is included in a group of which the institution is the parent company. The board must in turn appoint a managing director, who may not be the chair of the board of

3 See https://www.finansinspektionen.se/contentassets/ea1ec81d9a9d4b5589eb72a2ddc77faa/tillsynsstrategi-eng.pdf.

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directors. Authorisation to represent a Swedish credit institution and to sign on its behalf may only be granted to two or more persons acting jointly, and no other restrictions on the signing authority may be registered towards third parties with the Swedish Companies Registration Office (SCRO).

Directors sitting on the boards of Swedish credit institutions that are deemed significant owing to the nature, scale and complexity of their operations are permitted to sit on the boards of no more than three more companies. When calculating the number of permitted directorships, board assignments within the same group will count as one directorship, and the same will apply in relation to assignments in a company in which the significant financial institution has a qualifying holding (i.e., 10 per cent or more of the shares or voting rights, or both). However, directorships in non-commercial companies are not taken into account. In addition, the managing director of a significant financial institution may not have more than two additional directorships, although it is possible for the SFSA to grant exemptions for an additional directorship.

In connection with granting a Swedish credit institution licence, the board of directors of the company and the managing director are assessed by the SFSA as to their management suitability. If, during its supervision of a Swedish credit institution, the SFSA finds that a member of the board of directors or the managing director is unsuitable for such assignment, it shall, following discussions with the institution, inform the institution that it finds the board member or managing director to be unsuitable. If the credit institution has not dismissed the relevant board member or managing director within three months of receiving such notification, the SFSA may revoke the credit institution's licence, or order the dismissal of the board member and appoint a replacement, who will sit on the board of directors or be the managing director until the credit institution has appointed a new board member or managing director.

Remuneration

When employees of a credit institution are entitled to variable remuneration, the credit institution must ensure that the fixed and variable components are balanced. The SFSA Regulations FFFS 2011:1 stipulate that an appropriate balance may depend on the relevant employee's position as well as the institution's business activities.

Deferred payment

The SFSA Regulations provide that at least 40 per cent of the variable remuneration of staff whose actions can have a material impact on risk exposure, and that amounts to 100,000 kronor or more per year, must be deferred for three to five years. Furthermore, where the variable remuneration is particularly high, at least 60 per cent of the variable remuneration to the managing director, the deputy managing director, other members of the management group or a similar body that report directly to the board of directors or the managing director (senior management), and staff whose work duties have a material impact on the credit institution's risk profile must be deferred. Deferred remuneration may be distributed once per year, and evenly distributed over the period of time by which the distribution was deferred (*pro rata*).

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Composition of variable remuneration

An undertaking that is significant with respect to size, internal organisation and the nature, scope and complexity of its activities shall ensure that at least 50 per cent of the variable remuneration to an employee who is a member of senior management consists of:

a shares, participations or other instruments in the undertaking that are linked to the undertaking's shares or participations, or other equivalent instruments for undertakings whose shares or participations are not admitted to trading on a regulated market; or

b other instruments in accordance with Article 52 or 63 of the CRR or in accordance with Commission Delegated Regulation (EU) No. 527/2014 of 12 March 2014 supplementing the CRD with regard to regulatory technical standards specifying the classes of instrument that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration.

Where possible, the undertaking shall allow the variable remuneration components described above to consist of a balance of the instruments under points (a) and (b).

Loss of remuneration

A credit undertaking must ensure that variable remuneration to employees whose work duties have a material impact on the undertaking's risk profile, including deferred remuneration, is only paid or passed to those employees to the extent that is justifiable by the undertaking's financial situation and the performance of the undertaking, the business unit in question and those employee. The variable remuneration can also be cancelled in full for the same reasons.

iii Regulatory capital and liquidity

An institution's Tier 1 capital shall at all times amount to at least 6 per cent of risk-weighted assets, of which 4.5 per cent must consist of Common Equity Tier 1 capital (CET1 capital). The total capital relation – that is, the institution's capital base as a percentage of the institution's risk-weighted exposure amount – shall amount to at least 8 per cent of risk-weighted assets. Thus, 2 per cent of that 8 per cent may constitute Tier 2 capital.

Furthermore, there is a capital conservation buffer of 2.5 per cent of risk-weighted assets, a countercyclical capital buffer of (currently) 2 per cent of risk-weighted assets (to be assessed annually, and reaffirmed by the SFSA on 30 January 2019), and in relation to SEB, Swedbank, and Handelsbanken, a systemic risk buffer of 3 per cent of risk-weighted assets at the group level. All risk buffers must consist of CET1 capital. Within the scope of Pillar 2, SEB, Swedbank and Handelsbanken are also subject to a CET1 capital systemic risk buffer requirement of 2 per cent of risk-weighted assets at the group level.

The CRR requires a credit institution to have a liquidity buffer that enables it to meet cash flow needs during a period of 30 days in difficult stress scenarios.

Capital adequacy requirements, liquidity requirements and the SFSA's supervision apply on an individual credit institution basis as well as on a consolidated group basis.

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iv Recovery and resolution

Implementation of the BRRD

On 15 April 2014 and 6 May 2014 respectively, the European Parliament and the Council of Ministers adopted the final Bank Recovery and Resolution Directive (BRRD). On 1 January 2015, the BRRD was implemented into Swedish law through the Swedish Credit Institutions Resolutions Act (Resolutions Act), which came into effect on 1 February 2016.

The Swedish National Debt Office (NDO) has been designated as the resolution authority. In addition to resolution proceedings, the SFSA is responsible for write-downs and conversions of capital instruments. The government is responsible for the government stability tool.

Crisis prevention

The Resolutions Act contains requirements for the establishment of recovery plans and resolution plans. It also gives the NDO the right to require that a credit institution removes obstacles preventing resolution, such as requiring the credit institution to limit its largest or total exposures, dispose of certain assets and terminate certain business operations, or the development of certain services and products. The NDO, with the SFSA, also has the power to decide on the minimum amount of bail-in debt (i.e., the debt possible to write-down or convert into capital) that a credit institution must have in relation to its total debt and capital base. Furthermore, in relation to certain qualified debt constituting securities issued by a credit institution subject to foreign law, credit institutions are required to include bail-in clauses.

Resolution

The Resolutions Act allows the NDO to implement resolution measures in circumstances in which the NDO considers that the failure of a credit institution has become highly likely and poses a threat to the public interest. The resolution options available to the NDO (all of those stated below except (e), which is only available to the government) provide for:

a the sale of all or part of the business of the relevant entity to a purchaser that is not a bridge institution;
b the transfer of all or part of the business of the relevant entity to a bridge institution;
c the transfer to an asset management vehicle;
d the bail-in tool (write-down and conversion of debt); and
e the temporary public ownership (nationalisation) of the relevant entity.

Each of these stabilisation options is achieved through the exercise of one or more resolution powers, which include:

a the power to make share transfers, pursuant to which all or some of the securities issued by a credit institution may be transferred to a commercial purchaser, a bridge bank or the government;
b the resolution instrument power, which includes exercising the bail-in tool;
c the power to transfer all or some of the property, assets and liabilities of a Swedish credit institution to a commercial purchaser or the NDO; and
d the third country instrument powers that recognise the effect of a similar special resolution action taken under the law of a country outside the European Union.

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In addition, the Resolutions Act grants powers to modify contractual arrangements in certain circumstances, and powers to suspend enforcement or termination rights that might be invoked as a result of exercising the resolution powers.

Resolution financing

Swedish credit institutions are required to pay an annual resolution fee to be calculated in accordance with Commission Regulation 2015/63. Should the resolution reserve be equal to 3 per cent of guaranteed deposits, the resolution fee should be replaced with a risk fee that will be based on the risks of each respective credit institution. However, the government has proposed that the risk fee shall be scrapped and replaced with a transitionally higher resolution fee, while maintaining the goal of the reserve size, although it is unclear whether this proposal will enter into force. This fund may be used in connection with resolutions under certain exceptional circumstances (e.g., when there is a need for excluding conversions or a write-down of debt due for stability reasons).

Pursuant to the Swedish Preventive Support to Credit Institutions Act, the NDO may also provide support to credit institutions through the stability fund, which may only be used to prevent a serious disruption to the Swedish financial system. Support can be provided by way of guarantees or capital injections, or by way of guarantees to the SCB for liquidity support provided by the SCB to credit institutions.

There is also a deposit guarantee fund, which is a state-provided guarantee of deposits in all types of credit institutions through which customers can obtain compensation of up to 950,000 kronor per credit institution, or the equivalent of €100,000 in the case of a foreign branch of a Swedish credit institution. Credit institutions belonging to the deposit guarantee scheme must pay an annual fee to the NDO, which shall amount to 0.1 per cent of the value of the guaranteed deposits.

IV CONDUCT OF BUSINESS

Swedish credit institutions' operations must be organised and operated in such a manner that their structure, connections to other undertakings and financial position may be assessed by the SFSA. The head office of a Swedish credit institution must be located in Sweden.

Pursuant to the SFSA Regulations FFFS 2014:1, a Swedish credit institution is required to have separate functions for internal audit, compliance and risk management, and each function must be regulated by internal regulations that shall set out the responsibilities, assignments and routines of each function (note that the compliance function may not be combined with employment in an institution's legal division). All the functions must regularly report directly to the board of directors and to the managing director.

A Swedish credit institution is required to have several internal regulations in place governing, inter alia:

a internal governance and control;
b internal audit;
c risk management;
d handling of complaints;
e anti-money laundering;
f ethics;
g handling of conflicts of interest; and
h authorisation and payment approval and outsourcing.

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There must also be internal instructions regarding credit risk, operational risk, reporting of significant events and liquidity risk. With respect to credit risks in particular, during 2018 the SFSA adopted detailed regulations pertaining to the management of such risks in credit institutions including, inter alia, regulations regarding processes for credit assessment, and the monitoring and internal reporting of credit risks.

In the absence of authorisation or just cause, a customer's relations with a Swedish credit institution may not be disclosed, and this continues to apply after the customer relationship has ended. However, a Swedish credit institution is obliged to report information regarding an individual's relations with the institution where such information is requested by an investigating officer pursuant to the provisions regarding preliminary investigations in criminal cases, or where such information is requested by a prosecutor in a matter regarding legal assistance in a criminal case upon request by another state or an international court.

If a Swedish credit institution wishes to engage any third parties to perform any regulated services, the institution must inform the SFSA and file the relevant outsourcing agreement with the SFSA. Furthermore, outsourcing agreements may only be entered into when the institution remains responsible to the customer with respect to the entrusted operations: the operations are conducted by the service provider in a supervised and, from a bank secrecy perspective, satisfactory manner; and the services are not of such scope that the institution is unable to perform its obligations pursuant to the BFBA or other statutes governing the operations of the institution.

A Swedish credit institution must have at least one auditor, and at least one of the auditors elected must be an authorised public accountant or an approved public accountant holding a degree in public accountancy.

A Swedish credit institution must identify, measure, manage, internally report and have control over the risks associated with its operations. In this context, institutions must ensure that they possess satisfactory internal controls. An institution must specifically ensure that its credit risks, market risks, operational risks and other risks taken together do not entail that the institution's ability to fulfil its obligations is jeopardised. To fulfil this requirement, the institution must, as a minimum, have methods that enable it to regularly value and maintain a capital that, in terms of amount, class and allocation, is sufficient to cover the type and level of risks to which it is, or may become, exposed. Swedish credit institutions must evaluate these methods to ensure that they are comprehensive.

In addition to the black letter law and regulations published by the SFSA, a majority of Swedish banks (and certain Swedish branches of foreign credit institutions) are members of the Swedish Bankers' Association, which requires its members to comply with various guidelines, including, for example, a recently adopted code for the responsible provision of credits to consumers seeking to strengthen public confidence in the credit market.

V FUNDING

Swedish credit institutions mainly finance themselves through deposit-taking and lending to the general public, lending to each other, holding interest-bearing securities, trading in derivatives and issuing interest-bearing securities (bonds and certificates). In this context, Swedish banking has a high proportion of market funding when seen in an international

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context, with Swedish banks obtaining around 54 per cent of their funding via the markets.[4] In cases where there is a risk of serious disruption to the Swedish financial system, the government may provide support to credit institutions, as discussed in Section II.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Legal or natural persons wishing to acquire interests in a Swedish credit institution will be obliged to undergo ownership and management assessments when they directly or indirectly acquire 10 per cent or more of the shares or voting rights of, or if the acquisition otherwise enables the acquirer to exercise a significant influence in, an institution.

The assessments made by the SFSA are extensive, and the SFSA will grant a licence for acquisition if the acquirer is assessed to be suitable and the planned acquisition is financially sound. In conjunction with assessments, the SFSA will obtain information from, for example, the Swedish National Police Board, the SCRO, the Swedish Tax Agency and the Swedish Enforcement Authority and, in the case of foreign investors or foreign citizens that are part of the management of foreign investors, the SFSA will obtain information from corresponding authorities in the relevant home state. To the extent that the acquisition requires that the acquirer will obtain majority control over the shares or voting rights, or have the right to appoint or dismiss a majority of an institution's board members, the SFSA will require an extensive business plan containing, inter alia, a three-year financial forecast for the credit institution and the group to which it belongs.

Subject to receiving a complete application and the application fee of 35,000 kronor for each direct or indirect qualifying acquirer, the SFSA will process the application within 60 business days.

In relation to the structuring of banking acquisitions, it should be noted that a Swedish credit institution is prohibited from providing financial assistance (whether in the form of loans, guarantees or other security) with respect to another entity's acquisition of shares in the relevant institution or a superior company within the same group. The prohibition applies to loans made and securities given prior to the acquisition, but could also apply to post-completion assistance (e.g., by way of a loan from the target to its new parent to repay any external acquisition financing). A cautious attitude is recommended in this respect. Generally, post-acquisition assistance should at the very least not be secured or agreed between the parties prior to the transaction, and some time should elapse after the acquisition (generally three to six months) before, inter alia, any transfers of funds are made.

With only one exception (regarding financial assistance in connection with share offerings to employees), there are no safe harbours or general exemptions to this prohibition. However, it is possible to apply for an exemption from the Swedish Tax Agency prior to completing a transaction that would otherwise be unlawful. Such an exemption may be granted under special circumstances, but is seldom favoured by the parties involved because of, inter alia, aspects of timing and publicity.

4 https://www.fi.se/contentassets/ed78c9a0d9064cd088a6ad0be716d695/bankbarometer_2018-09-14.pdf.

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ii Transfers of banking business

There is no established process under which a Swedish credit institution may transfer all or part of its business (deposits, loan arrangements and other assets or liabilities) to another entity without the consent of the customers concerned. Instead, customer consent from each relevant customer of the transferor bank must, as a main rule, be obtained.

VII THE YEAR IN REVIEW

Swedish household indebtedness has risen continuously since the mid-1990s, both in absolute figures and relative to disposable income. The debt ratio (loans in relation to disposable income) for a Swedish household is, on average, slightly more than 185 per cent. A number of measures have been taken in recent years for the purpose of counteracting high indebtedness, including a mortgage cap, whereby home loans may not exceed 85 per cent of the value of the home (introduced by the SFSA), and a risk-weight floor for Swedish mortgages, in order to tie up more capital in relation to mortgage lending by banks. To further tackle increasing high indebtedness, the SFSA – following an extensive public debate – adopted regulations regarding amortisation requirements applicable to highly leveraged mortgages, whereby the borrower is required, depending on the circumstances, to pay off 2 or 3 per cent of the capital loan amount annually.

VIII OUTLOOK AND CONCLUSIONS

In summary, attention in 2018 continued to centre on the Swedish housing market and the mandatory amortisation requirements, as well as Nordea's relocation to Finland. 2018 also saw more structured attempts by new fintech firms competing for market share within the profitable Swedish mortgage credit market, which trend is likely to continue throughout 2019.

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Chapter 36

SWITZERLAND

Shelby R du Pasquier, Patrick Hünerwadel, Marcel Tranchet, Maria Chiriaeva, Valérie Menoud and Sotirios Kotronis[1]

I INTRODUCTION

The Swiss banking industry has a long tradition, and has been internationally focused from the outset. Services offered by Swiss banks comprise all banking services.

Currently there are 251 licensed banks in Switzerland, of which:

a two are big banks that are global systemically relevant banks (G-SIBs) (UBS AG and Credit Suisse AG) and three are systemically relevant banks or banking groups (SIBs) (Zurich Cantonal Bank, Raiffeisen Switzerland and PostFinance);

b 24 are (partly) state-owned cantonal banks;

c 60 are regional banks or savings banks;

d 75 are foreign-controlled banks (i.e., controlled by significant foreign shareholders); and

e 24 are Swiss branch offices of foreign banks.

Current challenges to the Swiss banking industry include the continued regulatory activity spurred by the 2008 financial crisis. The main focus still is on enhancing the international regulatory framework and cooperation, as well as the stability of the financial industry and its systems in line with the Basel III requirements, generally by reinforcing capital adequacy and solvency requirements, cutting back on incentivising short-term risk-taking, and – as a particular topic for big banks – addressing the too big to fail issue.

With Credit Suisse AG, UBS AG (G-SIBs) and Zurich Cantonal Bank, Raiffeisen Switzerland and PostFinance (SIBs), Switzerland currently has five banks, respectively banking groups, that are viewed as systemically important. Since the financial crisis, notably, Parliament has passed several amendments to the Banking Act that address capital adequacy, leverage ratios and liquidity requirements with specific and more stringent requirements for systemic banks, and the Swiss regulator, the Swiss Financial Market Supervisory Authority (FINMA), has strengthened its stance on risk management (including legal and reputational risk) and corporate governance requirements.

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II THE REGULATORY REGIME APPLICABLE TO BANKS

i Main statutes

The main statutes governing the Swiss financial markets are:

a the Federal Financial Market Supervision Act of 2007 (FINMASA);
b the Federal Banking Act of 1934 (BA);
c the Federal Stock Exchanges and Securities Trading Act of 1995 (SESTA);
d the Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading of 2015 (FMIA);
e the Federal Collective Investment Schemes Act of 2006 (CISA); and
f the Federal Act on Combating Money Laundering and Terrorist Financing in the Financial Sector of 1997 (AMLA).

These statutes are supplemented by a number of ordinances enacted either by the government (i.e., the Swiss Federal Council (Federal Council)) or, as regards more technical aspects, by FINMA; their practical application is further regulated by FINMA circulars.

These regulations are complemented by the Federal Act on the Swiss Financial Market Supervisory Authority, which is a framework law governing the supervisory activities and instruments of FINMA.

As from 1 January 2020, two other statutes will supplement this framework: the Federal Financial Institutions Act (FinIA) and the Federal Financial Services Act (FinSA) (see Section VII.ii).

ii Banking and securities dealing activities

Under Swiss banking laws, a business entity that solicits or takes deposits from the public (or refinances itself with substantial amounts from other unrelated banks) to provide financing to a large number of persons or entities is considered a bank. The conduct of banking activities in or from Switzerland is subject to a licensing requirement and to supervision by FINMA.

Swiss financial markets law makes no distinction between commercial and investment banks, and banks are not limited in the scope of their activities. As a result, banks may act as broker-dealers in securities, in addition to pursuing deposit-taking and lending activities (i.e., interest operations). However, banks need to apply for an additional authorisation as a securities dealer to conduct securities trading activities. The main statutes governing the securities business of both banking and non-banking intermediaries in Switzerland are the SESTA, the FMIA and their respective implementing ordinances.

Under Swiss securities laws, securities dealing activities are defined broadly. They encompass the activities of securities dealers, issuing houses, market makers, derivative houses, and brokers maintaining accounts in their books or holding securities deposits for more than 20 clients.

Although banking and securities dealing licences are two separate authorisations, most requirements in terms of minimum substance and documentation overlap. From a practical perspective, both banking and securities dealing licensing requirements are thus usually assessed within the same FINMA process. Broadly speaking, the conditions for the granting of a licence to conduct banking or securities dealing activities encompass financial and organisational requirements (see Sections III and IV), as well as fit and proper tests imposed on managers and qualified shareholders (see Sections III, IV and VI.i). FINMA grants a licence to the legal entity pursuing the banking activities, not to its managers or shareholders. It then

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continually monitors compliance with licensing criteria (and other regulatory obligations). If, at a later stage, any of the licence requirements cease to be fulfilled, FINMA may take administrative measures, including, in extreme cases, withdrawal of the licence.

This regime will change with the entry into force, on 1 January 2020, of the new FinIA, which will repeal and replace SESTA (see also Section VII.ii). First, from a formal perspective, FinIA will bring Swiss terminology closer to EU regulations, and refer to securities firms instead of securities dealers). Second, from a substantive point of view, FinIA will introduce a 'licence cascade', in which the banking licence will be considered as the highest ranking licence encompassing the authorisation to operate as a securities firm, asset manager, fund asset manager or trustee without the need to apply for a separate authorisation. In turn, a licence as a securities firm will encompass the authorisation to operate as an asset manager, a fund asset manager or a trustee. This formal simplification, however, will not exempt a licensed bank or securities firm from adapting, as the case may be, its capital, liquidity, organisation or internal policies to comply with the specific requirements applicable to the conduct of another category of regulated activities.

As regards cross-border banking and securities activities, the Swiss regime has been rather liberal to date: foreign-regulated entities that operate on a strict cross-border basis (i.e., by offering banking or securities services to Swiss investors without having a business presence in Switzerland) do not need to be authorised by FINMA. If, however, the activities of a foreign bank or securities dealer involve a permanent physical presence in Switzerland, this cross-border exemption is not available. In practice, FINMA considers a foreign entity to have a Swiss presence as soon as employees are hired in Switzerland. That said, FINMA may also look at further criteria to determine whether a foreign bank has a Swiss presence, such as the business volume of that bank in Switzerland or the use of teams specifically targeting the Swiss market. This liberal stance will change with the entry into force of the new FinSA on 1 January 2020 (see also Section VII.ii).

The granting of a licence to a foreign bank to establish a Swiss branch, representative office or agency is conditional upon the principle of reciprocity being satisfied in the country in which the foreign bank has its registered office, and if a Swiss bank or securities dealer is permitted to establish a representative branch, office or agency in the relevant foreign country without being subject to substantially more restrictive provisions than those imposed in Switzerland, FINMA will deem the reciprocity test met.

The granting of a licence to a Swiss bank or securities dealer controlled by foreign shareholders is also made dependent upon the reciprocity requirement by the relevant foreign country of domicile or incorporation of the foreign shareholders (see Section VI.i).

iii Other regulated activities

A Swiss bank may also serve as a custodian for collective investment schemes. This type of activity is subject to the CISA and its implementing ordinances.

Financial intermediaries are further supervised for the purpose of combating money laundering and the financing of terrorism according to the AMLA and its various implementing ordinances.

iv FINMA

The single integrated financial market supervisory authority, FINMA, is responsible for the supervision of banks, securities dealers, stock exchanges and collective investment schemes,

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as well as the private insurance sector. FINMA also monitors financial intermediaries with a view to preventing money laundering and the financing of terrorism.

FINMA is a public institution with separate legal personality. Although it carries out its supervisory activity independently, FINMA has a reporting duty towards the Federal Council, which approves its strategic objectives, as well as its annual report prior to publication, and appoints FINMA's Chief Executive Officer. Parliament is responsible for overseeing FINMA's activities.

FINMA employs approximately 500 full-time equivalent staff. Its operating expenses are covered by fees and duties levied from the supervised entities. FINMA is able to carry out its tasks within a relatively modest organisation mainly as a result of the Swiss financial markets supervision system's strong reliance on external auditors and self-regulatory organisations. Indeed, external auditors carry out direct supervision and on-site audits, whereas FINMA retains responsibility for the overall supervision and enforcement measures (see Section III).

Regulatory duties are delegated to self-regulatory organisations: the Swiss Bankers Association (SBA), for instance, issues self-regulatory guidelines to its members, which FINMA recognises as minimum standards that need to be complied with by all Swiss banks. In particular, the SBA's guidelines governing banks' duty of due diligence in identifying the contracting party and the beneficial owner of accounts,[2] the rules of conduct in securities dealing[3] and portfolio management[4] play an important role in practice.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The Swiss banking supervision system is based on an indirect (or dual) supervision model. Banks, foreign banks' branches and financial groups (or conglomerates) subject to Swiss supervision must appoint an external audit company supervised by the Federal Audit Oversight Authority. The auditor assists FINMA in its supervisory functions: it examines annual financial statements, and reviews whether regulated entities comply with their by-laws and with Swiss financial markets regulation and self-regulatory provisions. FINMA requires that financial and regulatory audits be conceptually separated and may require, where appropriate, that these two audits be carried out by different audit firms. The results of the financial and regulatory audits are detailed in annual audit reports that are to be handed over to the supervised entity and to FINMA. FINMA exercises its oversight and ascertains whether the various regulatory requirements are complied with, largely based on these reports. The intensity of the supervision and the direct involvement of FINMA, in particular as regards qualitative aspects of supervision, depend on the category to which a bank or securities dealer is assigned. In this context, FINMA applies a risk-oriented supervision, classifying regulated banks and securities dealers according to their importance (notably in terms of assets under management, deposits and required equity) and risk profile:

a category 1 institutions are extremely large, important and complex market participants, which require intensive and continuous supervision;

2 Agreement on the Swiss Banks' Code of Conduct with regard to the Exercise of Due Diligence of June 2015 (CDB 16). A revised version of these guidelines has been published in July 2018 will enter into force on 1 January 2020.

3 Code of Conduct for Securities Dealers governing securities transactions of May 2009.

4 Portfolio Management Guidelines of March 2017.

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b category 2 institutions are deemed very important and complex, and require close and continual supervision;

c category 3 market participants are large and complex to which a preventive supervision model is applied; and

d category 4 and 5 institutions are small to medium-sized participants, for which event-driven and theme-based supervision is generally deemed sufficient.

In addition, auditors are obliged to inform FINMA if they suspect any breach of law or uncover other serious irregularities. Supervised entities also have a general duty to inform FINMA of any event or incident that may be of relevance from a supervisory perspective. Furthermore, banks have special reporting duties: for instance, in cases of changes in the foreign controlling persons (or entities), in the qualified shareholders, and in the status of statutory equity capital, liquidity ratios or risk concentrations. Based on these informational tools, FINMA initiates investigations (if necessary, through an appointed investigator) and, if a breach is ascertained, takes administrative measures aimed at restoring compliance. In cases of serious breach, FINMA can ultimately decide to withdraw a licence. In the event of serious breach (and, in particular, in the event of violation of market conduct rules), FINMA may also order the disgorgement of illegally generated profits. In practice, the most common sanctions that FINMA imposes relate to the forced liquidation of unauthorised securities dealers, insolvency procedures and sanctions following non-compliance with Swiss know your customer rules.

Following the 2008 financial crisis, a more rigorous supervisory regime was put in place for UBS AG and Credit Suisse AG, as the size and complexity of these institutions raise systemic risks. Accordingly, FINMA does not rely exclusively on the reports of the banks' auditors, but carries out its own investigations and maintains close contact with the two banks.

FINMA has generally been more active and interventionist than was previously the case, with these two banks as well as with the other systemically important financial institutions. For several years, and in accordance with its risk-based approach, FINMA has carried out extensive stress tests at Credit Suisse AG and UBS AG to periodically and systemically assess their resilience against sharp deteriorations in economic conditions. Systemic banks are subject to a specific regime in terms of capital adequacy (see Section III.iii) and crisis resistance. In this context, they are required to establish detailed recovery and resolution plans, as well as to implement specific corresponding organisational measures. As an example, both Credit Suisse AG and UBS AG now have a non-operating holding company as group parent, and they have transferred Swiss-based systemically important functions to separate subsidiaries. Further steps will be undertaken in the future, in particular the reduction of the financial and operational dependencies that persist within the groups and the submission to FINMA of a feasible Swiss emergency plan by 2019. Within FINMA, a specific division, the Recovery and Resolution Division, which is in charge of crisis restructuring and insolvency proceedings, monitors and coordinates these emergency and resolution planning efforts.

While FINMA has noticeably heightened its focus over systemic banks, it has also recognised that the increase in normative intensity and complexity that followed the financial crisis represents a considerable challenge for small and micro banks. In recent years, FINMA has been exploring avenues to ease certain quantitative and reporting requirements, simplify procedures and reduce the frequency of regulatory audits for banks in supervisory categories

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4 and 5. In July 2018, FINMA began a pilot phase with around 70 small banks to test the new supervisory regime. With the results of this test phase progressively coming in, the topic will remain at the top of the regulator's agenda this year and in years to come.

ii Management of banks

The granting of a banking or securities dealer licence is conditional upon the fulfilment of certain organisational requirements. In particular, the articles of incorporation and internal regulations of a bank must define the exact scope of business and the internal organisation, which must be adequate for the activities of the bank. As a general rule, two separate corporate bodies must be in place:

a a board of directors that is primarily in charge of the strategic management of the bank, and the establishment, maintenance, monitoring and control of the bank's internal organisation. The board must comprise at least three members who meet professional qualifications, enjoy a good reputation and offer every guarantee of proper business conduct. Depending on the size, complexity and risk profile of the bank, FINMA may require that the board comprises more than three members. In addition, FINMA expects, as a rule, that a substantial number of the board members have a close relationship to Switzerland in terms of residence, career or education. In practice, FINMA expects at the very least that the chair or vice chair of the board be domiciled in Switzerland. As a matter of principle, the board must be free of any conflicts of interest with the management or with the bank itself. By law, the board of directors of a Swiss bank is non-executive, with a strict prohibition of a double mandate both as director and manager; and

b the executive management, which also implements the instructions of the board of directors. Its members must meet the various professional qualifications and fit and proper tests. As a rule, FINMA requires that a Swiss bank be managed from Switzerland, and senior managers are typically expected to be domiciled in Switzerland.

Under FINMA practice, the strategic management, supervision and control by the board of directors, the central management tasks of the management, and decisions concerning the establishment or discontinuation of business relationships may not be delegated to another affiliated or non-affiliated entity. As a result, a Swiss bank that is a subsidiary of a foreign group must be granted a certain degree of independence in its decision-making process. General instructions and decisions from a foreign parent entity are permitted, however. For the rest, as a general rule, outsourcing of other functions within a Swiss bank to affiliated or non-affiliated service providers both in Switzerland and abroad is generally permitted, subject to the satisfaction of certain requirements, in particular in relation to Swiss banking secrecy and data protection rules. As from 1 April 2018, outsourcing by banks is governed by FINMA Circular 2018/3, which replaced Circular 2008/7 and regulates the way in which banks handle outsourced services. The new Circular retains its principle-based and technology-neutral approach and imposes, inter alia, the following changes in comparison to the previous rules:

a banks must maintain an up-to-date inventory of all outsourced services, including information regarding the outsourced services, the service provider, the service recipient and the responsible unit within the financial institution;

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b in the case of outsourcing outside Switzerland, banks have to make sure that all necessary data for reorganisation, resolution and liquidation purposes remain accessible in Switzerland at all times;

c the requirements provided by the Circular are to be complied with regardless of whether outsourcing is within a group, although the intragroup nature of an outsourcing may be taken into account for risk assessment purposes; and

d the requirements for data protection and banking secrecy are not addressed by the new Circular, and banks are now required to assess compliance in light of the relevant statutes governing data protection and banking secrecy.

FINMA Circular 2018/3 applies to all new outsourcing arrangements entered into after 1 April 2018. Outsourcing arrangements that were already in place before 1 April 2018 have a five-year transition period (i.e., until 1 April 2023) to adapt to the new regulatory requirements.

Specific constraints and requirements regarding the organisation of a Swiss bank (e.g., with respect to internal audit, controls, compliance and reporting, segregation between trading, asset management and execution function) vary depending on the actual business and size of the bank.

In this context, FINMA Circular 2010/1 on remuneration schemes, the purpose of which is to increase the transparency and risk orientation of compensation schemes in the financial sector, provides for 10 principles that certain financial institutions must observe. Although these rules do not impose any absolute or relative cap on remuneration, FINMA requires that variable compensations (i.e., any part of the remuneration that is at the discretion of the employer or contingent upon performance criteria) be dependent on long-term sustainable business performance, taking into account assumed risks and costs of capital. FINMA thus expects a significant portion of the remuneration to be payable under deferral arrangements. Furthermore, the compensation policy is to be disclosed annually to FINMA. These rules are mandatory for banks, securities dealers, financial groups (or conglomerates), insurance companies, and insurance groups and conglomerates with capital or solvency requirements in excess of 10 billion Swiss francs. In practice, this concerns UBS AG and Credit Suisse AG. For other financial institutions, the Circular represents guidelines for adequate remuneration policies.

FINMA can, however, deviate from this and require, where appropriate, a determined institution to comply with some or all of the provisions of Circular 2010/1.

Finally, FINMA Circular 2017/1 on corporate governance and revised Circular 2008/21 on operational risks integrate the key principles of corporate governance and risk management recently issued by the Banking Committee on Banking Supervision into Swiss regulation. These circulars consolidate and strengthen several requirements that previously derived from less formal guidance and FINMA practice, notably as regards internal control processes and instances, as well as risk management frameworks and responsibilities.

iii Regulatory capital and liquidity

The Swiss regulatory capital and liquidity regimes implement the Basel III recommendations.[5] Capital adequacy and measurement rules are set out in the Capital Adequacy Ordinance

5 Basel III: A global regulatory framework for more resilient banks and banking systems and Basel III: International framework for liquidity risk measurement, standards and monitoring.

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(CAO), and the Basel minimum standards are defined therein by reference to the most recent recommendations of the Basel Committee on the calculation of capital requirements. The CAO, therefore, overall implements pure Basel III requirements as regards the minimum capital requirements and their measurement.

As the Basel III capital requirements are minimum requirements and Switzerland has a tradition of imposing more stringent capital requirements on its banks, the CAO provides for an additional layer of capital (additional capital), which requires Swiss banks to have additional capital based on the size and specificities of their business.

The differences from Basel III can be summarised as follows:

a the possibility of a partial waiver of capital instruments in cases of a point of non-viability (PONV);

b particular rules with respect to obligations to Swiss pension funds;

c the possibility of a direct deduction from Common Equity Tier 1 capital as an alternative to a risk-weighting of an asset;

d certain minor deviations with respect to deductions pending clarification of respective international standards; and

e the application of requirements on a stand-alone basis for which Basel III does not make any recommendations.

Calculation of capital requirements

As regards credit risks, Swiss banks can choose between the standard approach (international standard SA-BIS) and an internal ratings-based approach (IRB in its two variations: foundation IRB or advanced IRB). The CAO no longer provides for the simple Swiss standard, SA-CH, and banks using SA-CH have to move to SA-BIS within a certain transitional period.

As regards operational risks, Swiss banks can choose between the basic indicator and the standard approach as simple methods. A Swiss bank having the necessary resources may also choose the advanced measurement approach and thereby use a tailor-made proprietary risk model approved by FINMA.

As regards market risks, the CAO implements the respective rules developed by the Basel Committee in cooperation with the International Organization of Securities Commissions.

Capital requirements must be met both at the level of the individual institution and at the level of the financial group or conglomerate. Stand-alone reporting is required on a quarterly basis and consolidated reporting on a semi-annual basis.

The required capital is as follows.

Minimum capital requirements

The minimum capital requirements (after application of regulatory adjustments) call at all times for an aggregate (Tier 1 and Tier 2) capital ratio of 8 per cent of a bank's risk-weighted assets, with a minimum Common Equity Tier 1 capital ratio of 4.5 per cent and a minimum Tier 1 capital ratio of 6 per cent of such risk-weighted assets.[6] In this context, banks' assets are notably weighted against credit risk, non-counterparty-related risks, market risks, operational risks, risks under guarantees for central counterparties and value adjustment risks in connection with derivative counterparty credit risks.

6 These requirements form the first pillar of a bank's regulatory capital base.

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Capital buffer

As of 1 July 2016, banks must have a capital buffer up to the amount of the total capital ratio in accordance with requirements specified in the CAO for each bank category. If the minimum ratio is not met because of unforeseeable events, such as a crisis within the international or Swiss financial system, this does not amount to a breach of the capital requirements, but a deadline will be set by FINMA for replenishing the capital buffer.

Countercyclical buffer

The Swiss National Bank can request the Federal Council to order that banks must maintain a countercyclical buffer of up to 2.5 per cent of all or certain categories of their risk-weighted assets in Switzerland in the form of Common Equity Tier 1 capital if this is deemed necessary to back the resiliency of the banking sector with respect to risks of excessive credit expansion or to counter an excessive credit expansion. At present, a countercyclical buffer of 2 per cent applies to loans secured by Swiss residential property.

Extended countercyclical buffer

As of 1 July 2016, banks with total assets of at least 250 billion Swiss francs, of which the total foreign commitment amounts to at least 10 billion Swiss francs, or with a total foreign commitment of at least 25 billion Swiss francs, are required to maintain an extended countercyclical buffer in the form of Common Equity Tier 1 capital. An extended countercyclical buffer is calculated on the basis of foreign private sector credit exposures, including non-bank financial sector exposures.

Additional capital requirements

In special circumstances and on a case-by-case basis, FINMA may demand that certain banks maintain additional capital, notably to respond to risks that FINMA deems not adequately covered by the minimal capital requirements. The additional capital requirements, with the capital buffer, primarily aim at ensuring that the minimum capital requirements can also be met under adverse conditions.

Qualifying capital

To qualify under the capital requirements, equity must be fully paid in or have been generated by the bank. As a rule, it cannot be directly or indirectly financed by the bank, set off against claims of the bank or secured by assets of the bank. All qualifying capital must be subordinated to all unsubordinated claims of creditors in the case of liquidation, bankruptcy or restructuring of the bank. Capital instruments that are not only convertible, or subject to a conditional waiver in the case of an imminent insolvency of a bank, are qualified based on their respective terms prior to conversion or reduction, other than in the context of the requirements for additional capital or convertible instruments of systemic banks.

The capital qualifying under the above general requirements is divided into Tier 1 capital and Tier 2 capital. Tier 1 capital is, in turn, subdivided into:

a Common Equity Tier 1 capital, which consists of the paid-in capital, disclosed reserves, reserves for general banking risks (after deduction of latent taxes unless provided for) and profits carried forward and, with certain limitations, profits for the current business year as shown on audited interim financial statements reviewed in accordance with FINMA guidelines; and

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b Additional Tier 1 capital, which consists of perpetual equity or debt instruments with restricted optional repayments and discretionary distributions providing for a conversion into Common Equity Tier 1 instruments (or, in the case of equity instruments without a conversion feature, a waiver of any privilege over Common Equity Tier 1 instruments), or a reduction and write-off to contribute to the restructuring of a bank in the case of its threatened insolvency (PONV). The conversion or reduction must take place no later than at the acceptance of public aid or when ordered by FINMA to avoid insolvency in the case of equity instruments, whereas an additional trigger of breaching a minimum threshold of 5.125 per cent of Common Equity Tier 1 capital is required for debt instruments. Debt instruments with capital reduction may provide for a conditional participation in the benefits of a subsequent recovery of the bank's financial situation. Additional Tier 1 capital issued by a special purpose vehicle, the proceeds of which are immediately and without restrictions passed on to the ultimate holding company or an operative company of the group in the same or higher quality, qualifies as Additional Tier 1 capital on a consolidated basis.

Tier 2 capital consists of equity or debt instruments with a minimum term of five years with restricted optional repayments and discretionary distributions providing for their conversion or reduction at such time as the bank reaches the PONV as for Additional Tier 1 capital. During the last five years before final maturity, the amount of such instruments that qualify is reduced by 20 per cent of their nominal amount for each year. FINMA is to issue guidelines for further elements to qualify as Tier 2 capital.

Regulatory deductions

Banks must apply full or threshold deductions to the above capital elements to account for various items, such as losses, unfunded valuation adjustments, goodwill, deferred tax assets and defined benefit pension fund assets in line with the Basel minimum standards.

Leverage ratio

Based on the Liquidity Ordinance (LO), which provides for the implementation of a leverage ratio in line with Basel III, FINMA Circular 2015/3 'Leverage ratio – banks' (as last revised on 30 June 2018) defines the methodology for calculating the leverage ratio in line with the Basel III methodology.

The CAO was revised as of 1 January 2018 to introduce a leverage ratio. In accordance with Basel III requirements, the revised CAO requires a risk-weighted capital ratio as well as an unweighted capital adequacy requirement for all non-systemic banks. A safety net in the form of a leverage ratio has been implemented and provides for a minimum core capital (Tier 1) to a total exposure ratio of 3 per cent for all non-systemic banks. The revised FINMA Circular 2015/3 enables banks to also apply the Basel III standard approach for derivatives when calculating the leverage ratio.

Risk diversification rules

The maximum risk concentration permissible is 25 per cent of the overall required capital (after application of required deductions). With effect from 1 January 2019, the revised CAO provides that risk concentrations will be measured only against core capital (Tier 1), meaning that supplementary capital (Tier 2) will generally no longer be taken into account. Moreover, banks are allowed only very restricted use of models for determining their risk

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concentrations, as modelling errors have a major impact when calculating these risks. Further changes concern overruns of the upper limits set out in the CAO (large exposures exceeding 25 per cent of core capital are generally no longer permitted), the weighting of certain assets, as well as the adjustment of some special rules for systemically important banks (see below). The revised risk diversification provisions in the CAO are supplemented by the revised FINMA Circular 2019/1 'Risk diversification – banks'.

Liquidity requirements

The LO sets out the quantitative and qualitative requirements for the minimum liquidity for banks and systemic banks. Although FINMA is in charge of the implementation and enforcement of the new LO, it must consult with the Swiss National Bank on any questions relating to its implementation.

With the revision of the LO as of 1 January 2015, the quantitative elements required by the Basel III framework for the liquidity coverage ratio (LCR) were introduced for non-systemic banks and will be gradually implemented until 2019, whereas systemic banks had to adhere to these requirements and the additional Swiss requirements applicable to them as from 2015. The net stable funding ratio (NSFR) was due to be implemented in January 2018 following a test reporting phase. Owing to delays in the introduction of the NSFR on the EU and US financial markets, the Federal Council decided in November 2018 to postpone the implementation of the NSFR, and to reassess the situation and decide on the next steps at the end of 2019. The LO was further revised with effect from 1 January 2018 to relax the LCR requirements for small banks, which are further detailed in the revised FINMA Circular 2015/2 on the liquidity risk for banks, which also entered into force on 1 January 2018.

Banks have to report their LCR as at each month end to the Swiss National Bank, within 20 calendar days for non-systemic banks or within 15 calendar days for systemic banks.

Banks that hold privileged deposits must maintain additional liquid assets to cover their respective obligations, as set by FINMA, based on the amount of privileged deposits reported annually by the bank. Financial groups must maintain adequate liquidity on a consolidated basis. Finally, certain short-term liabilities to one single customer or bank in excess of 10 per cent of the aggregate of short-term liabilities on a gross basis must be reported.

Specific regime applicable to systemic banks: capital, liquidity and risk diversification

As regards capital requirements, on 11 May 2016, the Federal Council adopted an amendment to the CAO that sets out the specific capital requirements for SIBs and introduces new requirements for G-SIBs in line with G20 standards. The revised CAO came into effect on 1 July 2016, subject to certain phase-in provisions.

SIBs must have sufficient capital to ensure continuity of their service at times of stress and to avoid state intervention, restructuring or winding up by FINMA (i.e., going concern capital requirement). The going concern requirement consists of a basic and a progressive component, and is set with respect to both the bank's leverage ratio and its risk-weighted assets.

The progressive component is calculated based on the degree of systemic importance of a bank, such as its size and market share. The basic going concern capital requirement of a SIB consists of a base requirement of 4.5 per cent leverage ratio and 12.86 per cent risk-weighted assets, and a surcharge. With the inclusion of the progressive component, G-SIBs will have

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to comply with a 5 per cent leverage ratio and 14.3 per cent for risk-weighted assets. The size of the surcharge is set with respect to the degree of systemic importance (i.e., the total exposure and the market share of the relevant SIB). The going concern requirement is further split into a minimum requirement component of a 3 per cent leverage ratio and 8 per cent risk-weighted assets that a SIB has to maintain at all times, and a buffer component by which a SIB may temporarily fall short (e.g., in the case of losses and under strict conditions). From 1 January 2018, systemic banks may also be subject to a total exposure ratio up to 10 per cent.

Systemic banks operating at an international level are further subject to an additional capital requirement to guarantee their recovery or the continuation of their systemic functions in an operating unit while liquidating other units without support from the public (i.e., gone concern requirement). By analogy, the gone concern requirement of a G-SIB quantitatively corresponds to its total going concern capital requirement: that is, a minimum 4.5 per cent leverage ratio and a minimum 12.86 per cent risk-weighted assets, plus any surcharges applicable to the relevant G-SIB, to the exclusion of countercyclical buffers. After consultation with the Swiss National Bank, FINMA may lower the level of those requirements, based on the effectiveness of measures taken to improve the global resolvability of the relevant G-SIB group and in consideration with other factors. However, the gone concern requirement must not fall below a 3 per cent leverage ratio or 8.6 per cent risk-weighted assets or, if higher, the applicable international standards, provided that the requirement adjustment does not jeopardise the implementation of the G-SIB's emergency plan. The gone concern requirement is complied with, as a general rule, by means of bail-in instruments such as bonds with conversion rights, subject to the regulator's decision. In February 2018, the Federal Department of Finance initiated a consultation on amendments to the CAO regarding gone concern requirements for the three SIBs (i.e., PostFinance AG, Raiffeisen and Zürcher Kantonalbank). In November 2018, the Federal Council adopted the relevant amendments to the CAO, which entered into force on 1 January 2019. Following the introduction of gone concern capital requirements for the G-SIBs (UBS and Credit Suisse) in 2016, these now also apply to the SIBs. The amended CAO also provides for new rules for the treatment of systemically important banks' stakes in their subsidiaries (see below).

Systemic banks also have to satisfy the countercyclical buffer and extended countercyclical buffer requirements. Capital requirements apply both on a stand-alone and consolidated basis. In this context, FINMA may alleviate the requirements on a stand-alone basis if these would otherwise increase the requirements on a consolidated basis and the financial group has taken appropriate measures to avoid an increase. Both stand-alone and consolidated requirements, as well as any alleviation, have to be disclosed by FINMA with respect to the principles, as well as by the bank or the financial group as part of its regular reporting. Finally, FINMA may, in extraordinary circumstances, require a SIB to hold additional capital or demand that the going concern capital requirement is fulfilled with higher-quality capital.

In addition, systemic banks are subject to more stringent liquidity requirements both on a stand-alone and a consolidated basis, which take into account extraordinary stress scenarios. As a result, systemic banks must be able to cope with all liquidity drains that are to be expected under a particular stress scenario over a period of 30 days. In this context, no liquidity gap, as defined for the relevant period in the LO, may arise on a seven-day and a 30-day liquidity outlook. The particular stress scenario must be based on the assumption that, inter alia, the bank loses access to financing in the markets, and that large amounts of deposits are being withdrawn. Systemic banks must further hold a regulatory liquidity buffer

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consisting of primary and secondary buffers comprising determined qualifying assets listed in the LO. However, FINMA may modify the list and determine the minimum deductible to establish the sales value of the assets. The percentage of liquidity that can be generated by a sale of assets allocated to the regulatory liquidity buffer qualifying for the primary buffer must amount to at least 75 per cent on a seven-day outlook and 50 per cent on a 30-day outlook. Finally, systemic banks must report monthly on changes in their liquidity position, highlighting and explaining the reasons for the most significant changes.

As regards risk diversification, the maximum risk concentration permissible for systemic banks is 25 per cent of the Common Equity Tier 1 capital (other than Common Equity Tier 1 capital constituting the progressive element) only. The Federal Council requested that the Federal Department of Finance prepare, by the end of February 2018, a proposal on the risk weighting principles applicable to positions held in subsidiaries. The Federal Council adopted in November 2018 an amendment to the CAO providing for new rules for the treatment of systemically important banks' stakes in their subsidiaries. In this context, the same regime now applies to SIBs as to G-SIBs. This regime provides, inter alia, for an abolition of the full deduction of parent companies' positions held in subsidiaries from core equity capital and of the accompanying relief measures allowed for these two large banks and for replacement thereof, after a transition period, by a risk weighting of up to 250 per cent with respect to positions in Swiss-based subsidiaries and 400 per cent with respect to positions in foreign subsidiaries of these two large banks. These requirements relate to parent companies' stand-alone capital ratios, but not the consolidated ratios. Finally, in addition to measures relating to capital, liquidity, organisational and risk diversification requirements, the amendment to the BA also entails provisions that allow the government to order adjustments to the remuneration system of a bank that would have to rely on government funding.

Transitional period

The new rules for banks and systemic banks overall not only provide for increased capital ratios, but also significantly vary as to the quality of the capital and deductions that need to be applied to the capital, and smaller banks that used the simplified SA-CH standard approach to measure credit risk will have to move to the SA-BIS.

In light of these changes, very detailed transitional rules are intended to allow banks and finance groups to adjust to the increased requirements over time by building up the required capital and replacing or phasing out capital that no longer qualifies under the new rules.

As regards capital requirements, both the going concern requirement and the gone concern requirement are subject to a phase-in with gradually increasing requirements, and must be fully applied by 1 January 2020.

Future developments

The evolution of the standards issued by the Basel Committee on Banking Supervision, changes to the Banking Ordinance and the CAO, as well as amended international accounting standards, have necessitated changes to a number of FINMA circulars (i.e., 2008/6 'Interest rate risks – banks', 2011/2 'Capital buffer and capital planning – banks', 2013/1 'Eligible capital – banks', 2016/1 'Disclosure – banks', 2017/7 'Credit risks – banks'). A consultation was opened until the end of January 2018 for this purpose. FINMA Circular 2008/6 'Interest rate risks – banks' has been replaced by a new FINMA Circular 2019/2 'Interest rate risks – banks', which entered into force on 1 January 2019. FINMA Circulars 2011/2 'Capital

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buffer and capital planning – banks', 2013/1 'Eligible capital – banks', 2016/1 'Disclosure – banks' and '2017/7 'Credit risks – banks' were all amended in June 2018. The revised versions of these circulars entered into force on 1 January 2019.

Most of the legal and regulatory capital adequacy requirements deriving from the Basel III standards have been gradually implemented into the Swiss regulatory framework. This revision package is one of the last steps in the national implementation of the Basel III standards. The implementation of the NSFR (see above), and the revised standards published by the Basel Committee in December 2017, are still pending. These will be handled under the lead of the Federal Department of Finance via amendments to the relevant Federal Council ordinances and associated FINMA circulars.

iv Recovery and resolution

The provisions of the BA dealing with insolvent banks aim at streamlining reorganisation procedures, ensuring prompt repayment of preferential deposits and the continuity of basic banking services. These provisions enhance the flexibility of such proceedings, and confer additional instruments and powers to FINMA with a view to increasing the likelihood of a successful reorganisation. FINMA is, for instance, empowered to order a transfer of all or part of a failing bank's activities to a bridge bank, the conversion of certain convertible debt instruments issued by the bank (CoCos or convertibles), the reduction or cancellation of the bank's equity capital and, as an *ultima ratio*, the conversion of the bank's obligations into equity.

The FINMA Banking Insolvency Ordinance reflects a quite extensive interpretation of the new instruments and powers of the BA. For instance, it allows FINMA to order, as an *ultima ratio* to ensure the presence of sufficient equity capital, the conversion of the bank's obligations (third-party funding) into equity capital, with the exception of certain limited claims that would be ranked in privileged classes in the event of a liquidation procedure. This measure could also potentially concern clients' deposits that do not qualify as preferential deposits (being defined as cash deposits of up to 100,000 Swiss francs whose payment would be secured within liquidation proceedings). In addition, FINMA may order a temporary stay of a counterparty's right to terminate agreements with a bank.

Following a revision of the BA that entered into force on 1 January 2016, FINMA's power to order a stay of early termination rights has been considerably broadened: FINMA may now couple a stay with any of the protective or reorganisation measures it may take in the event of insolvency risk (not only, as was formerly the case, in connection with a transfer of the relevant agreements to a bridge bank), and can order a stay in relation to any contractual agreement with the bank (not only in relation to certain financial agreements). In this context, where agreements subject to termination rights in the case of protective or reorganisation measures are governed by non-Swiss law or non-Swiss jurisdiction clauses, the Banking Ordinance generally requires, for enforceability purposes, that Swiss banks and securities dealers only enter into new agreements or agree to the amendment of agreements, provided the counterparty contractually acknowledges and consents to a stay of the termination right. This obligation has now been further specified in the revised FINMA Banking Insolvency Ordinance, which entered into force in April 2017. Finally, FINMA may also order the stay of certain netting, private sale and claim transfer rights that are, in principle, recognised and protected within FINMA insolvency proceedings.

On 15 February 2017, the Federal Council instructed the Federal Department of Finance to prepare a consultation draft with the aim of strengthening the current deposit

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protection scheme on the basis of the recommendations of the group of experts on the further development of the financial market strategy and the continuing discussions between the State Secretariat for International Financial Matters, FINMA and the Swiss National Bank on this issue. The consultation draft has been published on 8 March 2019 and is subject to a consultation procedure until 4 June 2019. One notable proposal is to require a Swiss bank to pay cash deposits within seven business days of its bankruptcy, which is in line with international standards.

In line with international standards, systemic banks must have both a recovery plan and a resolution plan for identifying risks to the stability of the financial system due to their systemically important nature, and to determine viable ways of dealing with the effects of a crisis. Pursuant to the Banking Ordinance, a systemic bank has to establish a recovery plan that contains the measures that it would implement in the event of a crisis and that would allow it to pursue its activity without requiring government funds. Responsibility for drafting and regularly updating the recovery plan lies at executive board level of the systemic bank and must be embedded in a viable corporate governance framework. The recovery plan and any amendments thereto are subject to FINMA's approval. If the legal requirements are met, FINMA will approve the recovery plan, and then develop a resolution plan itself based on the information provided by the systemic plan. At the time of writing, FINMA considers that the two largest banks, Credit Suisse AG and UBS AG (G-SIBs) have improved their crisis resistance over the years by establishing detailed recovery and resolution plans and implementing the necessary organisational measures. Both banks now have a non-operating holding company acting as their respective group parent and have transferred their Swiss-based systemically important functions to separate subsidiaries. Nevertheless, according to FINMA, further steps are to be undertaken to reduce financial and operational dependencies that persist in the groups. Both banks are due to submit revised emergency plans to FINMA in 2019 that are to address this issue, among others.

IV CONDUCT OF BUSINESS

The obligations ordained by the anti-money laundering regulations have a material effect on how banks conduct their activities. Financial intermediaries are required to verify the identity of their contracting partners and the beneficial owner of accounts.

Furthermore, if reasons for suspicion of money laundering exist, banks must notify the Money Laundering Reporting Office (MRO) of the Swiss Federal Office of Police. The rules applicable to the freezing of assets following a suspicious activity report were recently revised. Until January 2016, a report would lead to the immediate freezing of the assets relating thereto. Under these rules, only reports linked to individuals or organisations identified in accordance with UN Resolution 1373 (2011) require immediate freezing measures. Otherwise, banks may continue to execute transactions requested while preserving a paper trail. The MRO examines cases and, if necessary, communicates a matter to the competent criminal prosecution authorities. If the MRO decides to forward a case to the criminal authorities, a freeze must be implemented. The MRO is vested with powers regarding requests for information from the Swiss financial intermediaries and the exchange of information with foreign financial intelligence units (FIUs). The rules of conduct of Swiss banks in relation to the prevention of money laundering and terrorism financing are further detailed by the CDB Agreement on the Swiss Banks' Code of Conduct with regard to the Exercise of Due Diligence of June 2015 (CDB), which represents minimum standards. A breach by a bank

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of its duty to communicate is subject to a fine of up to 500,000 Swiss francs. In addition, certain behaviours may constitute a criminal offence of money laundering, as the case may be, by negligence.

With respect to its customer relationships, a bank is primarily bound by the duties and obligations stated in the relevant contractual documentation. In addition, banks licensed as securities dealers are bound by qualified duties of information, diligence and loyalty towards their clients under regulatory law. Inter alia, a bank must draw clients' attention to the risks involved in the relevant securities transactions, and ensure that its clients are granted the best possible terms of execution for their transactions and that they are not disadvantaged by any conflicts of interest. These rules of conduct have been further defined by case law and supervisory practice, and are detailed in a number of self-regulation guidelines (see Section II.iv). A breach of the duties of information, diligence and loyalty may give rise to civil liability as well as regulatory consequences to the extent that FINMA is of the view that a bank no longer meets the requirements of good reputation and proper business conduct.

A Swiss bank is bound by a statutory duty of confidentiality towards its clients. A breach of that duty is considered to also be a breach of the client–bank contractual relationship, and may give rise to civil and criminal liability. As a general rule, any disclosure of client data to a third party, including the parent company, its supervisory authority or an affiliated entity, is prohibited. Exceptions apply under certain circumstances, such as in the context of consolidated supervision, or following a request for international judicial or administrative assistance issued by a public authority (including FIUs for anti-money laundering purposes), or if a client has consented to a disclosure. In recent years, the importance and scope of Swiss banking secrecy has been the subject of intense discussion in Switzerland following pressure from other countries, and the situation recently changed with the implementation of the automatic exchange of information (see Section VII).

V FUNDING

The main funding sources for Swiss banks are money market instruments, interbank funding, customer savings accounts, other customers' deposits, cash bonds and bonds.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

For purposes of the BA, a participation is deemed to be qualified if it amounts to at least 10 per cent of the capital or voting rights of a bank, or if the holder of the participation is otherwise in a position to significantly influence the business activities of the bank (a qualified participation). It should be noted that, in practice, FINMA often requires disclosure of participations of 5 per cent or more for its assessment of whether the requirements of a banking licence are continuously being met.

The BA does not set any restrictions on the type of entities or individuals holding a controlling stake in a bank. However, one of the general licensing conditions is that individuals or legal entities that directly or indirectly hold a qualified participation in a bank must ensure that their influence will not have a negative impact on the prudent and reliable business activities of the bank. Thus, the bank's shareholders and their activities may be of relevance for the granting and maintenance of a banking licence. Shareholders with a qualified participation may be deemed to have a negative influence on the bank; for example, in cases

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of a lack of transparency, unclear organisation or financial difficulties of financial groups or conglomerates, and influence of a criminal organisation on the shareholders. Should FINMA take the view that the conditions for the banking licence are no longer being met because of a shareholder with a qualified participation, it may suspend the voting rights in relation to that qualified participation or, if appropriate and as a last measure, withdraw the licence.

If foreign nationals with a qualified participation directly or indirectly hold more than half the voting rights of, or otherwise have a controlling influence on, a bank incorporated under the laws of Switzerland, the granting of the banking licence is subject to additional requirements. In particular, the corporate name of a foreign-controlled Swiss bank must not indicate or suggest that the bank is controlled by Swiss individuals or entities, and the countries where the owners of a qualified participation in a bank have their registered office or their domicile must grant reciprocity (i.e., it must be possible for Swiss residents and Swiss entities to operate a bank in the respective country, and the banks operated by Swiss residents must not subject to more restrictive provisions than foreign banks in Switzerland). In practice, the reciprocity requirement no longer applies as regards foreign holders of qualified participations domiciled or incorporated in Member States of the World Trade Organization or signatories of the General Agreement on Trade and Services.

Furthermore, FINMA may request that a bank is subject to adequate consolidated supervision by a foreign supervisory authority if the bank forms part of a financial group or conglomerate.

If a Swiss bank falls under foreign control, as described above, or if a foreign-controlled bank experiences changes in its foreign shareholders directly or indirectly holding a qualified participation, a new special licence for foreign-controlled banks must be obtained prior to such events. Under the BA, a foreigner is (1) an individual who is not a Swiss citizen and has no permanent residence permit for Switzerland;, or (2) a legal entity or partnership that has its registered office outside Switzerland or, if it has its registered office within Switzerland, is controlled by individuals as defined in (1).

According to Swiss law, there are no restrictions regarding the business activities of the entities holding qualified participations in a bank as long as the conditions for granting and maintaining the licence are complied with. Generally, transactions between the (controlling) shareholders of a bank and the bank itself may be subject to specific requirements (e.g., the granting of loans to significant shareholders must be in compliance with generally recognised banking principles).

Each controlling shareholder has the duty to notify about an acquisition or disposal of a qualified participation, as well as the fact that its participation reaches, exceeds or falls below certain thresholds. Further, as mentioned above, the holder of a qualified participation is required not to negatively influence the prudent and reliable business activities of the bank.

Even though the acquisition of a qualified participation in a bank by a Swiss individual or a Swiss entity in theory only triggers notification obligations, it is necessary to seek a letter of no objection from FINMA for the account of the bank prior to an envisaged transfer of a controlling stake in a Swiss bank, since FINMA controls the continuing compliance with the conditions of a banking licence. FINMA will examine whether the influence of the new shareholder with a qualified participation would be detrimental to the prudent and reliable business activities of the bank.

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ii Transfers of banking business

Historically, the vast majority of acquisition transactions in the Swiss banking industry were structured as share deals. Over the course of the past few years, a number of transactions were structured as asset deals.

VII THE YEAR IN REVIEW

In their continued effort to adapt financial regulation after the 2008 crisis, FINMA and the government enacted several regulatory amendments, and examined potential revisions concerning key aspects of banking regulation and supervision. 2018 was mostly a year of the consolidation and fine-tuning of the substantial regulatory work developed and pursued in the years following the crisis.

i Regulatory developments

In addition to the issues addressed in the foregoing sections, the following regulatory developments can be outlined.

Direct transmission of information in supervisory matters

Since 1 January 2016, Swiss banks may directly share certain non-public information with foreign supervisory authorities under certain conditions set out in a new provision introduced in the FINMASA and further detailed in FINMA's new Circular 2017/06.

In a nutshell, under these rules, a Swiss bank may share non-public information with a foreign supervisor directly (i.e., without having to resort to international administrative assistance), provided the foreign supervisor is bound by official or professional secrecy provisions (confidentiality principle) and provided further that it will use the information exclusively to enforce financial market law (speciality principle), and that the protection of personal and confidential data relating to clients and third parties (notably employees) is guaranteed (in accordance with Swiss data protection, banking secrecy, business confidentiality and employment laws).

FINMA publishes a list of foreign supervisory authorities to which it has granted administrative assistance in the past. If a foreign authority is on the list, banks may, as a rule, assume that this authority meets the requisites of confidentiality and speciality. If, however, a foreign authority does not appear on FINMA's list, further clarifications will have to be sought (including, as the case may be, by reaching out to FINMA), and if doubts remain, a direct transmission will have to be refused and the foreign authority directed towards administrative assistance channels. In addition, if the information to be transmitted qualifies as important information that would, in any event, have to be reported by the Swiss bank to FINMA under Swiss law, a direct transmission of this information to a foreign supervisor requires FINMA's prior approval. The same applies if the transmission itself appears to be of substantial importance.

As a result, the scope of information that may be transmitted without FINMA's prior approval under Circular 2017/06 is fairly limited, and mainly concerns non-public information that has to be reported routinely to foreign supervisors, such as organisational charts, governance information, and capital and liquidity figures that must be published periodically (e.g., Common Equity Tier 1 equity, leverage ratio, liquidity coverage ratio), or reports on proceedings that have been finally disposed of.

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A transfer of information that is not made in compliance with rules on the direct transfer of information may be construed as an official act performed on behalf of a foreign state on Swiss territory in breach of Swiss sovereignty, which may constitute a criminal offence under Swiss law.

Anti-money laundering regulation and implementation of the latest recommendations of the Financial Action Task Force

The backbone of the Swiss anti-money laundering framework is the AMLA and its implementing ordinances (FINMA AML Ordinance of 8 December 2010 and AML Ordinance of 11 November 2015). Following the issuance of revised recommendations by the Financial Action Task Force (FATF) in 2012, as well as the various FATF evaluation reports on Switzerland, the government has been working on different revisions of the legal and regulatory framework.

As a result of those revisions, financial intermediaries are today, among other things, required to establish the identity of the beneficial owners of operating companies (i.e., individuals holding 25 per cent of the share capital or voting rights or controlling the company in any other manner) or, if no beneficial owner can be identified, the identity of the most senior member of management. Further, financial intermediaries must only implement a freeze if and when the MRO, after a maximum period of 20 days, informs it that it has transferred the case to a criminal prosecution authority and for a maximum of five days until a decision to maintain the freeze is made by the criminal authority. This mechanism aims to give the MRO more time for its analysis, while avoiding raising the account-holder's suspicion of an MRO communication.

Following the latest FATF mutual evaluation report on Switzerland, FINMA decided to further revise the FINMA AML Ordinance to eliminate certain shortcomings identified in Swiss legislation. The main development is that financial intermediaries will in the future have a duty to verify information on beneficial ownership for all clients, including low-risk clients, and to update client information regularly. It is also thought that the amended FINMA AML Ordinance will include obligations for financial intermediaries with foreign branches or subsidiaries to monitor legal and reputational risks globally. It is expected to enter into force in 2020.

It is worth noting that, in parallel, in June 2018, the Federal Council opened up a consultation procedure on a new revision of the AMLA. Among other things, the draft provides for the extension of due diligence obligations to advisory services related to the setting up, management and administration of offshore companies and trusts, regardless of the absence of any pure financial intermediation activity (i.e., services involving financial transactions or an activity of a corporate body of an offshore company). The draft further provides for the abolition of the 20-day period during which the MRO is to review the reporting made by the financial intermediary and revert, as the case may be. According to the Federal Council, this would allow the MRO to prioritise filings and treat them in a more efficient manner. The entry into force of the revised AMLA is not expected before 2020.

Finally, since 1 January 2016, the revised FINMA AML Ordinance and the CDB. allow, inter alia, online onboarding. In this context, FINMA published a circular on video and online identification (FINMA Circular 2016/7), which entered into force on 18 March 2016 and was revised on 1 August 2018. One of the main purposes of this Circular is to clarify and facilitate video and online client identification for financial intermediaries subject to know your customer duties. The revised Circular takes into account technological developments

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to ensure that the effectiveness of preventing money laundering is maintained. Financial intermediaries will have to comply with the revised Circular by 1 January 2020. The revised version of the CDB will also enter into force on 1 January 2020, and will be aligned with the above revised FINMA AML Ordinance and FINMA Circular 2016/7.

Financial market infrastructure

FMIA and its implementing ordinances (Financial Market Infrastructure Ordinance (FMIO) and FMIO-FINMA) entered into force on 1 January 2016. The new law primarily aims at harmonising Swiss law with international developments (in particular with the Markets in Financial Instruments Directive II (MiFID II), the Market in Financial Instruments Regulation and the European Market Infrastructure Regulation) as regards the regime applicable to negotiation platforms, central counterparties, central securities depositories, payment and securities settlement systems, and derivatives trading. From a formal perspective, the new FMIA also gathers in one single statute former provisions related to the organisation and operation of the market infrastructure, including conduct of business rules (e.g., shareholding disclosures). The new statute has introduced, inter alia, a licensing regime similar to that applied to stock exchanges for multilateral trading facilities and organised trading facilities, and a licensing obligation for central counterparties, central securities depositories and trade repositories, with the application of specific additional requirements. Further, clearing, reporting and risk-mitigation obligations have been introduced for determined exchange-traded and over-the-counter (OTC) derivative transactions to which a professional investment firm is party.

Following the entry into force of the new regime, financial market infrastructures and the operators of organised trading facilities were granted a one-year transitional period to comply with some of the new requirements (e.g., pre and post-trade transparency information duties). Moreover, participants in a trading venue and securities dealers were released from fulfilling the extended record-keeping and reporting duties regarding securities transactions until 1 January 2017. This transitional period was based on the expected date on which the corresponding provisions in MiFID II were expected to become effective. As this date has been postponed by a year, the Federal Council decided to extend the corresponding transitional period to 1 January 2018. As of 1 October 2018, this reporting obligation has been extended to include all derivative transactions, if the relevant derivative's underlying is admitted to trading on a Swiss trading venue. However, new rules provided for a 'backloading' period. As a result, all transactions that would have to be reported under the new rules between 1 January 2018 and 30 September 2018 had to be reported by 31 December 2018.

On 3 April 2017, FINMA authorised the first Swiss trade repository (SIX Securities Services) and recognised the first foreign trade repository for Switzerland (REGIS-TR) for the purposes of the reporting obligations introduced by the FMIA. For the time being, however, recognition of the foreign trade repository is restricted to the receipt of reports under Swiss law (as opposed to any foreign law (e.g., the European Market Infrastructure Regulation)). In this context, the Federal Council decided in September 2018 to extend the time frames until reporting requirements enter into force. To give sufficient time to small non-financial counterparties for the technical implementation of their obligation to report derivative transactions to a trade repository, the transitional period has been extended until 1 January 2024 for OTC derivative transactions and for exchange-traded derivatives' transactions in cases of derivatives' transactions with foreign counterparties that do not report in accordance with FMIA.

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In May 2018, FINMA amended the provisions of the FMIO-FINMA to introduce a clearing obligation for standardised interest rate and credit derivatives traded OTC that are listed in Annex 1 of the FMIO-FINMA. OTC derivatives are already subject to a clearing obligation under EU regulations. The revised FMIO-FINMA entered into force on 1 September 2018. Since that date, participants must comply with the deadlines set out in the FMIO. The effective dates of the clearing obligation of each counterparty are as follows:

a 1 March 2019 for derivatives transactions that participants in an authorised or recognised central counterparty conclude anew with one another;

b 1 September 2018 for derivatives transactions that participants in an authorised or recognised central counterparty conclude anew with other financial counterparties that are not small, or derivatives transactions that other financial counterparties that are not small conclude anew with one another, and

c 1 March 2020 for all other derivatives transactions concluded anew.

Finally, the Federal Department of Finance is currently considering revising the FMIA, namely to take into account the emergence of fintech companies and the technological developments in the sector.

Financial technology

Since 2015, FINMA has been focusing on adapting the regulatory framework to the needs of the fintech sector and put in place a special fintech desk to efficiently address key issues arising in this sector. In the past couple of years, various amendments of the BA and the Banking Ordinance have also been put forward and adopted with the aim of reducing market entry barriers for fintech firms. These regulatory amendments reflect a compromise between investor protection and the fostering of the competitiveness of the Swiss financial centre. They are based on the following three complementary pillars:

a the extension of the execution period for settlement accounts to 60 days without any limitation in terms of amounts (as opposed to the previous FINMA practice to limit the settlement deadline to seven days);

b the creation of an innovation area known as a sandbox, in which the providers of financial services are allowed to accept public deposits up to a limit of 1 million Swiss francs, coming from more than 20 investors, provided that no interest is paid on the deposits, and the investors are informed in advance that the sandbox is not subject to FINMA supervision and that the deposits are not covered by the banking deposit protection; and

c the introduction of a new category of simplified authorisation for fintech firms, the activities of which are limited to deposit-taking activities to the exclusion of lending activities involving maturity transformation. This licence entitles fintech firms to accept and hold public funds up to 100 million Swiss francs without any time limit, provided such deposits do not bear interest and are not used to fund a traditional lending business during this period of custody. To obtain a fintech licence, a firm needs to fulfil certain organisational, risk management, compliance and audit requirements, as well as client risk disclosure obligations. Capital requirements also apply: firms applying for a fintech licence have to hold a minimum (fully paid-up) capital representing at least 3 per cent of the public funds, but in any case, not less than 300,000 Swiss francs.

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The first two pillars of the fintech regime were adopted by the Federal Council on 1 August 2017. FINMA subsequently amended its Circular 2008/003 on public deposits with non-banks, which entered into force on 1 January 2018. The amended Circular specifies the sandbox regime, and provides for concrete examples with respect to the extension of the time frame applicable to settlement accounts. In this context, FINMA clarified that the settlement account exemption does not apply to cryptocurrency dealers as long as their activity is comparable to that of a foreign exchange trader.

The third pillar of the fintech regime (the fintech licence) entered into force on 1 January 2019. It is primarily aimed at fintech business models requiring the holding of deposits of more than 1 million Swiss francs for longer than 60 days, such as crowdfunding models. In December 2018, FINMA issued its guidelines for fintech licence applications, which highlight the information and documents that an applicant must submit when applying for such authorisation.

ii Future changes

New legislation on financial services and financial institutions

In November 2015, the Federal Council published two new draft laws of the FinSA and the FinIA. The objective of the draft FinIA is to provide a new legal framework governing all financial institutions, and the purpose of the draft FinSA is to regulate financial services in Switzerland, whether performed in Switzerland or on a cross-border basis. Both statutes further aim, among other things, to align the Swiss legal and regulatory framework with the relevant international standards, including the recognition of equivalence under the third-country rules provided for by MiFID II. During the debates in Parliament, the drafts initially published by the Federal Council were subject to intense discussions and were amended in various respects. On 15 June 2018, Parliament agreed on the final version of both statutes. The new legislation will enter into force on 1 January 2020, including the implementing ordinances.

The introduction of the new FinSA and FinIA will involve a number of key changes to the current Swiss regulatory framework. Financial services and institutions will be governed by a general set of regulations on the supervision of financial services, embodied in the FinSA and the FinIA, to complement FINMASA as framework laws. In particular, the following notable changes will be introduced:

a the introduction of prudential supervision over independent asset managers and trustees (not directly by FINMA, but by independent supervisory organisations approved and monitored by FINMA);

b a set of categorisation rules based on the EU concept of professional clients and private clients;

c a number of market conduct rules, including the obligation to verify the appropriateness and suitability of financial services, as well as inducements and transparency rules (integrating into the draft FinSA the most recent case law of the Swiss Supreme Court as regards the transparency and consent requirements for a financial institution to keep trailer fees);

d the obligation for Swiss and foreign client advisers (i.e., individuals acting for financial services providers) to register in a register as a prerequisite to providing financial services in Switzerland; and

e uniform prospectus rules that generally apply to all securities offered publicly into or in Switzerland.

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VIII OUTLOOK AND CONCLUSIONS

The 2008 financial crisis brought up many regulatory topics that have been examined by the supervisory authority and extensively discussed within the banking industry, such as the effects of a high density of regulations for certain sectors, and governmental influence on and support of financial institutions. In general, FINMA has been more active and interventionist in recent years, in particular with the two largest Swiss banks, Credit Suisse AG and UBS AG. In line with international developments and discussions, as measures that aim to refine and strengthen capital adequacy and liquidity requirements have been formally enacted, FINMA continues to focus more closely on systemic risk issues. The Swiss regulatory framework is further progressively converging from a principle-based to a rule-based approach, with a particular focus on systemically important financial institutions, in accordance with FINMA's risk-based approach.

In November 2016, FINMA published its strategic goals and priorities for the period 2017 to 2020. These reflect current and future challenges in financial regulation and supervisory trends, and include:

a ensuring that banks and insurance companies have strong capitalisation;
b mitigating the too big to fail issue through viable emergency plans and credible resolution strategies;
c contributing to the protection of creditors, investors and insured persons through accompanying structural change in the financial industry;
d promoting the removal of unnecessary regulatory obstacles for innovative business models;
e providing for principle-based financial market regulation and promoting equivalence with relevant international requirements; and
f keeping the cost of supervision stable and achieving further efficiency gains.

In addition, in recent years, FINMA has continuously increased its enforcement action and, consequently, the resources dedicated to it. While FINMA's enforcement practice generally remains focused on financial entities, the regulator has increased its targeted actions against individuals responsible for serious violations of supervisory law with, as the case may be, a professional ban imposed on such individuals, and publication of the relevant decisions.

One of the main regulatory challenges in future years is likely to be the implementation of the new legislation on financial services and financial institutions (see Section VII.ii), which represents a complete overhaul of the framework applicable to financial institutions and to the provision of financial services in Switzerland. The growth of the Swiss fintech sector and the continued emergence of innovative business models will undoubtedly also represent an important challenge for both the Swiss legislator and regulator in the years to come.

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Chapter 37

UNITED ARAB EMIRATES

Amjad Ali Khan, Stuart Walker and Adite Aloke[1]

I INTRODUCTION

The United Arab Emirates, and in particular Dubai, have in recent years developed as the key financial hub of the Middle East, and is fast becoming one of the leading financial centres in the world.

There are essentially three broad categories of banks in the UAE: commercial banks, Islamic banks and foreign banks, all licensed and regulated by the UAE Central Bank. Based on the total assets at the end of the third quarter of 2018, the five largest banks in the UAE are:[2]

a First Abu Dhabi Bank;
b Emirates NBD;
c Abu Dhabi Commercial Bank;
d Dubai Islamic Bank; and
e Mashreq Bank.

In 2018, the UAE's banking sector maintained a steady growth of assets, improved profitability and asset quality, and according to bankers, rating agencies and banking sector analysts is expected to deliver a similar performance in 2019.[3]

II THE REGULATORY REGIME APPLICABLE TO BANKS

i UAE

The regulatory framework for banking in the UAE is based on the Banking Law.[4] The Banking Law came into force on 30 September 2018 and repealed the previous banking law, Federal Law No. 10 of 1980. Under the Banking Law, the Central Bank of the UAE was created and entrusted with the issuance and management of the country's currency, and the regulation of

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2 https://www.alvarezandmarsal.com/sites/default/files/uae_banking_pulse_q3_2018_final.pdf.

3 https://gulfnews.com/business/banking/uaes-banking-sector-profitability-to-remain-strong-in-2019-1.61120149.

4 Federal Law No. 14 of 2018 concerning the Central Bank, and Organisation of Financial Institutions and Banking.

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the banking and financial sectors. The Banking Law provides for the licensing and regulation by the Central Bank of:

a banks, which are defined to include institutions licensed to primarily carry on the activity of accepting deposits and other licensed financial activities such as granting loans, issuing and collecting cheques, placing bonds, trading in foreign exchange and precious metals, or carrying on other operations allowed by law or by customary banking practice;

b exchange houses and money intermediaries (i.e., foreign exchange dealers who purchase and sell currencies);

c Islamic financial institutions, which are defined as financial institutions licensed to undertake all the activities of a commercial bank, but in accordance with the principles of Islamic *shariah*; and

d other financial institutions.

The Banking Law does not apply to statutory public credit institutions, governmental investment institutions, and development funds, private savings and pension funds, or to the insurance sector. It also does not apply to the free zones or financial institutions established therein. The Central Bank does, however, have the right to exercise its powers over financial institutions outside the UAE or in free zones after consulting the relevant authority.

The Banking Law has introduced several changes to the previous regime. Some of the key changes are:

a Federal Law No. 10 of 1980 Concerning the Central Bank, the Monetary System and the Organisation of Banking and Federal Law No. 6 of 1985 Concerning Islamic Banks, Financial Establishments and Investment Companies have been repealed. All existing Central Bank regulations, circulars and decisions issued under these repealed laws will remain in force for a period of three years, unless replaced by new regulations, circulars and decisions;

b licensed financial institutions are now prohibited from charging customers interest on accrued interest charged on any credit or funding facilities;

c the establishment of a Financial Activities Committee under the Ministry of Finance (composed of a member from each of the Central Bank, the Emirates Securities and Commodities Authority and the Insurance Authority) has been contemplated to opine on the introduction of new financial activities within the purview of the Banking Law;

d provisions pertaining to mergers of licensed financial institutions have been introduced;

e provisions pertaining to governance, financial infrastructure system oversight and maintenance of customer confidentiality have been introduced;

f provisions concerning credit control within banks (including restrictions on loans to management) have been introduced; and

g the Central Bank's enforcement powers have been strengthened by granting it authority to impose a wider range of penalties.

While the Central Bank is the principal regulatory authority of banks and financial institutions in the UAE, all such entities are also subject to additional registration and licensing requirements at the federal and emirate levels.

All commercial banks incorporated in the UAE must be established as public shareholding companies, and must be majority-owned by UAE nationals. A majority of directors of such companies must be UAE nationals. The minimum UAE national shareholding requirement

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for finance companies, banks and exchange houses is 60 per cent. Unlike branches of foreign companies in the UAE, foreign banks are not required to appoint a national agent in order to establish a branch in the UAE.

In recent years, only banks incorporated in Member States of the Gulf Cooperation Council (GCC) have been allowed to establish branches. GCC banks have also been allowed to acquire controlling stakes in UAE banks and financial institutions. A few non-GCC banks were issued wholesale banking licences in 2014 and 2015.

The number of UAE banks reduced by one to 21 as the result of a merger between the First Gulf Bank and the National Bank of Abu Dhabi. Discussions are also ongoing between Abu Dhabi Commercial Bank, Union National Bank and Al Hilal Bank in relation to a potential three-way merger. The number of foreign banks registered in the UAE remained unchanged at 26.

The principal difference in the treatment of local and foreign commercial banks is that local banks are not subject to any taxation on their income, whereas foreign banks are subject to tax at the emirate level.

Non-resident banks can grant bilateral credit facilities and participate in syndications in the UAE. They are not deemed to be resident, domiciled or carrying on business in the UAE, and are not liable to pay tax in the UAE merely on account of such bilateral facilities or participation in syndications. All licensed financial institutions are required under the Banking Law to maintain the confidentiality of all customer data and information.

ii Emirates Securities and Commodities Authority

The Emirates Securities and Commodities Authority (SCA) regulates the securities markets in the UAE. All UAE banks are listed in one of the two onshore markets, the Abu Dhabi Exchange and the Dubai Financial Market. The SCA licenses all brokers, consultants and custodians who provide services related to listed securities. The Investment Funds Regulation issued by the SCA in July 2013 transferred regulatory responsibility for the licensing and marketing of investment funds, and for a number of related activities, from the Central Bank to the SCA. The sale, marketing and promotion of foreign securities and funds in the UAE and the establishment of domestic funds require the approval of the SCA. This requirement has been further clarified and established under SCA Board of Directors Decision No. 3 of 2017 on the Regulation of Promotion and Arranging Activities.

iii Dubai International Financial Centre

The Dubai Financial Services Authority (DFSA) has adopted a regulatory approach modelled, at least in part, on the former Financial Services Authority in the United Kingdom. The DFSA does not grant banking licences *per se*; rather, it authorises financial service providers to undertake specific financial services. The relevant financial services in respect of banks include providing credit and accepting deposits. There are about 450 financial services firms with a presence in the Dubai International Financial Centre (DIFC). Of these, a substantial number of institutions do not have authority to accept deposits. This reluctance on the part of various institutions to be a 'true' bank can be traced back to two causes:

a DIFC entities were historically not able to deal with retail customers. This restriction was lifted several years ago, but the business model of the vast majority of institutions within the DIFC has been to focus on corporate clients or high-net-worth individuals; and

b banks have been reluctant to apply for authorisation to accept deposits because they remain unable to deal in dirhams or accept deposits from the UAE markets.

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Most of the banks that have set up in the DIFC have done so as branches of overseas companies; this has been done for capital adequacy reasons. Recently, however, it has been the policy of the DFSA to encourage banks to incorporate new subsidiaries within the DIFC and capitalise those subsidiaries to an acceptable level.

iv Abu Dhabi Global Market

Following the success of the DIFC, a new financial free zone, the Abu Dhabi Global Market (ADGM), was set up in Abu Dhabi and became operational in the second half of 2015. The financial services regulatory framework for the ADGM aims to reflect current international best practices by assimilating the key aspects of other regulatory regimes across the world. The ADGM has its own regulator, the Financial Services Regulatory Authority (FSRA). Like the DFSA, the FSRA does not grant banking licences *per se*. Banks licensed in the ADGM are prohibited from accepting deposits from the UAE market, and may not accept deposits or undertake foreign exchange transactions involving UAE dirhams.

v US Foreign Account Tax Compliance Act

The UAE and the United States reached an agreement in substance in May 2014 to include the UAE on the list of jurisdictions to be treated as having an intergovernmental agreement in effect in relation to the US Foreign Account Tax Compliance Act (FATCA). The UAE has adopted Model 1. Banks and financial institutions now routinely comply with FATCA requirements.

vi Common Reporting Standard

The UAE Cabinet has approved the agreement on mutual administrative assistance in tax matters and the multilateral competent authority agreement by way of Cabinet Resolution No. 9 of 2016. Thus, the Common Reporting Standard (CRS) of the Organisation for Economic Co-operation and Development (OECD) has been effective in the UAE since 1 January 2017 to implement the automatic exchange of information about financial accounts. The International Financial Reporting Standard 9 is required to be complied with by banks and financial institutions in the UAE. As of 1 January 2019, the new International Financial Reporting Standard 16 (which applies to leases and replaces the IAS17 standard) has also become effective.

vii OECD

The UAE has implemented the standards of joint disclosures and the exchange of information for tax purposes set out by the G20 and the OECD. This follows the UAE Cabinet's decision requiring the Ministry of Finance to coordinate with various government authorities to collect financial information to implement information exchanges for tax purposes. The CRS calls on jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions annually. Banks and financial institutions started collecting the required financial data as of 1 January 2017.

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III PRUDENTIAL REGULATION

i UAE

The Central Bank has issued regulations on a whole range of issues and ensures compliance with those regulations on the basis of a bank–examiner-type approach.

In a significant development, the Central Bank issued Circular No. 52 of 2017, which came into effect on 1 February 2017, on capital adequacy norms by way of the phased implementation of Basel III. Article 2 of the regulations explains the quantitative requirements and states that the total regulatory capital comprises the sum of two tiers, where Tier 1 capital is composed of a Common Equity Tier 1 (CET1) and an additional Tier 1. Banks must comply with the following minimum requirements at all times: CET1 must be at least 7 per cent of risk-weighted assets (RWA); Tier 1 capital must be at least 8.5 per cent of RWA; and total capital, calculated as the sum of Tier 1 capital and Tier 2 capital, must be at least 10.5 per cent of RWA. The full implementation of the regulations was effective from 1 January 2018.

Circular No. 16/93 issued by the Central Bank governed large exposures incurred by banks. Large exposures were funded exposures. Banks were restricted from exceeding the maximum exposure per client or group. Circular No. 32/2013 was issued by the Central Bank in November 2013 to replace Circular No. 16/93. Now large exposures include funded and unfunded exposures and unutilised committed lines. Revised restrictions have been imposed with regard to lending to government and government-owned entities. Banks cannot lend sums exceeding 100 per cent of their capital to governments and their related companies, or more than 25 per cent to an individual borrower. The rules also prescribe the manner in which different categories of assets are to be risk-weighted. Circular No. 32/2013 allows banks five years within which to bring their exposure within the prescribed limits. Given the current banking situation, the deadline is likely to be extended.

In 2012, a circular was issued by the Central Bank to restrict mortgage loans to expatriates to 50 per cent of the value of a first home and 40 per cent of the value of a second home. Loans to UAE nationals were capped at 70 per cent of the value of their first home and 60 per cent of their second home. At the request of the banks, the circular was reconsidered by the Central Bank and reissued in October 2013. As reissued, the mortgage caps have been revised, and banks are now permitted to grant mortgage loans to expatriates of up to 75 per cent of the value of a first home and up to 60 per cent of the value of a second. Loans to UAE nationals are capped at 80 per cent of the value of their first home and up to 65 per cent of the value of the second. If the value of the first home exceeds 5 million dirhams, the mortgage loan cap applicable to an expatriate and a UAE national is 65 and 70 per cent, respectively.

ii DIFC

Relationship with the prudential regulator

Firms authorised by the DFSA are required to notify the DFSA of all matters that could reasonably be expected to be notified to the DFSA. There are quarterly reporting requirements in respect of capital adequacy. The DFSA regularly conducts themed reviews. Previous reviews have focused on the prevention of money laundering and terrorism financing. The DFSA has also focused on authorised firms' compliance with restrictions imposed on dealing with Iranian counterparties arising from the UN sanctions relating to non-nuclear proliferation and political exposed persons. Recent reviews have also looked at client take-on processes and suitability assessments.

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Management of banks

The DFSA requires all financial institutions active in the DIFC to have adequate systems and controls in place to ensure that they are properly managed. There are a number of mandatory appointments (senior executive officer, chief financial officer, etc.). Individuals holding these mandatory positions are subject to prior clearance by the DFSA. The DFSA does not impose any requirements or make any restrictions in respect of bonus payments to management and employees of banking groups.

Regulatory capital

Those firms holding authorisations to accept deposits and provide credit fall into prudential category 1 (being the highest of categories 1 to 5). Category 1 firms have a base capital requirement of US$10 million. The actual capital requirement may be significantly higher, depending upon the volume of business being conducted and other factors set out in the DFSA Rulebook. As previously mentioned, historically most banking groups established branches in the DIFC and were able to obtain waivers of the capital adequacy requirements on that basis: in short, they looked to their head office balance sheet as support for their DIFC functions. This approach is becoming less and less acceptable to the DFSA, particularly for smaller financial institutions coming from jurisdictions other than Tier I jurisdictions.

In line with the revised rules outlined for Basel III implementation, DFSA revised the Prudential Investment Business Module of the DFSA Rulebook in 2018. This introduced changes to minimum capital requirements, new capital buffers, leverage and liquidity coverage ratios, and disclosure and monitoring requirements.

iii ADGM

The Prudential – Investments, Insurance Intermediation and Banking Rules have been promulgated by the FSRA. Regulated firms are classified into five categories, primarily on the basis of the activities for which they are authorised. Banking activities, including taking deposits, fall into category 1, and attract stricter requirements such as a base capital requirement of US$10 million. Firms that are authorised to deal in investments as principal or provide credit but that cannot accept deposits fall under category 2, with a base capital requirement of US$2 million. These rules were revised by the ADGM in 2018 for the purposes of compliance with Basel III.

IV CONDUCT OF BUSINESS

i UAE

Local banks have a board of directors, a chief executive, a number of board committees and senior executives. There is currently no regulation of bonus payments to management; bonus payments have, however, not been of a magnitude that requires regulation.

UAE banks are all publicly listed companies, and must comply with the Central Bank, UAE companies and SCA laws, all of which, inter alia, regulate management.

There is currently little or no regulation of bank holding companies or subsidiaries.

Banks are required to publish quarterly audited accounts, and to have their annual audited accounts approved by the Central Bank before they are published. Banks are required to obtain prior approval from the Central Bank for changes in directors, senior management, shareholders (holding more than 5 per cent equity), constitutional documents and capital.

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The Banking Law, along with various circulars and notices issued from time to time by the Central Bank, govern the conduct of business by banks in the UAE. The Banking Law lists various administrative and financial sanctions that may be imposed on banks as well as individuals for breach of provisions of law, regulations, decisions, rules, standards and instructions issued by the Central Bank. Accordingly, a bank may be subject to civil or regulatory liability under the Banking Law. There may also be occasions where a bank may be exposed to criminal liability under the UAE Federal Penal Code.

In a significant development, the New Companies Law[5] came into force on 1 July 2015, replacing Federal Law No. 8 of 1984, the previous companies law of the UAE. Under the New Companies Law, neither a company nor any of its subsidiaries can give financial assistance to any person to subscribe to its shares, bonds or *sukuk*. The term financial assistance extends to giving loans or gifts, or providing any securities or guarantees. This is likely to have a significant impact on acquisition finance transactions in the UAE. In a positive development, a mortgage of shares of UAE companies is recognised as a registrable security under the New Companies Law.

The New Companies Law also empowers the SCA to regulate the listing of public companies.

Dubai Law No. 31 of 2016 imposes restrictions on the registration of mortgages of granted or gifted land in the emirate of Dubai.

ii Value added tax

In a significant development, value added tax (VAT) was introduced in the UAE from 1 January 2018. VAT is charged at a rate of 5 per cent for goods and services (unless exempted or zero-rated). Interest-bearing banking transactions are zero-rated, whereas transaction fees and margin-based transactions attract VAT at the rate of 5 per cent. For the purposes of VAT, Islamic banking products are treated at par with conventional banking products. This development has marginally increased the cost of banking for customers.

iii DIFC

The DFSA Rulebook contains a detailed conduct of business module. The Rulebook is essentially a principle-based system:[6] for example, principle 1 (integrity) states that an authorised firm must observe high standards of integrity and fair dealing, while Principle 5 (marketing conduct) states that an authorised firm must observe proper standards of conduct in financial markets. There are 12 principles, the final two being 'compliance with high standards of corporate governance', which states that an authorised firm must meet the applicable standards of corporate governance as appropriate to the nature, size and complexity of the authorised firm's activities; and 'remuneration practices', which states that authorised firms must have remuneration structures and strategies that are well aligned with the long-term interests of the firm, and that are appropriate to the nature, scale and complexity of its business. A bank operating in the DIFC will be subject to civil liability under the various DIFC laws; and to regulatory liability in respect of the applicable DIFC laws, such as the Market Law and the Regulatory Law, plus the provisions of the DFSA

5 Federal Law No. 2 of 2015.

6 Note that the principles are set out in the general module of the Rulebook, not the conduct of business module.

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Rulebook. Depending on the relevant customer documentation, a bank in the DIFC may also be exposed to civil liability under the laws of the UAE outside the DIFC. Finally, there may be occasions when a bank in the DIFC would be exposed to criminal liability (i.e., under the UAE Federal Penal Code).

iv ADGM

The FSRA promulgated the Code of Business Rulebook (COBS), which must be followed by regulated firms operating in the ADGM. The COBS describes the standard of business and client treatment obligations of these entities. The COBS consists of 16 chapters of various rules and regulations.

V FUNDING

i UAE

Under the Banking Law, commercial and investment banks must have a minimum paid-up capital. All foreign banks are required to allocate capital for their UAE operations. At least 10 per cent of the annual net profits of banks is required to be allocated to a special reserve until that reserve equals 50 per cent of the bank's paid-up capital or, in the case of a foreign bank, the amount allocated as capital for its UAE operations.

ii DIFC

There is no central bank or equivalent within the DIFC; therefore, banks registered within the DIFC must fund their activities through support from other branches of their international operations or debt issuance programmes of their own. As previously mentioned, deposit-taking is not a significant source of funding for any institution in the DIFC.

iii ADGM

The analysis set out above in relation to the DIFC is also valid for the ADGM.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i UAE

There is no specific definition of control (except in relation to the determination of large exposures). Control is generally viewed as a majority shareholding interest or a right to appoint the majority of the board of directors of a bank, or both. Any change in control requires the prior approval of the Central Bank.

A transfer of customer relationships (e.g., deposits, loans, credit cards, accounts, investment products) generally requires customer consent. There is no statutory mechanism for the transfer of such relationships. In recent acquisition activities, customer consent has been assumed on the basis of the provision of information regarding such acquisition activities to the customer, as well as correspondence by both the acquiring and the selling parties to the customer and the customer's failure to object.

ii DIFC

Any material change of control in a DFSA-authorised firm requires prior approval from the DFSA.

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The DFSA Rulebook does not include detailed provisions regarding the methods by which banks may transfer all or part of their business (comprising deposits, and possibly loan agreements and other assets) to another entity without the consent of the customers concerned. The ability of an institution to do this would be governed by the assignment clauses in their contractual documentation as interpreted in accordance with the DIFC Contract Law. Further, any such material transfer would also require the consent and approval of the DFSA.

iii ADGM

Change of control provisions are set out in the Financial Services and Markets Regulations (FSMR) issued by the FSRA. Any material change of control in an ADGM-regulated firm requires prior approval from the FSRA. Part 10 of the FSMR deals with changes in control.

VII THE YEAR IN REVIEW

i UAE

The following developments were observed in the UAE in the past year:

a the Banking Law was enacted as the new law regulating financial services within the UAE and operations of the Central Bank, repealing the previous Federal Law No. 10 of 1980 and Federal Law No. 6 of 1985;

b VAT came into effect in the UAE;

c the implementation of Basel III was ongoing in the UAE (including in the DIFC and the ADGM);

d Abu Dhabi Commercial Bank, Union National Bank and Al Hilal Bank commenced discussions in relation to a potential three-way merger;

e the impact of the cryptocurrency industry continued to be felt. These are still nascent days for these rather boundary-less currencies, and the Central Bank is rather apprehensive about bitcoin and other cryptocurrencies; and

f Qatari shareholders of UAE banks are considering the sale of their shareholding following the recent breakdown in relations between the two countries.

ii SCA

The SCA saw the following developments in the past year:

a in May 2018, the SCA issued Decision of the Chairman of the SCA Board of Directors No. (22/R.M) of 2018 Concerning Regulation of Derivative Contracts, which introduces, inter alia, mandatory reporting of derivative contracts;

b in July 2018, the SCA approved a plan to regulate initial coin offerings and recognise digital tokens as securities; and

c in response to rapid advances in the fintech sector and the constant emergence of new innovative financial services and products, in September 2018, the SCA also issued Decision of the Chairman of the SCA Board of Directors No. (28/Chairman) of 2018 Approving the Fintech Regulatory Framework to define a framework to operate and manage the testing environment for innovative financial services and products.

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iii DIFC

The DIFC further consolidated its position as the regional financial hub in the past year.

iv ADGM

The ADGM has made substantial developments in terms of issuing licences to new entities in the past year.

It further launched its framework to regulate cryptoasset activities conducted in or from the ADGM.

VIII OUTLOOK AND CONCLUSIONS

2018 was a year of many developments, and we expect that trend to continue in 2019.

Reports suggest that the merger of Abu Dhabi Commercial Bank, Union National Bank and Al Hilal Bank (expected to be implemented in 2019) will establish a bank with combined assets of nearly US$115 billion, making it the fifth-largest bank in the Middle East and North Africa region.

The final phase of implementation of Basel III (as per the central rules regulating the capital adequacy of banks operating in the UAE) will occur in 2019.

In September 2018, the FSRA issued a consultation paper (and invited comments) on proposed bank recovery and resolution regulations to address the risks posed by the failure of any bank or significant financial institution, or of a member of its financial group in the ADGM. A new regime for ADGM financial institutions facing financial difficulties can be expected in 2019.

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Chapter 38

UNITED KINGDOM

Jan Putnis, Nick Bonsall and David Shone[1]

I INTRODUCTION

More than a decade has now passed since the onset of the financial crisis, but while the existential threat posed by that crisis may have been averted, UK banks and their groups continue to operate in a challenging regulatory and business landscape.

Recent years have seen the introduction of a wide rage of legislation relating to capital adequacy, conduct and individual accountability, while the regulators established in the wake of the financial crisis (the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA)) have proved themselves both ready and able to enforce the new regime.

Ultimately, the UK's impending withdrawal from the European Union (Brexit) poses the most significant post-crisis challenge for the UK banking sector. Lingering uncertainty as to the final outcome of Brexit negotiations between the UK and remaining EU Member States (EU27) means that many banks have already completed contingency planning arrangements based on worst-case assumptions, notwithstanding any more palatable arrangement that may ultimately be reached with the EU. Much of the regulatory framework applicable to UK banks derives from EU legislation. While this will initially be incorporated into the UK domestic framework following Brexit, the direction of travel of UK and EU financial services legislation thereafter remains to be seen.

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

II THE REGULATORY REGIME APPLICABLE TO BANKS

i The UK regulatory framework for banks

Regulatory and supervisory responsibility for UK banks is divided principally between the Bank of England (in its capacity as the PRA) and the FCA. The Bank of England exercises its role as the PRA through its Prudential Regulation Committee, while its Financial Policy Committee (FPC) has a macroprudential mandate to identify imbalances, risks and

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2 The five largest UK banking groups ranked by market capitalisation as at 23 April 2019.

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vulnerabilities in the UK financial system, and can direct the PRA and the FCA to take certain actions to mitigate those risks. The Bank of England also acts as the UK's resolution authority for banks, building societies and certain investment firms.

The authority of the PRA and the FCA derives from the Financial Services and Markets Act 2000 (as amended) (FSMA). The FSMA sets out objectives for each regulator and requires each regulator to exercise its powers in a manner that it considers will advance those objectives.

The PRA

The PRA is the prudential regulator of all UK banks and building societies, insurance companies and certain investment firms. The conduct of business of PRA-authorised firms is regulated by the FCA, and these firms are therefore referred to as dual-regulated.

Under the FSMA, it is a criminal offence for a person to engage in regulated activities by way of business in the United Kingdom unless authorised (an authorised person) or exempt from the authorisation requirement. Regulated activities are prescribed in secondary legislation made under the FSMA.[3] Accepting deposits is a regulated activity where such deposits are lent to third parties or where any other activity is financed wholly or to a material extent out of capital or interest on deposits. The regulated activity of accepting deposits is specified for the purposes of the Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order 2013 (PRA Order); consequently, firms that wish to carry on deposit-taking activities (i.e., prospective banks and building societies) are required to seek authorisation to do so from the PRA.

An application to the PRA for authorisation must cover all regulated activities that the applicant wishes to carry on, regardless of whether those activities are specified in the PRA Order. The PRA is required to obtain consent from the FCA before granting any authorisation. The FCA is fully involved in the authorisation process for such firms, and may request information from, or ask questions of, the applicant.

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

The PRA's general objective is to promote the safety and soundness of the firms it regulates. The PRA is required to advance this objective by seeking to ensure that the business of PRA-authorised firms is carried on in a way that avoids any adverse effect on the stability of the UK financial system, and by seeking to minimise the adverse effect that the failure of a PRA-authorised firm could be expected to have on the stability of the UK financial system. The second element of this objective reflects the principle that the PRA does not operate on a zero-failure basis: a core aspect of the PRA's approach to banking supervision is its focus on

3 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended) (SI 2001/544) and the Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order 2013 (as amended) (SI 2013/556). The latter specifies the regulated activities that, if carried on, bring a firm within the regulatory purview of the PRA.

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the establishment, maintenance and implementation of appropriate recovery and resolution arrangements. Since 1 January 2019, the PRA has had specific responsibilities relating to ring-fenced bodies and ring-fencing requirements when advancing its general objective. The PRA also has a specific insurance objective and a secondary competition objective.

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

The PRA has adopted a set of Fundamental Rules, which are a series of high-level prudential principles that underpin the PRA's regulatory approach to the firms it regulates. These focus on certain matters relating to governance, integrity, resolvability and financial resources. The Fundamental Rules are drafted as clear statements of principle, and include statements that 'a firm must at all times maintain adequate financial resources' and 'a firm must deal with its regulators in an open and cooperative way and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice'.

Consistent with its judgment-led approach to supervision, the PRA's supervisory approach focuses on the most significant risks to its statutory objectives. The PRA draws on a broad set of information and data in forming supervisory judgments and relies on banks – and other firms that it regulates – to submit that information and data. Periodically, the PRA may validate data though on-site inspections conducted either by its own supervisory staff or by third parties. To support its information-gathering and analysis, the PRA requires firms to participate in meetings with supervisory staff at senior and working levels.

The FCA

The FCA is responsible for the regulation of conduct of business at all authorised firms in the United Kingdom (including banks and other PRA-authorised firms) and the conduct of business in respect of wholesale and retail financial markets and market infrastructure. The FCA is also responsible for the prudential supervision of firms that are not subject to prudential regulation by the PRA, which may include banks' subsidiaries or other entities within banking groups, such as dedicated consumer credit lenders and investment firms. Firms subject to both prudential and conduct of business regulation by the FCA are not dual-regulated, and therefore only need to seek authorisation from the FCA to carry on regulated activities.

Under the FSMA, the FCA has a strategic objective to ensure that markets for financial services in the United Kingdom function well. This is supported by three operational objectives: consumer protection, enhancing the integrity of the market and promoting competition.

When pursuing its consumer protection objective, the FCA must have regard to consumers' need for timely information and advice that is accurate and fit for purpose, and whether firms are providing an appropriate level of care to consumers, among other factors. The FCA has various powers to further its consumer protection objectives, including powers to introduce product intervention rules (pursuant to which it can ban the sale or distribution of certain products), to require the withdrawal of misleading financial promotions, and to publicise the issue of a warning notice (a stage in an FCA regulatory investigation prior to any finding of guilt or wrongdoing).

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The FCA uses its supervisory and enforcement work, thematic reviews and market studies to further its objectives. The FCA also has competition powers relating to the financial services sector that are concurrent with those of the Competition and Markets Authority (CMA). The FCA's competition powers permit it to investigate the performance of any market for financial services under the Enterprise Act 2002, and investigate and enforce against any breach of the Competition Act 1998 in financial services. In addition to the specific competition objective described above, the FCA is also subject to a general duty to promote effective competition in the interests of consumers, and may use its general powers under the FSMA to do so.

The FCA has the power under the FSMA to make rules that apply to all regulated firms, and to issue related guidance with respect to the carrying on of regulated activities and other unregulated business activities carried on by regulated firms. The FCA may, however, only make such rules as it considers necessary or expedient for the purpose of advancing one or more of its operational objectives. Like the PRA's Fundamental Rules, the FCA's Principles for Businesses set out high-level requirements that apply to the firms it regulates. One key principle is that a firm must pay due regard to the interests of its customers and treat them fairly.

The Bank of England

Alongside its roles as a microprudential regulator (exercised in its capacity as the PRA) and as the central bank of the UK, the Bank of England has specific regulatory functions relating to financial stability. In particular, it is the body responsible for the enforcement of the special resolution regime introduced by the Banking Act 2009 (see further Section III.vii) and, acting through the FPC, has the macroprudential objective of protecting and enhancing financial stability and the resilience of the UK financial system. The FPC does this by monitoring threats and taking action where necessary to address any perceived or identified vulnerabilities and imbalances in the UK financial system. The FPC has the power to issue macroprudential recommendations and directions to the PRA and the FCA. It does not, however, have the power to exert control over, or issue directions to, individual firms.

ii Management of banks

The Financial Services (Banking Reform) Act 2013 (Banking Reform Act) introduced amendments to the FSMA that have established an enhanced regulatory framework for individuals performing certain functions at UK banks or, in certain circumstances, UK branches of foreign banks. These reforms were primarily intended to enhance individual accountability in the banking sector and to address concerns that continuing responsibilities of senior bankers were inadequately defined. This section provides an overview of this framework, which includes a senior managers regime (which replaced the approved persons regime for banks), a certification regime (applying to other bank staff in positions where they could pose a risk of significant harm to the firm or its customers) and a set of conduct rules (which replaced the previous Statements of Principle and Code of Practice for Approved Persons) enforceable by either the PRA or the FCA. This framework, which originally only applied to UK banks and PRA-designated investment firms, was extended to cover insurers with effect from 10 December 2018, and will be extended to apply to FCA-authorised firms with effect from 9 December 2019 (subject to certain transitional measures).

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Senior managers regime

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

There are currently 30 specified senior management functions (SMFs), each of which is labelled with an SMF number. Some of these functions relate to insurance undertakings only, and not all SMFs will therefore be relevant to banks and their groups. Banks are required to allocate overall responsibility for each of their activities, business areas and management functions to a person approved to perform a senior management function. If a person responsible for an activity, business area or management function that does not have a designated SMF number is not already approved to perform another senior management function, that person must be approved to perform the 'other overall responsibility' function.

Certain non-executive directors (NEDs) also require pre-approval as senior managers, including the chair, senior independent director and chairs of the risk, audit, remuneration and nominations committees. Other NEDs (termed notified or standard NEDs) fall outside the scope of the senior managers and certification regime, but are subject to certain FCA conduct rules (see below). The regulators also retain the ability to prohibit notified NEDs from carrying out their roles.

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

The PRA and FCA also specify certain prescribed responsibilities, which banks must allocate to individuals holding senior management functions. This is designed to ensure that there is individual accountability for the fundamental responsibility inherent in a particular function. Certain prescribed responsibilities are designed to be assigned to executives, while others reflect non-executive roles. Not all of the prescribed responsibilities will be relevant to all firms – for example, certain prescribed responsibilities apply only in specific circumstances (such as where a bank carries out proprietary trading or where a bank is ring-fenced). In general, each prescribed responsibility should be allocated to one individual, although the regulators have recognised that the sharing of responsibilities may be necessary in limited circumstances (e.g., where departing and incoming senior managers work together temporarily as part of a handover).

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

Qualifications for approval: fitness and propriety

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

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

Duty of responsibility

The senior managers regime is designed to increase individual accountability and is supported by a duty of responsibility, which allows the PRA or the FCA to bring a misconduct claim against the accountable senior manager if the authorised firm has contravened a relevant requirement. Broadly, the PRA or the FCA, or both, must show in any misconduct claim against an individual that the senior manager with the relevant responsibility did not take such steps as a person in the senior manager's position could reasonably have been expected to take to avoid the contravention occurring. The burden of proof lies on the regulator. Both regulators have produced guidance on the factors they will consider when addressing the duty of responsibility. Where the FCA or the PRA finds that a senior manager is in breach, it may suspend or limit the senior manager's approval, impose a penalty, impose conditions on the individual's approval or publish a statement of misconduct.

Certification regime

The certification regime applies to individuals employed in positions where they could pose a risk of significant harm to a firm or its customers. Neither the PRA nor the FCA pre-approves these individuals, but banks are required to certify that the individuals are fit and proper for their roles, both at the point of recruitment and thereafter (at least annually). If it believes that an individual within the scope of the regime fails to meet the requisite standards, a bank must refuse to renew that individual's certificate of fitness and propriety.

Conduct rules

The FCA and the PRA have each issued conduct rules that apply to those subject to the senior managers and certification regimes. The FCA's conduct rules apply to all individuals approved as senior managers or covered by the certification regimes, as well as notified NEDs and all other employees (other than certain ancillary staff who perform a role that is not specific to the financial service business of the firm). The PRA's conduct rules apply to individuals approved as senior managers or covered by the certification regime, and to notified NEDs.

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

Both the FCA's and the PRA's conduct rules are in two tiers: those that apply to all individuals within the scope of the conduct rules (individual conduct rules) and those that apply only to senior managers (senior management conduct rules). The latter include the requirement to disclose to the regulators any information of which they would reasonably expect notice and to take reasonable steps to delegate responsibilities and oversee the delegation

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of responsibilities to an appropriate individual. In addition to the individual conduct rules, notified NEDs are subject to the senior management conduct rule requiring them to disclose to the regulators any information of which the regulators would reasonably expect notice.

Relevant individuals who fail to comply with a conduct rule, or who are knowingly involved in a contravention by an authorised firm of any requirement imposed on it by or under the FSMA, or FCA or PRA rules, may be fined or publicly censured, or both. Both regulators have the power to discipline an approved senior manager who has breached a conduct rule that it has issued, irrespective of whether it has approved the individual. Both regulators also have the power to withdraw approval from individuals or to issue a general or specific prohibition order prohibiting an approved person from carrying on any senior management function, or both.

Reckless misconduct in the management of a bank

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

a made, or agreed to the making of, a decision by or on behalf of the bank or investment firm as to the way in which the business of the financial institution, or another financial institution in its group, was to be carried on, or that individual failed to take steps that he or she could take to prevent such a decision being taken;

b at the time of the decision, the individual was aware of a risk that the implementation of the decision could cause the failure of the relevant financial institution;

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

d the implementation of the decision caused the failure of the relevant financial institution.

The offence has been in force since 7 March 2016, and applies to any decision made on or after that date that causes a financial institution to fail.

III PRUDENTIAL REGULATION

i Regulatory capital

Many of the detailed rules regarding the application of prudential supervision by competent authorities and in relation to regulatory capital adequacy are contained within the EU Capital Requirements Regulation[4] (CRR) and the Capital Requirements Directive[5] (CRD), together referred to as CRD IV (for further information, see the European Union chapter). The CRR is, at present, directly applicable in the United Kingdom and, accordingly, the PRA has not made rules to implement its provisions, except in relation to certain discretions afforded. The CRD, as an EU directive, is not directly applicable and has been implemented by means of legislation and regulatory rules adopted in the UK. It should be noted that the

4 Regulation (EU) No. 575/2013.

5 Directive 2013/36/EU.

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European Parliament has adopted, and the Council of the EU is (at the time of writing) soon expected to adopt, a directive amending the CRD and a regulation amending the CRR, a package commonly referred to as CRD V, later in 2019. If adopted in its current form, CRD V would entail significant changes to the regulatory capital and liquidity requirements that apply to UK banks. For the reasons set out in subsection i of Section VIII of this chapter, it is anticipated that once adopted by both the European Parliament and the Council of the EU, CRD V will be adopted or implemented (as applicable) in the UK regardless of the outcome of Brexit.

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

The rules on market risk apply to trading activity where the bank's purpose is to make a profit, or avoid a loss, from short-term changes in market prices (i.e., proprietary trading). Such trading positions constitute the bank's trading book. A building block approach applies, whereby capital must be held against specific risks (e.g., position risk, counterparty risk, foreign exchange risk and commodities risk). Transactions giving rise to more than one risk category may trigger several different capital charges. Banks can (with PRA approval) use a market risk internal model to calculate their capital requirements for market risk.

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

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

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

ii Types of capital

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

a UK banks are required under the CRR to hold base regulatory capital of at least 8 per cent of the total risk exposure amount (which takes account of exposures arising in respect of credit risk, market risk and operational risk) plus additional capital in

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respect of various regulatory capital buffers. The capital buffers include the CRD IV combined capital buffer (which is formed of a capital conservation buffer of 2.5 per cent of a bank's total risk exposure amount, plus a countercyclical buffer that the Bank of England calibrates on advice from the FPC), certain sector-specific capital buffers calibrated by the FPC, Pillar 2 capital buffers (which the PRA has split into Pillar 2A, a capital buffer to address risks that are not adequately captured by the CRR capital requirements, and Pillar 2B, an additional capital buffer to address risks to which the bank may become exposed over a forward-looking planning horizon) and systemic capital buffers (reflecting the global or domestic systemic importance of a bank). Ultimately, the effect of the buffers is that UK banks are required to hold regulatory capital of an amount that is significantly in excess of 10.5 per cent of the applicable total risk exposure amount (being the 8 per cent base requirement plus the 2.5 per cent capital conservation buffer).

b The base capital requirement relating to the highest quality of capital (Common Equity Tier 1 (CET1) capital, which is broadly ordinary share capital and reserves) is at least 4.5 per cent of the total risk exposure amount. Banks are required to satisfy the regulatory capital buffers referred to in (a) using CET1 capital and will, accordingly, need to maintain a CET1 capital ratio significantly in excess of 4.5 per cent of the total risk exposure amount. The PRA has the power to restrict the payment of distributions (in the form of dividends or staff bonuses) by UK banks unless this and certain other capital buffers are satisfied (further details of these measures are set out in the European Union and International Initiatives chapters).

c Subject to specified limits on eligibility, banks are permitted to hold other types of capital instrument to satisfy their total capital requirement, with these instruments categorised as Additional Tier 1 (broadly, perpetual subordinated debt instruments or preference shares with no incentive to redeem and that will automatically be written down or converted into CET1 upon the bank's CET1 ratio falling below a specified level, which the PRA expects to be at least 7 per cent) and Tier 2 (broadly, subordinated debt instruments with an original maturity of at least five years).

d In addition to the regulatory capital requirements under CRD IV, the Banking Reform Act introduced a framework for regulators to impose non-capital primary loss-absorbing capacity requirements on ring-fenced banks and banks that are systemically important. This requirement to hold additional loss-absorbing capacity, the amount of which is calibrated according to the minimum requirement for own funds and eligible liabilities (MREL) framework under the EU Bank Recovery and Resolution Directive[6] (BRRD) and, for UK global systemically important banks (G-SIBs), the Financial Stability Board's total loss-absorbing capacity requirement (see subsection vii), will be fully implemented by 1 January 2022.

iii Group supervision

Regulatory capital requirements apply to individual banks on a stand-alone (solo) basis and to their groups on a consolidated basis. The PRA also supervises banking groups on a consolidated basis. The relevant requirements can be complex, but the basic principle is that

6 Directive 2014/59/EU.

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banking groups must hold prescribed minimum amounts of capital, on a group-wide basis, to cover the risk-weighted assets and off-balance sheet liabilities of members of the group, whether they are regulated or not.

Under the CRR, consolidated supervision generally applies at the level of the highest parent undertaking incorporated in the European Economic Area (EEA) with its subsidiary undertakings that are banks or investment firms or that carry on broadly defined financial activities.[7] Subsidiary undertakings are required to be consolidated in full, although proportionate consolidation for non-wholly owned subsidiaries is permitted in certain circumstances, subject to supervisory permission. Banking groups are permitted, subject to the satisfaction of certain prescribed conditions and haircuts, to recognise on a consolidated basis the minority interest that arises in respect of non-wholly owned subsidiaries that are fully included within the consolidation. Participations are also included within the scope of consolidated supervision on a proportionate basis. A participation is presumed to be held where there is a holding of 20 per cent or more of the share capital in another undertaking.

iv Liquidity

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

The CRR introduced a binding liquidity coverage ratio (LCR) and also contemplates the introduction of a net stable funding ratio (NSFR) requirement, measuring liquidity over a longer period of time than the LCR. The CRD V proposals include the implementation of a binding NSFR requirement which, if CRD V is adopted in its current form, would take effect during 2021.

v Leverage ratio

Given the number of systemically important banks in the UK and the relative size of the UK banking system, the FPC directed the PRA in 2015 to introduce a leverage ratio in the UK ahead of any internationally agreed standard. The PRA has implemented the FPC's proposals in relation to UK banks and building societies that have retail deposits equal to or greater than £50 billion, which include a minimum leverage ratio requirement of 3.25 per cent; a countercyclical leverage ratio buffer set at 35 per cent of the firm's countercyclical buffer; and for UK G-SIBs (and, from 2019, domestic systemically important banks (D-SIBs)), an institution-specific supplementary leverage ratio buffer.

If implemented in its current form, CRD V will introduce a binding leverage ratio requirement of 3 per cent of Tier 1 capital that firms must meet in addition to their risk-based requirements. This would apply from the date on which the regulation amending the CRR enters into force.

7 Following Brexit, it is anticipated that this consolidation will instead apply at the level of the highest UK holding company. See the Capital Requirements (Amendment) (EU Exit) Regulations 2018/1401, and Section VIII.i.

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vi Ring-fencing

The Banking Reform Act introduced the legal framework for the ring-fencing of core banking services that are critical to retail and small amd medium-sized enterprise (SME) clients. Affected banks were required to organise themselves to comply with the requirements by 1 January 2019. As a result, the core deposit-taking business of affected banks is now carried out through entities that are legally and financially independent of other group entities that carry on various wholesale or investment banking activities. Key details on the scope of the ring-fencing requirements and the restrictions applying to ring-fenced entities are set out in a combination of relevant secondary legislation[8] and regulatory rules.

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

a made by large organisations (undertakings that are not SMEs) and their group members;
b made by relevant financial institutions;
c made by certified, consenting high-net-worth individuals and closely related persons; and
d taken by branches of an affected UK bank outside the EEA.

Banks whose core deposits do not exceed £25 billion are exempt from the ring-fencing requirements. This threshold is calculated taking into account all UK banks in a group. Building societies, insurance firms, credit unions, cooperative societies, community benefit societies, and Northern Ireland industrial and provident societies are also exempt.

Ring-fenced banks are subject to significant restrictions on their banking activities, including a prohibition (subject to exceptions) on incurring exposures to relevant financial institutions (e.g., non-ring-fenced banks, global systemically important insurers and investment firms) and limitations on the types of financial products and services that ring-fenced banks may provide. Ring-fenced banks are also prohibited from having branches outside the EEA and, subject to exceptions, participating interests (presumed to exist at a holding of 20 per cent or more of issued share capital) in undertakings incorporated or formed under the law of a jurisdiction outside the EEA. The scope of application of this requirement following Brexit is not yet clear.

A fundamental principle of the regime is that ring-fenced banks may not deal in investments as principal, except where narrowly drawn exceptions apply relating to matters including risk management, debt-for-equity swaps, securitisation of assets originated by the ring-fenced bank, certain simple derivative products, security over shares or other investments and entering into transactions with central banks.

The role of the PRA

The Banking Reform Act amended the PRA's general objective under the FSMA with effect from 1 January 2019 to provide that it must discharge its general functions in relation to ring-fenced bodies and ring-fencing requirements to ensure the continuity of the provision

8 The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (SI 2014/1960) (as amended), the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (SI 2014/2080) (as amended) and the Financial Services and Markets Act 2000 (Banking Reform) (Pensions) Regulations 2015 (SI 2015/547).

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of core services in the UK. These core services are broader than the core activity of accepting deposits and extend to facilities for making payments from, and overdrafts in connection with, deposit accounts.

The PRA rules on ring-fenced banks are designed to ensure that:

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

b ring-fenced banks make commercially independent decisions;

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

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

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

vii Recovery and resolution regime

The PRA requires UK banks to produce and maintain a recovery plan, describing actions that could be taken by the bank to ensure the continuity of all or part of its (or of a group member's) business in prescribed stress scenarios; and a resolution pack containing information and analysis that would assist the regulator with any action it needs to take in the event that the bank is likely to, or does in fact, fail. The PRA has issued supervisory statements prescribing the information and analysis that must be set out in recovery plans and resolution packs, which take into account the requirements of the BRRD.

The Banking Act 2009 introduced a special resolution regime for UK banks, which is intended to facilitate the orderly resolution of banks in financial difficulties. The Banking Act 2009 also established two new insolvency proceedings for banks that are available in respect of failed banks or residual parts of banks that are in wind-down (referred to as the modified insolvency processes). Failure for these purposes includes insolvency, bankruptcy or administration of the bank concerned or the exercise of resolution powers under Part I of the Banking Act 2009 (the latter are referred to as the stabilisation options) in relation to that bank. The stabilisation options comprise methods for addressing the situation if a bank has encountered or is likely to encounter financial difficulties and can be summarised as the transfer of all or part of the business of the bank to a private sector purchaser, a bridge bank wholly owned by the Bank of England or an asset management vehicle; the bail-in option (see below); and taking the bank into temporary public ownership.

Exercise of the stabilisation options is subject to certain strict conditions prescribed under the Banking Act 2009. The PRA (having consulted with the Bank of England) must be satisfied that the relevant bank is failing, or is likely to fail, and the Bank of England (having consulted with HM Treasury, the PRA and the FCA) must be satisfied that, having regard to timing and other relevant circumstances, it is not reasonably likely that (aside from the stabilisation options) actions will be taken by or in respect of the bank that will enable the bank to cease to be failing or likely to fail. The Bank of England must have regard to certain special resolution objectives, and must be satisfied that the stabilisation option is necessary having regard to the public interest in the advancement of one or more of these objectives; and that one or more of the objectives would not be met to the same extent by the winding up of the bank. Each stabilisation option is subject to additional specific controls to ensure it is used only where the relevant authority considers it necessary having regard to relevant circumstances, such as the public interest in the stability of the UK financial system.

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The Banking Reform Act amended the Banking Act 2009 to introduce bail-in as a stabilisation option. This came into effect on 1 January 2015. Broadly speaking, the bail-in tool enables the Bank of England, during the stabilisation period of a failing bank, to impose losses on shareholders and, subject to limited exceptions, unsecured creditors of a bank as if that bank were insolvent, through write-down or conversion into different forms of liability (e.g., equity). The bail-in tool, as implemented, is intended to reflect the powers required under the BRRD, and its use would be subject to the no creditor worse off principle (i.e., affected creditors must not be left worse off under bail-in than they would otherwise have been under ordinary insolvency proceedings).

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

As the UK resolution authority under the BRRD, the Bank of England is also required to set MREL requirements for UK banks, building societies and investment firms within the scope of the BRRD. MREL supports the bail-in tool and is intended to ensure that firms within the scope of the BRRD have sufficient own funds and other eligible liabilities to facilitate the effective application of bail-in on resolution. The Bank of England sets MREL requirements on an institution-specific basis and according to the preferred resolution strategy applicable to that institution and its group. For UK G-SIBs, the Bank of England also sets MREL as necessary to implement the Financial Stability Board's total loss-absorbing capacity (TLAC) standard.

Different requirements apply in relation to external MREL (which applies to resolution entities, i.e., the entity or entities in respect of which a group's preferred resolution strategy envisages that resolution action would be taken) and internal MREL (which applies to legal entities within a group that are not themselves resolution entities).

For resolution entities in respect of which bail-in or partial transfer is the preferred resolution strategy, the MREL requirements are to be phased in as follows:

a since 1 January 2016, all resolution entities in respect of which bail-in or partial transfer is the preferred resolution strategy have been required to maintain MREL resources at least equal to their capital requirements;

b since 1 January 2019, G-SIBs with a resolution entity incorporated in the UK have been required to meet an MREL requirement equal to the TLAC standard, being the higher of 16 per cent of risk-weighted assets or 6 per cent of leverage exposures;

c from 1 January 2020, G-SIBs and D-SIBs with a resolution entity incorporated in the UK will be required to meet an MREL requirement equal to the higher of two times their Pillar 1 capital requirement plus their Pillar 2A capital requirement, or two times the leverage requirement (to the extent applicable). Other institutions in respect of which bail-in or partial transfer is the preferred resolution strategy will be required to meet an MREL requirement of 18 per cent of their risk-weighted assets; and

d from 1 January 2022, all resolution entities in respect of which bail-in or partial transfer is the preferred resolution strategy will be subject to an MREL requirement equivalent to the higher of two times their regulatory capital requirement (plus any relevant buffers), two times the leverage requirement (to the extent applicable) or, in the case of G-SIBs only, 6.75 per cent of leverage exposures.

The Bank of England generally expects to set internal MREL requirements as equal to an institution's capital requirements for those institutions that are not material in a group

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context. Material subsidiaries, however, are subject to an internal MREL requirement that is calibrated at 75 to 90 per cent of the external MREL requirement that would apply to that entity if it were itself a UK resolution entity. Material subsidiaries for these purposes are those that have more than five per cent of the consolidated risk-weighted assets of a group, generate more than five per cent of the total operating income of the group, have a leverage exposure measure larger than five per cent of the group's consolidated leverage exposure measure, or are otherwise material to the delivery of a group's critical functions.

The Bank of England intends to review its calibration of MREL by the end of 2020 before setting the end-state MRELs that will apply to institutions from 1 January 2022. Institutions that have adopted a modified insolvency process (rather than bail-in) as their preferred resolution strategy will be required to meet an MREL equal to their regulatory capital requirements; no separate requirement will apply.

If CRD V is adopted in its current form, it would introduce further requirements relating to internal MREL for G-SIBs, as well as detailed requirements relating to the eligibility of liabilities as MREL resources. These are expected to apply from the date that CRD V enters into force.

viii FSCS

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

The FSCS, which is funded by levies on regulated firms imposed on different sectors (and is therefore free to consumers), protects certain retail deposits (primarily those of private individuals and small businesses), and claims relating to certain investment products and certain types of insurance policies. The maximum current level of protection for bank deposits is £85,000 per depositor in respect of all the depositor's accounts held at a bank.

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

IV CONDUCT OF BUSINESS

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

UK banks should also be aware that UK consumer protection legislation will render certain unfair or unreasonable terms in consumer and certain other contracts as void or unenforceable. There are also restrictions in the FCA's rules that effectively prevent regulated firms from seeking to exclude or restrict, or to rely on any exclusion or restriction of, certain duties or liabilities that they may otherwise have to customers.

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Further, the FCA's Banking Conduct of Business Sourcebook contains a set of reasonably high-level FCA rules that apply in relation to deposit-taking activities, and relate to matters such as communications with customers, financial promotions, post-sale requirements and cancellation rights in relation to banking products.

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

i Mortgage regulation

The Mortgage and Home Finance Conduct of Business Sourcebook (MCOB) contains FCA rules in respect of activities associated with regulated mortgage contracts. These rules apply to banks and other entities that carry on regulated activities associated with mortgages, including entering into regulated mortgage contracts as lender, and administering, arranging and advising on such contracts. A regulated mortgage contract is, broadly, a loan secured by a mortgage on land in the EEA where at least 40 per cent of that land is used, or intended to be used, as or in connection with a dwelling by the borrower where the borrower is an individual or a trustee. MCOB sets out regulatory requirements relating to (among other things) advising and selling standards, disclosure obligations (both at the pre-application and offer stages of the negotiation of a regulated mortgage contract), arrears and repossessions, and equity release products.

The Mortgage Credit Directive[9] was implemented in the United Kingdom on 21 March 2016. This moved the regulation of second charge mortgages from the FCA's consumer credit regime to its regulated mortgage regime (bringing second charge mortgages within the scope of the provisions in MCOB) and granted the FCA additional supervisory powers in respect of certain categories of buy-to-let mortgages.

ii Consumer credit

The FCA has been responsible for the regulation of consumer credit activities since 1 April 2014, when it assumed this role from the (now defunct) Office of Fair Trading. The regulatory framework is complex, and is split between requirements under the Consumer Credit Act 1974 (as amended) (CCA) and the FCA's own consumer credit rules. As a result of the transfer of regulatory responsibility to the FCA, activities that were regulated under the CCA (which include consumer lending, credit brokerage and debt collection) are now regulated activities under the FSMA. Firms carrying out consumer credit activities are subject to various parts of the FCA Handbook (such as the FCA's Principles for Businesses).

iii Investment business

Investment business, in this context, includes activities such as dealing in investments (whether as principal or as agent), managing investments and providing investment advice. If a bank, or another entity within its group, intends to carry on these regulated activities in the UK, it must be appropriately authorised by the PRA or FCA (as applicable). These activities are subject to their own detailed conduct of business rules, including the rules in the Conduct of Business Sourcebook and the Principles for Businesses referred to above.

9 Directive 2014/17/EU.

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The provision of various investment services and activities in relation to certain financial instruments also falls under the ambit of the MiFID II regime,[10] which came into force on 3 January 2018. The MiFID II regime has been implemented in the United Kingdom through various pieces of legislation and rules of the PRA and FCA. The regime imposes various additional organisational and conduct of business requirements on investment firms. (For more information about MiFID II, see the European Union chapter.)

iv Payment services

The revised Payment Services Directive[11] (PSD2), which came into effect on 13 January 2018, has been implemented in the United Kingdom by the Payment Services Regulations 2017 (PSRs).

The PSRs set out an authorisation and prudential supervisory regime for payment service providers that are not banks, building societies or e-money issuers (each of which are required to be authorised under separate legislation); these businesses are known as authorised payment institutions. The FCA is the competent authority for the conduct of business aspects of the PSRs in relation to all payment service providers (including banks), and for the prudential aspects of the PSRs in relation to authorised payment institutions.

V FUNDING

UK banks raise funding from a number of different sources. In addition to deposits, interbank lending and wholesale funding, receipts from securitisations are gradually becoming more important as the securitisation market continues to recover.

The ability of UK banks to rely on sources of funding from within their group to meet liquidity requirements is limited under the PRA's rules, as noted in Section III.

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

VI CHANGE OF CONTROL AND TRANSFERS OF BANKING BUSINESS

i Acquisitions of control: the FSMA regime

Outline of the UK regime

Under the UK change in control framework, which is set out under the FSMA and reflects requirements originally introduced through the Acquisitions Directive[12] (and now set out in CRD and other sectoral directives), any person who decides to acquire or increase control of a UK-authorised person must first obtain the approval of the appropriate regulator (i.e., for banks, the PRA).

Where the PRA is the appropriate regulator, it is required to consult the FCA before finalising its determination in respect of the change of control, and the FCA is permitted to make representations to the PRA in respect of matters including the suitability of the proposed controller and the financial soundness of the acquisition; the likely influence that

10 Comprising Directive 2014/65/EU, Regulation 600/2014/EU and other implementing measures.

11 Directive 2015/2366/EU.

12 Directive 2007/44/EC (no longer in force).

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the proposed controller would have on the UK-authorised person; and whether there are reasonable grounds to suspect, or suspect an increased risk of, money laundering or terrorist financing in relation to the proposed change in control.

The PRA has an assessment period of 60 working days to make its determination, commencing on the date on which it acknowledges receipt of a complete change in control application. The PRA may, no later than the 50th working day of the assessment period, request further information to complete its assessment, and can interrupt the assessment period once for up to 20 working days while this information is provided (30 working days if the notice-giver is situated or regulated outside the EEA, or is not subject to supervision under certain EU financial services directives). The process can be completed well within the maximum time allowed, but it can never be assumed that this will be possible.

Completion of such an acquisition without prior approval from the appropriate regulator is a criminal offence, and may result in the acquirer's shareholding rights being restricted or a court ordering the sale of the shares.

An existing controller of a UK-authorised person that decides to reduce its control over that person is required to give notice of that intention to the appropriate regulator (although no formal consent is required for such a reduction).

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

Meaning of control

The term control is broadly defined, such that a person (A) will have control over a UK bank (B) for the purposes of the regime if A holds 10 per cent or more of the shares or voting power in B or a parent undertaking (P) of B; or holds shares or voting power in B or P as a result of which A is able to exercise significant influence over the management of B.

A will be treated as increasing its control over B, and requiring further approval from the PRA (or the FCA, as appropriate), if the level of shareholding or voting power in B or P, as the case may be, increases through any threshold step. In addition to 10 per cent, threshold steps occur at 20, 30 and 50 per cent, and upon becoming a parent undertaking.[13]

For these purposes, a controller's (or proposed controller's) shareholdings or voting power are aggregated with those of any person with whom it is acting in concert. There is no statutory definition of acting in concert for these purposes, although the European Union and the United Kingdom have issued guidance indicating, broadly, that persons will be acting in concert when each of them decides to exercise his or her rights linked to shares acquired in accordance with an explicit or implicit agreement made between them.

The UK regulatory approach to change in control of a bank

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

13 Certain shareholdings may be disregarded to a specified extent, including those held by a UCITS management company (or its parent), a custodian or its nominee or, subject to certain conditions, an underwriter of a securities offering (in each case acting in its capacity as such).

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

Broadly speaking, the assessment criteria include:

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

b the financial soundness of the acquirer;

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

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

e whether there are reasonable grounds to suspect financial crime.

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

ii Transfers of banking business

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

Part VII transfers

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

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

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

Implementation procedure

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

a High Court application: an application to the Court can be made by the transferor, the transferee, or both. The court procedure involves two hearings (a preliminary hearing and a final hearing, each described in more detail below);

b preliminary hearing: the Court is requested to grant a preliminary order sanctioning the publication of notices (see below) and setting a date for the final hearing. Once

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

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

d scheme statement: a statement explaining and setting out the terms of the scheme document must be prepared and be given free of charge to anyone who requests it. A copy of the court application and the statement must be provided to the PRA, which will share the documents with the FCA;

e regulatory approval: although not a legal requirement, the approval (or confirmation of no objection) of both the PRA and the FCA should be sought before the final hearing. As a practical matter, the PRA and FCA have the right to attend and make representations at the final hearing (see below), and the Court will attach great weight to their views. A banking business transfer scheme that has not been approved by the regulators is therefore unlikely to proceed; and

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

The Court may sanction the scheme if:

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

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

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

d the Court is satisfied that, in all the circumstances of the case, it is appropriate to sanction the Part VII transfer.

The Court has wide-ranging powers to make the scheme effective, including providing for the transfer to the transferee of the whole or any part of the undertaking concerned, and of any right, property or liability of the transferor (whether the transferor has the capacity to effect the transfer in question or not). If any property or liability included in the order is governed by the law of a country or territory outside the United Kingdom, the final court order may require the transferor, if the transferee so requires, to take all necessary steps for securing that the transfer of that property or liability is fully effective under the law of that country or territory. The Part VII transfer takes effect as provided in the scheme document, and this normally happens shortly after the final court order is made.

In the past year, a number of banking groups have made use of banking business transfer schemes to transfer EEA banking business from UK banks to entities authorised in the EEA as part of their Brexit contingency planning arrangements. The sheer number of such transfers (alongside ring-fencing transfer schemes and Brexit-related transfers of insurance business under Part VII of the FSMA) has placed significant pressure on the capacity of the

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regulators and the courts. This has in turn caused delays to the overall Part VII process, both for transfers motivated by Brexit contingency planning and for those with business-as-usual commercial drivers.

Ring-fencing transfer schemes

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

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

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

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

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

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

VII REMUNERATION

On 1 July 2015, the FCA and the PRA introduced five new remuneration codes primarily aimed at strengthening the alignment of long-term risk and reward. These remuneration codes apply to more than 3,000 banks, building societies and investment firms in the United Kingdom. Banks are subject to two of these codes, namely the PRA's CRR Remuneration Code and the FCA's Dual-Regulated Firms Remuneration Code. These are supplemented by guidance and opinions from the PRA and the FCA and, since 1 January 2017, guidelines issued by the European Banking Authority (EBA) under CRD IV. The provisions of the two remuneration codes affect certain senior and risk-taking individuals in UK banks, staff engaged in control functions, and those earning in the same remuneration bracket as senior management and risk-takers. In addition, UK banks are required to apply the provisions of the remuneration codes to their subsidiaries and other members of their consolidation group, including such entities that are established in countries or territories outside the EEA.

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A central focus of the remuneration codes is the amount and nature of variable remuneration payments, such as bonuses. In general, firms must have a clear distinction between their criteria for setting basic fixed remuneration (which should reflect relevant experience and responsibility) and variable remuneration (defined as remuneration reflecting a 'sustainable and risk-adjusted performance as well as performance in excess of that required to fulfil the employee's job description as part of the terms of employment'). The EBA's guidelines emphasise that fixed pay should provide a stable source of income, whereas variable pay should incentivise prudent risk-taking and sound risk management.

The rules provide, inter alia, that:

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

b the variable remuneration component must not exceed 100 per cent of the fixed component (i.e., the ratio is capped at 1:1) unless shareholder approval above a prescribed threshold is given to extend it. This approval may not extend the ratio above 2:1;

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

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

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

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

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

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

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

The bank's board of directors must adopt and periodically review the bank's remuneration policy, and is responsible for its implementation. The remuneration policy should be subject to central and independent internal review for compliance. A bank that is 'significant in terms of its size, internal organisation or activities' (essentially, all large UK banks and investment firms that engage in proprietary trading) must establish a remuneration committee for this purpose.

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

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

VIII THE YEAR IN REVIEW

The regulatory agenda for the past year has been dominated by Brexit. At the time of writing, the final settlement that will be reached between the United Kingdom and EU27 remains unclear. Reflecting this uncertainty, UK and EU banks have been forced into worst-case contingency planning. These plans, many of which have now been implemented, have focused on the design of new operating and booking models, and in many cases include the incorporation of subsidiaries in the EU27 (in the case of UK banking groups) or the UK (in the case of EU banking groups) and the transfer of business and personnel to those subsidiaries.

While Brexit has occupied significant resources and management time in the past year, this has by no means been to the exclusion of other challenges. In common with previous years, UK banks continued to grapple with a number of ongoing regulatory change projects during 2018. In particular, the past year has seen the completion of a number of internal reorganisations intended to facilitate compliance with UK ring-fencing requirements, which came into effect on 1 January 2019. The adoption of the PSRs in January 2018, ongoing efforts to implement the CMA's Open Banking standard and the implementation of the General Data Protection Regulation[14] (GDPR) have been key areas of focus for retail banks, in particular. A number of G-SIBs with resolution entities or material subsidiaries in the UK have also been required to undertake internal restructurings in response to the phasing in of MREL requirements above capital requirements from 1 January 2019.

i Brexit

On 23 June 2016, the UK electorate voted in a referendum to leave the European Union. The government triggered the formal process for the UK's withdrawal from the EU on 29 March 2017 by delivering a notice to the European Council under Article 50 of the Treaty on the European Union. The Article 50 process provides for a negotiation period of up to two years, after which the EU treaties cease to apply to the Member State seeking to withdraw from the EU.

Under that process, the UK was due to withdraw from the EU on 29 March 2019. This was subsequently extended by agreement between the UK and the EU27 following the UK government's failure to secure parliamentary approval for the terms of the UK's withdrawal from the EU, as set out in the draft withdrawal agreement between the UK and the EU27 (Withdrawal Agreement). At the time of writing, the UK is set to leave the EU on

14 Regulation (EU) 2016/679.

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31 October 2019 or earlier if the UK government is able to secure parliamentary approval for the Withdrawal Agreement. This assumes that the UK will hold elections to the European Parliament. If it fails to do so, the UK will leave the EU on 1 June 2019.

Legislative developments

At present, the European Communities Act 1972 (as amended) (ECA) provides for the supremacy of EU law in the UK. The European Union (Withdrawal) Act 2018 (Withdrawal Act), which received Royal Assent on 26 June 2018, will repeal the ECA with effect from the date of the UK's withdrawal from the EU (exit day) and, together with subordinate legislation, sets out the UK legislative framework that will apply from that date.

The Withdrawal Act aims to create a snapshot of retained EU law, as it applied in the UK immediately before exit day. As such, the Withdrawal Act:

a preserves UK domestic legislation that has implemented non-directly applicable EU law (such as EU directives);

b converts directly applicable EU legislation (such as EU regulations and decisions and certain tertiary legislation) into UK domestic legislation;

c preserves as UK domestic law any EU rights (such as directly effective EU treaty rights) that are not otherwise captured by the preceding provisions; and

d gives HM Treasury the power to remedy (by subordinate legislation) deficiencies in retained EU law arising from its domestication under the Withdrawal Act.

The Withdrawal Agreement provides for a transitional period to 31 December 2020 (extendable by up to two years), during which the UK will continue to be bound by EU law. The European Union (Withdrawal Agreement) Bill (WAB), the instrument by which the government intends that the provisions of the Withdrawal Agreement should implemented in domestic legislation, contains saving provisions that would amend the Withdrawal Act to give effect to the transitional period. In very broad terms, this would involve preserving the effect of the ECA during the transition period, such that most EU law would continue to apply in the UK during that period.

The Withdrawal Act does not apply to 'in-flight' EU legislation. If Parliament approves the WAB, any regulations and other directly applicable legislation adopted by the EU after exit day, but during the transition period, would be directly applicable in the UK. The UK would also be required to implement any EU directives (and other non-directly applicable) legislation adopted during that period. If Parliament does not approve the Withdrawal Agreement and the UK leaves the EU with no deal, the Financial Services (Implementation of Legislation) Bill would, if passed, give HM Treasury the power to adopt subordinate legislation to give effect to specified EU financial services legislation that has been adopted but does not yet apply, as well as specified legislative proposals that have been published but not yet adopted by the European Parliament and European Commission (including the CRD V reforms discussed in more detail in Section III.i).

As noted above, the Withdrawal Act gives HM Treasury the power to adopt subordinate legislation to correct deficiencies arising from the domestication of EU law. HM Treasury has adopted or published in draft a number of statutory instruments intended to correct such deficiencies. HM Treasury has also adopted a large number of statutory instruments intended to establish new regulatory frameworks that will apply after exit day, and to effect the transition to a new relationship between the UK and EU on financial services.

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These include the EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018 (SI 2018/1149) (TPR Regulations) which, in the event of a no-deal Brexit, will establish a temporary permissions regime (TPR) for EEA firms currently operating in the UK in reliance on EEA passporting rights in the event of a no-deal Brexit. At present, EEA banks and financial services firms are able to carry on business in the UK without requiring separate authorisation under the FSMA, in reliance on passporting rights under the relevant EU directives. UK banks and financial services firms are also currently able to carry on business in other EEA states in reliance on such rights. These passporting rights will cease to apply to UK firms, and (in relation to activities carried on in the UK) to EEA firms operating in the UK, from exit day (subject to any transitional period that may apply). In the event of a no-deal Brexit, the TPR will allow EEA firms that currently rely on passporting rights to carry on business in the UK to continue doing so for a period of up to three years following exit day, pending their authorisation under the FSMA. EEA banks wishing to make use of the TPR were required to notify the PRA of their intention to do so by 12 April 2019, but may still enter the TPR if they submit an application for the authorisation of a third-country branch before exit day. Firms in the TPR will be invited to apply for authorisation in several 'landing slots' stretching from October 2019 to March 2021, and will be required to comply with specified PRA and FCA rules while in the TPR.

HM Treasury has also adopted the Financial Services Contracts (Transitional and Saving Provision) (EU Exit) Regulations 2019 (SI 2019/405), which will amend the TPR Regulations to provide for the creation of the financial services contracts regime (FSCR). The FSCR will allow EEA firms currently operating in the UK in reliance on passporting rights, but which do not enter the TPR (or exit the TPR before obtaining full authorisation under FSMA), to run off their activities in an orderly manner in the event of a no-deal Brexit.

Changes to regulatory rules and guidance

The Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018 (SI 2018/1115) give the Bank of England, PRA, FCA and Payment Systems Regulator the power to make instruments (which must be approved by HM Treasury) correcting deficiencies in domesticated implementing technical standards and regulatory technical standards. The PRA and FCA have also reviewed the rules in the PRA Rulebook and FCA Handbook, respectively, and introduced a number of changes that are intended to ensure that the existing rules continue to operate as intended following exit day. Key changes are discussed throughout this chapter where relevant.

The Bank of England, PRA and FCA have also issued guidance clarifying their approach to guidance and other non-binding materials issued by the European Supervisory Authorities (ESAs). Under the approach adopted by the UK regulators, these materials will continue to be relevant following exit day unless the relevant UK regulator had previously informed the relevant ESA that it did not intend to comply with them. As such, UK firms will be expected to continue to apply such material as they did prior to exit day. The UK regulators, for their part, will continue to have regard to this material as appropriate.

Impact on UK banking groups

As noted above, UK banks and other financial services firms are expected to lose the benefit of passporting rights under the relevant EU sectoral directives with effect from exit day (subject to any transitional period). As a result, they may not be able to conduct business in other EEA jurisdictions without obtaining separate authorisation there. This has prompted a number of

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banking groups domiciled or active in both the UK and EEA to establish or upsize existing EEA subsidiaries to ensure continuity in their provision of services after exit day. While EEA firms operating in the UK can benefit from the TPR in the event of a no-deal Brexit, there is at the time of writing no equivalent transitional regime that will apply to UK firms operating in the EEA in such circumstances.

ii Regulatory change

Following the introduction of an array of EU financial services legislation in January 2018, large-scale regulatory change projects (other than those relating to Brexit) were a less prominent feature of 2018 than in the previous year. There have, however, been a number of significant regulatory changes over the past year to which UK banking groups have had to adapt.

Benchmark reform remains an ongoing issue for UK banking groups. The Benchmarks Regulation,[15] which has applied since 1 January 2018, required benchmark administrators to seek authorisation or registration by that date. Transitional measures, however, extended this to 1 January 2020 for entities already providing benchmarks on 30 June 2016. This includes many banking group companies, which will need to obtain authorisation or registration during 2019.

UK banking groups (and other financial and non-financial institutions) also continue to prepare for the transition from LIBOR. The FCA announced in 2017 that from 2021 it would no longer compel banks to submit rates to enable the calculation of LIBOR, and that firms could therefore not assume that LIBOR would be available from that date. In September 2018, the FCA and PRA wrote to major UK banks regarding their preparations for the transition from LIBOR to the alternative risk free rates (RFRs) that are intended to replace it. The FCA required banks to provide the regulators with a summary, approved by their respective boards of directors, of their assessment of the key risks relating to the discontinuation of LIBOR, and to identify senior managers responsible for overseeing the implementation of any transition plans, in each case by 14 December 2018. Planning for the transition to alternative RFRs is likely to escalate as 2021 approaches.

While the MiFID II regime has applied since 3 January 2018, a number of banks and other financial services firms did not meet the implementation deadline, and spent much of 2018 implementing and adjusting to the new requirements. To date, the FCA has adopted a pragmatic and somewhat sympathetic approach to the delayed implementation of the MiFID II requirements, although the regulator's approach will harden as the new requirements settle. It is therefore likely that there will be increased supervisory and enforcement activity in this area during the year to come.

iii Ring-fencing regime

After several years of planning, banking groups subject to the ring-fencing regime are now adjusting to the operational and structural realities of its requirements, which have applied since 1 January 2019. In anticipation of this deadline, 2018 saw the completion of a number of ring-fencing transfer schemes by banking groups subject to the ring-fencing requirements.

15 Regulation (EU) 2014/1011.

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iv Innovation

Whether driven by new regulation or by market forces, UK banks remain under considerable business and regulatory pressure to innovate in their provision of services to customers.

PSD2, implemented in the United Kingdom by the PSRs, created two new payment services: account information services (whereby a payment service provider accesses customer data relating to a payment account held with another payment service provider, and displays it to the customer in a consolidated form); and payment initiation services (whereby a payment service provider allows a customer to initiate payments drawn on an account held with another payment service provider). This, with the CMA's Open Banking standard (described in more detail below), is spurring innovation in the sector, with a raft of new firms emerging to take advantage of the opportunities created by the changes.

Despite these changes, and the growing number of challenger banks and innovative financial technology companies that have emerged in the UK in recent years, new market entrants are yet to have a truly disruptive effect on the UK banking market. UK banks are nevertheless having to adapt to an increasingly innovative and agile marketplace, and to customers who are increasingly engaged with their personal finances.

Perhaps for that reason, the FCA and the PRA continue to be enthusiastic about the potential for innovation in the sector. The FCA, in particular, has recognised the benefit of new technologies in overcoming regulatory challenges in financial services. Its regulatory sandbox, which allows firms to test innovative products and services in a controlled environment, remains the most advanced programme of its kind in the EU, if not globally, having now accepted four cohorts of firms.

v Remuneration

The issue of bankers' remuneration, and in particular bankers' bonuses, has been a politically charged issue in recent years.

As the regulatory emphasis shifts towards the accountability of senior management for conduct and culture, senior managers at UK banks will increasingly be at risk of bonus cancellations and clawback claims. Prior to this, banks may have been reluctant to seek to recover the bonuses of employees who have been dismissed. However, the new rules mean that banks will be under greater regulatory and reputational pressure to claw back bonuses than previously.

vi Conduct investigations

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

Over the course of the past year, four of the five individuals accused of manipulating EURIBOR[16] have been convicted, receiving custodial sentences of between four and eight years. One of the defendants was acquitted.

While the convictions have been welcomed by the Serious Fraud Office, which brought the prosecutions, it is striking that investigations into the manipulation of EURIBOR and LIBOR have resulted in only a handful of successful convictions, and that no charges were brought against the firms that employed those convicted.

16 Euro Interbank Offered Rate.

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UK banks also continue to be subject to complaints relating to the mis-selling of payment protection insurance (PPI), over a decade since the initial controversy emerged. The volume of complaints increased following the FCA's imposition of a deadline of 29 August 2019 for consumers to bring complaints relating to PPI policies sold before 29 August 2017 and its development of a communications campaign designed to inform consumers of this deadline. The FCA has also recently consulted on proposals that would require firms that failed to disclose details of PPI commission or profit share arrangements, or both, to their customers to write to affected complainants and inform them that they can make a new complaint in light of that non-disclosure. This would apply to complainants whose complaints the firms had previously rejected on the grounds that they were out of jurisdiction, did not involve an unfair credit relationship, or both.

If these proposals are adopted, they may contribute to a short-term increase in complaints as the August 2019 deadline approaches, or require banks to revise their estimated PPI losses.

vii Competition

The FCA has in recent years initiated a number of market studies in the financial services sector. In October 2016, it published the final findings of a market study in the investment and corporate banking sector identifying possible conflicts of interest in that sector as well as competition issues relating to the transparency of information and the bundling or cross-selling of services. The FCA subsequently updated its conduct of business rules to include restrictions on the use of clauses that restrict a client's choice of future providers of primary market services (defined as debt capital market services, equity capital market services and merger and acquisition services). The amended rules came into force on 3 January 2018 and, together with the focus on the unbundling of services under MiFID II, have had a significant effect on how investment banks price their services and draft certain of their customer engagement terms.

The CMA completed a market investigation into the retail banking sector in the United Kingdom in August 2016. The final report identified features of the relevant markets that are having an adverse effect on competition in the retail banking sector and, in February 2017, the CMA published an order implementing certain remedies intended to address these adverse effects. This included the development and implementation of the Open Banking standard, which requires the nine largest banks in the UK to develop an application programming interface to allow read and write access to bank account data.

IX OUTLOOK AND CONCLUSIONS

While the pace of regulatory change arising from the financial crisis of a decade ago has slowed in recent years, UK banks and their groups continue to navigate a challenging regulatory and business landscape.

The UK's decision to withdraw from the European Union has created unprecedented regulatory challenges for UK banks, which have been compounded by the persistent uncertainty as to the UK's future relationship with the EU. It is therefore not surprising that Brexit has dominated the regulatory agenda over the last year, and threatens to do so for the foreseeable future as the shape of the UK's future relationship with the EU continues to emerge.

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UK banks and their groups continue to face other challenges, however. In particular, the relatively recent implementation of the ring-fencing requirements by the largest UK retail banking groups will have a substantial impact on the sector as affected groups settle into their new legal and operating structures under the regime. It remains the case that the ring-fencing regime presents a fundamental challenge to the universal banking model, and it is not yet clear what effect this may have on the competitiveness of the UK banking groups to which the regime now applies.

It is in part because of the complexity of the regulatory landscape faced by UK banking groups that the extent of mergers and acquisition activity in the sector remains relatively limited. Where such activity does occur, regulators can be expected to apply close scrutiny to the proposed arrangements. While recent government policy has been directed at encouraging competition from new market entrants and 'challenger banks', it may be the case that future activity in the sector focuses on acquisitions and strategic investments by incumbent players in innovative new providers of financial services.

During the coming year, it seems likely that all this will develop against the backdrop of significant structural changes to the UK legal and regulatory system, alongside perennial banking sector issues, such as the remuneration paid to senior bankers and alleged mis-selling of financial products. There seems little prospect of the banking sector stepping out of the political and media spotlight in the near future.

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Chapter 39

UNITED STATES

Luigi L De Ghenghi, John W Banes and Karen C Pelzer[1]

I INTRODUCTION

Financial regulatory reform has remained firmly on the agenda of both lawmakers and regulators in the United States throughout 2018 and into 2019. On 24 May 2018, President Trump signed the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) into law,[2] which requires various aspects of the financial regulatory framework imposed by the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd–Frank Act)[3] to be tailored to bank organisations' business model, risk profile and size. With a divided Congress following the midterm elections, the prospects of further statutory reform are uncertain, and will require bipartisan support and extensive negotiation and compromise. Notwithstanding any resulting reduction in the pace of statutory reform, reforms are continuing through regulations, interpretations and guidance driven both by new agency leadership and statutory mandates, such as the EGRRCPA. We further expect the scope of laws and regulations to continue to adapt to technological and market changes, for example with respect to digital tokens, fintech charters and virtual currencies. Overall, the fundamental features of the post-financial crisis financial regulatory framework established by the Dodd–Frank Act remain in place, albeit subject to additional tailoring and recalibration as well as adaptation to an ever-changing market environment for the financial industry. This chapter summarises the principal elements of banking regulation in the United States.

II THE REGULATORY REGIME APPLICABLE TO BANKS

i Dual banking system

The United States has a dual banking system, whereby banks, or depository institutions, may be chartered by either federal or state authorities. To accept deposits, an institution must apply for and obtain a bank or thrift charter from either a federal or state regulator. The Office of the Comptroller of the Currency (OCC) is the federal bank regulator with the power to

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2 EGRRCPA, Pub L No. 115-174, S 2155, 115th Cong Sections Section 402 (2018).

3 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong (2010).

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charter national banks[4] and, since 2011, thrifts or federal savings associations.[5] The OCC is part of the US Treasury Department. Separately, each state also has a regulatory agency that may charter either banks or thrifts. The Board of Governors of the Federal Reserve System (Federal Reserve) is the primary federal supervisor of state-chartered banks that choose to become members of the Federal Reserve System.

The Federal Deposit Insurance Corporation (FDIC) is the primary federal supervisor of state-chartered banks that are not members of the Federal Reserve System.[6] The FDIC also administers the federal deposit insurance programme that insures certain bank deposits, including supervising any bank failures, and regulates certain bank activities and operations to protect the federal deposit insurance fund.

All nationally chartered banks are required to hold stock in one of the 12 Federal Reserve banks, while state-chartered banks may choose to be members of and hold stock in a regional Federal Reserve bank, upon meeting certain standards. Benefits of Federal Reserve membership include eligibility to vote in the election of their regional Federal Reserve bank's board of directors, which affords member banks the opportunity to participate in monetary policy formulation.[7]

ii Bank holding companies

Any legal entity with a controlling ownership interest in a bank or thrift is regulated as a bank holding company (BHC) or savings and loan holding company (SLHC) by the Federal Reserve.[8]

iii Foreign banks

Foreign bank activities in the United States are supervised by the Federal Reserve, or any other regulator implicated by the type of charter or entity that a foreign bank uses to conduct its banking business in the United States.

4 National Bank Act Section 2; 12 USC Section 26.

5 OCC, Interim Final Rule: Office of Thrift Supervision Integration Pursuant to the Dodd–Frank Act, 76 Fed Reg 48950 (9 Aug 2011), www.gpo.gov/fdsys/pkg/FR-2011-08-09/pdf/2011-17581.pdf; OCC, Final Rule: Office of Thrift Supervision Integration; Dodd–Frank Act Implementation, 76 Fed Reg 43549 (21 Jul 2011), www.gpo.gov/fdsys/pkg/FR-2011-07-21/pdf/2011-18231.pdf. This chapter largely focuses on bank and bank holding company regulation, and does not cover the entire scope of thrift and thrift holding company regulation.

6 Federal Deposit Insurance Act, Section 1; 12 USC Section 1811(a).

7 See Federal Reserve Bank of Boston, Federal Reserve Membership, https://www.bostonfed.org/supervision-and-regulation/supervision/federal-reserve-membership.aspx; Federal Reserve Bank of Dallas, Becoming a Member Bank of the Federal Reserve System: Questions & Answers, www.dallasfed.org/banking/apps/faq.cfm.

8 The Bank Holding Company Act of 1956 (BHC Act) defines a bank holding company as any company that has control over any bank or over any company that is or becomes a BHC by virtue of the Act. See BHC Act, 12 USC Section 1841(a). The Home Owners' Loan Act of 1933 (HOLA) defines a savings and loan holding company as any company that controls a savings association or any other company that is an SLHC. See HOLA, 12 USC Section 1467a(a)(1)(D)(i). Some depository institutions do not fall within the definition of bank under the BHC Act and do not trigger BHC status for companies that control such institutions – for example, an industrial loan company or a credit card bank.

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iv Relationship with the prudential regulator

Most banks are first regulated by their chartering entities, or their primary regulators. Primary regulators are generally responsible for conducting bank examinations, initiating supervisory and enforcement actions, and approving branch, change of control, merger and other applications. State-chartered institutions are regulated at the federal level by the Federal Reserve in the case of state member banks, or by the FDIC in the case of state non-member banks. The following chart summarises these relationships.

Institution type	Chartering agency	Primary federal regulator	Secondary federal regulator
Federal charter			
National bank	OCC	OCC	Federal Reserve, FDIC
Federal savings association	OCC	OCC	FDIC
Federal savings bank	OCC	OCC	FDIC
State charter			
State non-member bank	State agency	FDIC	N/A
State member bank	State agency	Federal Reserve	FDIC
State savings bank	State agency	FDIC	N/A
State savings association	State agency	FDIC	N/A
Foreign banks			
Foreign bank uninsured state branches and agencies	State agency	Federal Reserve	N/A
Foreign bank uninsured federal branches and agencies	OCC	OCC	Federal Reserve
Foreign bank commercial state chartered lending companies	State agency	Federal Reserve	N/A
Foreign bank representative offices	State agency	Federal Reserve	N/A

Banks and BHCs may also be subject to functional regulation by other regulatory agencies, depending on the types of activities in which they engage. For instance, a BHC's securities underwriting and dealing activities are also regulated by the US Securities and Exchange Commission (SEC), the functional regulator of any SEC-registered broker-dealer.

III PRUDENTIAL REGULATION

i Regulatory reporting requirements and bank examinations

Regulators have two primary tools to supervise BHCs and banks: regulatory reporting requirements and on-site examinations. BHCs and banks are subject to extensive financial, structural and other periodic reporting requirements. Financial reporting requirements for banks include capital, asset and liability data reported quarterly on call reports, and requirements for BHCs include financial statements for the BHC and certain non-bank subsidiaries. BHCs must also provide annual reports to the Federal Reserve that detail their shareholders and organisational structure. Banking institutions that are experiencing financial difficulties or that are not in compliance with regulatory requirements face more frequent and additional reporting obligations.

Bank regulators also conduct on-site examinations of BHCs and banks. Regulators generally conduct three principal types of formal examinations: safety and soundness, or full scope, which determine the bank's fundamental financial health and generally occur every

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12 or 18 months;[9] compliance examinations covering consumer compliance and fair lending issues; and speciality examinations covering areas such as trust activities and information technology infrastructure.

Congress expanded bank regulators' authority to examine entities beyond BHCs and banks in the Dodd–Frank Act. For instance, the Federal Reserve was granted the authority to examine functionally regulated subsidiaries (i.e., subsidiaries whose activities are regulated by another US regulatory authority, such as the SEC) and all insured depository institutions (IDIs) (including those for which the Federal Reserve is not currently the primary federal banking regulator).[10]

The Dodd–Frank Act also requires the Federal Reserve to examine the permissible activities of BHCs' non-depository institution subsidiaries that are not functionally regulated or subsidiaries of a depository institution.[11] The Federal Reserve must examine these entities subject to the same standards and with the same frequency as would be required if the activities were conducted in the lead IDI. With respect to federal consumer financial law, these expanded examination authorities are shared with the Consumer Financial Protection Bureau (CFPB), as described in more detail in Section IV.iv.

Aside from transactions such as mergers and acquisitions or other matters that require formal approvals,[12] bank regulators are also routinely informed or involved on a more informal basis with certain key decisions contemplated by a bank or BHC, including capital-raising activities, dividend policies, and changes in business plans or strategies.

ii Deposit insurance requirements

The Dodd–Frank Act permanently increased the Standard Maximum Deposit Insurance Amount (SMDIA) to US$250,000.[13] For a foreign bank to establish or operate a state branch without federal deposit insurance, the branch, in addition to meeting other requirements, may accept initial deposits only in an amount equal to the SMDIA or greater.[14]

In addition, the Dodd–Frank Act changed how the FDIC assesses deposit insurance premiums against IDIs. An IDI's quarterly deposit insurance assessment is determined by multiplying its assessment rate by its assessment base.[15] An IDI's assessment base was

9 The largest BHCs and banks are generally subject to continuous examinations. On 28 December 2018, the FDIC, Federal Reserve and OCC published final rules increasing the number of small banks and savings associations eligible for an 18-month examination cycle rather than a 12-month examination cycle. OCC, Federal Reserve and FDIC, Final Rule: Expanded Examination Cycle for Certain Small Insured Depository Institutions and US Branches and Agencies of Foreign Banks, 83 Fed Reg 43961 (28 December 2018), www.govinfo.gov/content/pkg/FR-2018-12-28/pdf/2018-28267.pdf.

10 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 604 (2010).

11 Ibid.

12 For a further discussion, see Section VI.

13 Pub L No. 111-203, Section 335, 124 Stat 1,540.

14 12 CFR Section 347.213, www.gpo.gov/fdsys/pkg/CFR-2011-title12-vol4/pdf/CFR-2011-title12-vol4-sec347-213.pdf; FDIC, Final Rule: Deposit Insurance Regulations; Temporary Increase in Standard Coverage Amount; Mortgage Servicing Accounts; Revocable Trust Accounts; International Banking; Foreign Banks, 74 Fed Reg 47711 (17 Sep 2009), www.fdic.gov/regulations/laws/federal/2009/09Final917.pdf.

15 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 331(b) (2010).

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historically its domestic deposits, with some adjustments.[16] The Dodd–Frank Act, however, requires the FDIC to redefine the assessment base as average consolidated total assets minus average tangible equity during the assessment period.[17] As a result, the distribution of assessments and the cost of federal deposit insurance has been shifted to larger banks, which fund a greater percentage of their balance sheet through non-deposit liabilities.[18] The FDIC uses an assessment system for large IDIs and highly complex IDIs[19] that combines supervisory ratings and certain financial measures into two scorecards, one for most large IDIs and another for highly complex IDIs, and modifies and introduces new assessment rate adjustments.[20]

iii Management of banks

The two traditional areas of regulatory focus on the management of banks have been the responsibilities and duties of BHCs and bank boards, directors and senior management, and the regulation of insider loans.

Bank and BHC boards of directors are different from corporate boards in that they normally have more competing interests to balance, such as shareholder, depositor, parent holding company (in the case of a bank), creditor and regulatory interests. Bank and BHC boards are generally responsible for overseeing management plans and ensuring that adequate controls and systems are in place to identify and manage risk, while management is responsible for the implementation, integrity and maintenance of risk-management systems. Bank examiners normally review bank and BHC board performance and make recommendations

16 FDIC, Final Rule: Assessments, Large Bank Pricing, 76 Fed Reg 10672, 10673 (25 Feb 2011), www.gpo.gov/fdsys/pkg/FR-2011-02-25/pdf/2011-3086.pdf.

17 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 331(b) (2010).

18 FDIC, Final Rule: Assessments, Large Bank Pricing, 76 Fed Reg 10672 (25 Feb 2011), www.gpo.gov/fdsys/pkg/FR-2011-02-25/pdf/2011-3086.pdf.

19 A large IDI is defined as an IDI with at least US$10 billion in total assets for at least four consecutive quarters, while a highly complex IDI is an IDI (other than a credit card bank) with US$50 billion or more in total assets for at least four consecutive quarters controlled by a parent or intermediate parent company with more than US$500 billion in total assets, or a processing bank or trust company with at least US$10 billion in total assets for at least four consecutive quarters. FDIC, Final Rule: Assessments, Large Bank Pricing, 76 Fed Reg 10672, 10688 (25 Feb 2011), www.gpo.gov/fdsys/pkg/FR-2011-02-25/pdf/2011-3086.pdf.

20 Each scorecard assesses certain risk measures to produce two scores that are combined and converted into an initial assessment rate. The performance score measures an IDI's financial performance and its ability to withstand stress. The loss severity score quantifies the relative magnitude of potential losses to the FDIC in the event of the IDI's failure. According to the FDIC, the scorecard method better captures risk at the time it is assumed by a large or highly complex IDI, better differentiates risk among such institutions during periods of good economic and banking conditions based upon how they would fare during periods of stress or economic downturns, and better takes into account the losses that the FDIC may incur if such an institution fails.

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for improvement if they find weaknesses.[21] The Federal Reserve has recently devoted additional attention to these issues, issuing proposed guidance for large financial institutions on board effectiveness[22] and supervisory expectations for management.[23]

The Federal Reserve Act of 1913 (FRA) and implementing regulations also govern extensions of credit by a bank to an executive officer, director or principal shareholder of that bank, of a BHC of which the member bank is a subsidiary or of any other subsidiary of that BHC. In general, a bank may not extend credit to any such insider unless the extension of credit is made on substantially all the same terms, and subject to no less stringent credit underwriting procedures, as those for comparable transactions by the bank with persons who are not insiders and not employed by the bank, and the transaction does not involve more than the normal repayment risk or present other unfavourable features. The Dodd–Frank Act expanded the types of transactions subject to insider lending limits to include derivative transactions, repurchase agreements, and securities lending or borrowing transactions. It also imposed limitations on the sale of assets to, or the purchase of assets from, insiders by requiring that such transactions be on market terms and, in the case of significant transactions, have the approval of the majority of disinterested board members.[24]

iv Enhanced prudential standards

Section 165 of the Dodd–Frank Act, as amended by the EGRRCPA, subjects BHCs with total consolidated assets of US$100 billion or more and systemically important non-bank financial companies to enhanced prudential standards (EPS) and other standards, and enhanced reporting and disclosure requirements. In November 2019, this statutory threshold will increase from US$100 billion to US$250 billion, although the Federal Reserve has the authority under the EGRRCPA to apply any of the EPS requirements to any BHC with US$100 billion or more but less than US$250 billion in total consolidated assets.[25] The heightened standards include increased capital and liquidity requirements, leverage limits, contingent capital, resolution plans, credit exposure reporting, concentration limits, public

21 OCC, Detecting Red Flags in Board Reports – a Guide for Directors (2004), www.occ.gov/publications/publications-by-type/other-publications-reports/rf_book.pdf; OCC, Internal Controls – a Guide for Directors (2000), www.occ.gov/publications/publications-by-type/other-publications-reports/IntCtrl.pdf; OCC, The Director's Book – Role of Directors for National Banks and Federal Savings Associations (2016), www.occ.gov/publications/publications-by-type/other-publications-reports/The-Directors-Book.pdf.

22 Federal Reserve, Proposed Guidance on Supervisory Expectations for Boards of Directors, 82 Fed Reg 37219 (9 Aug 2017), www.govinfo.gov/content/pkg/FR-2017-08-09/pdf/2017-16735.pdf.

23 Federal Reserve, Proposed Supervisory Guidance, 83 Fed Reg 1351 (11 Jan 2018), www.govinfo.gov/content/pkg/FR-2018-01-11/pdf/2018-00294.pdf.

24 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Sections 614, 615 (2010).

25 In October 2018, the Federal Reserve proposed rules that would tailor the applicability of the EPS requirements consistent with the threshold changes under the EGRRCPA. Federal Reserve, Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed Reg 61408 (29 Nov 2018). Because the EGRRCPA became effective in May 2018 for BHCs with less than US$100 billion in total consolidated assets, and the Federal Reserve's EPS tailoring proposal has not yet been finalised, the Federal Reserve has stated that it will not seek to enforce EPS requirements that had previously applied to BHCs at a lower asset threshold.

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disclosures and short-term debt limits. The Financial Stability Oversight Council (FSOC) is authorised to make recommendations to the Federal Reserve concerning prudential standards, and the Federal Reserve must consider those recommendations in prescribing standards.[26]

All BHCs covered by the relevant rules finalised by the Federal Reserve under Section 165 of the Dodd–Frank Act must comply with, and hold capital commensurate with, the requirements of any regulations adopted by the Federal Reserve related to capital plans and stress tests, including the Federal Reserve's capital planning rule. The capital planning rule, described in greater detail below, requires firms to meet minimum capital regulatory requirements under economic scenarios published by the Federal Reserve.

The liquidity provisions of the final rules require covered BHCs to maintain a sufficient quantity of highly liquid assets to survive a projected 30-day liquidity stress event, conduct regular liquidity stress tests and implement liquidity risk-management requirements, including periodic reviews of business lines for liquidity risks. A BHC's board of directors is ultimately responsible for liquidity risk management, including periodic review, and a risk committee is responsible for approving a contingency funding plan to address potential liquidity stress events.

BHCs with total consolidated assets of US$50 billion or more must also comply with a range of corporate governance requirements, such as establishing a risk committee of the board of directors, and appointing a chief risk officer with defined responsibilities.

The final rules also incorporate the Federal Reserve's supervisory stress test and company-run stress test requirements for covered companies. The stress tests, which are designed to assess firms' capital adequacy, involve nine-quarter planning horizons under both supervisory and company-designed scenarios. The Federal Reserve publishes public summaries of companies' stress test results, with more detailed information remaining confidential. The stress tests are designed to work in tandem with the capital planning rule, which requires large US BHCs to submit annual capital plans to the Federal Reserve for approval while demonstrating capital adequacy under baseline, adverse and severely adverse scenarios.[27]

The final rule also implements a provision of Section 165 that imposes a 15:1 debt-to-equity limit on any BHC that is determined by the FSOC to represent a grave threat to US financial stability.

In June 2018, the Federal Reserve finalised a rule to implement single-counterparty credit limits.[28] The final rule limits net credit exposure to any single counterparty to 25 per cent of Tier 1 capital for BHCs with US$250 billion or more in total consolidated assets. A more stringent net credit exposure limit of 15 per cent of Tier 1 capital would apply to the US global systemically important banks (G-SIBs) with respect to certain large counterparties, including other G-SIBs and non-bank SIFIs. The rule also requires BHCs to aggregate

26 The Dodd–Frank Act created the FSOC to oversee and identify risks in the financial system. The FSOC's duties include collecting information to assess risks to the US financial system through its Office of Financial Research; monitoring the financial services marketplace; designating as systemically important any non-bank financial company if the failure of such company would threaten US financial stability; identifying gaps in regulation; recommending supervisory priorities; and facilitating information sharing and coordination among financial regulatory agencies.

27 The EGRRCPA eliminates the adverse scenario from the Dodd–Frank Act stress tests (DFAST) and the Federal Reserve is expected to follow suit for the Comprehensive Capital Analysis and Review (CCAR).

28 Federal Reserve, Single Counterparty Credit Limits for Large Bank Holding Companies and Foreign Banking Organizations; Final Rule, 83 Fed Reg 38460 (6 Aug 2018).

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exposures between counterparties that are economically interdependent or in the presence of certain control relationships. Compliance is required beginning on 1 January 2020 for G-SIBs and beginning on 1 July 2020 for all other covered companies.

The early remediation regime in rules proposed in 2012 would address material financial distress or management weaknesses at any company covered by the proposed rules. A company would be placed into one of four early remediation levels based on triggers related to capital and leverage, forward-looking stress tests, risk management or liquidity. In addition, under the proposed rules, a company may be considered for placement into the lowest early remediation category in response to volatility in certain market indicators tied to the company's financial strength. The four levels of early remediation, which include increasingly severe limitations and requirements, are heightened supervisory review, initial remediation, recovery and resolution assessment. As at 31 December 2018, the Federal Reserve had not yet adopted final rules implementing the early remediation framework.

v Regulation of foreign banking organisations

On 18 February 2014, the Federal Reserve adopted final rules that use a tiered approach for applying US capital, liquidity and other Dodd–Frank EPS to the US operations of foreign banking organisations (FBOs) with total global consolidated assets of US$50 billion or more (large FBOs). The most burdensome requirements apply to FBOs with US$50 billion or more in US assets, excluding US branch and agency assets, and certain other US assets (each such FBO, an IHC FBO).[29] Fewer requirements apply to FBOs with limited US footprints, but a large FBO that is not subject to the requirement to form a US intermediate holding company (IHC) must still comply with new EPS, including liquidity, stress testing and risk management requirements.[30]

An IHC FBO must create a separately capitalised, top-tier US IHC to hold substantially all of its ownership interests in its US bank and non-bank subsidiaries. For the purposes of identifying subsidiaries, the final rule relies on the BHC Act definition of control, including the facts and circumstances-based controlling influence test. With very limited exceptions, an IHC FBO may not retain any ownership interest in the US subsidiary directly or through

29 US assets include all on-balance sheet assets of US subsidiaries other than assets held by a branch subsidiary that holds assets acquired in the ordinary course of business for the sole purpose of securing or collecting debt previously contracted in good faith by that branch or agency and all held pursuant to Section 2(h)(2) of the BHC Act, which exemption allows qualifying FBOs to retain their interest in foreign commercial firms that conduct business in the United States. The asset amount may be reduced by the amount corresponding to any balances and transactions between any top-tier US subsidiaries that would be eliminated in consolidation if an IHC were already formed.

30 Federal Reserve, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 12 CFR Part 252, www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf; see also Davis Polk, 'Foreign Banks: Overview of Dodd–Frank Enhanced Prudential Standards Final Rule' (24 Feb 2014), www.davispolk.com/sites/default/files/Visual.Summary.Foreign%20Banks.Dodd_.Frank_.Enhanced.Prudential.Standards.Final_.Rule_.pdf. Although the EGRRCPA generally raised the threshold for EPS from US$50 billion to US$100 billion in May 2018 and to US$250 billion effective November 2019, the statute did not alter the application of the Federal Reserve's EPS regulations to FBOs with US$100 billion or more in total consolidated assets. While the Federal Reserve has indicated that it plans to develop a separate proposal relating to FBOs that would implement Section 401 of the EGRRCPA for IHCs of FBOs (see 83 Fed. Reg. 61408, 61411), it has, as of 31 December 2018, not issued any such proposal.

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non-US affiliates. However, the final rule does not require an IHC FBO to be the 100 per cent owner of any US subsidiary. In other words, an IHC FBO is not required to buy out other, unaffiliated third-party investors in a US subsidiary. Regardless of whether an IHC controls a US bank, an IHC will be subject to US Basel III (subject to limited adjustments),[31] capital planning and Dodd–Frank company-run and supervisory stress-testing requirements, qualitative and quantitative liquidity standards, risk-management standards and other EPS. In addition, the Federal Reserve has the authority to examine any IHC and any IHC subsidiary. Although the US branches and agencies of an IHC FBO's foreign bank are not required to be held beneath the IHC, they are also subject to certain EPS.

A large FBO with US$50 billion or more in US assets (including US branch and agency assets) is subject to a qualitative liquidity framework that includes liquidity risk management and related governance requirements, as well as a requirement to maintain separate US liquidity buffers (based on results of internal liquidity stress tests) for its US branches or agencies and, if applicable, its IHC. The liquidity buffers must consist of unencumbered highly liquid assets sufficient to meet net stressed cash flow needs. The Federal Reserve's prescribed method for calculating net stressed cash flow needs distinguishes between external and internal stressed cash flow needs such that internal cash flows cannot be used to offset external cash flows; it is designed to minimise maturity mismatches such that intragroup cash flow sources may offset intragroup cash flow needs of the US branches or agencies or IHC only to the extent that the term of the intragroup cash flow source is the same as or shorter than the term of the intragroup cash flow need.

FBOs that meet the characteristics of G-SIBs, FBOs with US$250 billion or more in total global consolidated assets and US IHCs are subject to single-counterparty credit limit requirements established by the Federal Reserve.[32] Under these requirements, which become effective in 2020, an FBO that meets the characteristics of a global systemically important bank will be required to limit, with respect to its combined US operations, its net credit exposure to each counterparty to 15 per cent of Tier 1 capital. Other FBOs with US$250 billion or more in total global consolidated assets and their US IHCs will be subject to single-counterparty net credit exposure limits of 25 per cent of Tier 1 capital, while US IHCs of FBOs with US$50 billion or more but less than US$250 billion in total global consolidated assets will be subject to single-counterparty net credit exposure limits of 25 per cent of capital stock and surplus, which is a broader base than Tier 1 capital.

EPS of more general applicability to FBOs include risk management requirements. All large FBOs, as well as publicly traded FBOs with US$10 billion or more in total global consolidated assets (public mid-size FBO), must establish a US risk committee. A large FBO with US$50 billion or more in US assets (including US branch and agency assets) that conducts its operations through US branches or agencies (in addition to its IHC, if any) may maintain its US risk committee either as a committee of its global board of directors, on a stand-alone basis or as part of its enterprise-wide risk committee, or as a committee of its IHC's board of directors, on a stand-alone basis or as a joint committee with the IHC's risk

31 An IHC will not be subject to the US advanced approaches capital rules unless the IHC expressly opts in. However, an IHC that crosses the applicability threshold for the US advanced approaches capital rules will be subject to the US Basel III supplementary leverage ratio and certain other capital requirements applicable to advanced approaches banking organisations.

32 Federal Reserve, Single Counterparty Credit Limits for Large Bank Holding Companies and Foreign Banking Organizations; Final Rule, 83 Fed Reg 38460 (6 Aug 2018).

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committee. The US risk committee for an IHC FBO must include at least one member with experience in identifying, assessing and managing risk exposures of large, complex financial firms and at least one member who meets certain independence requirements. A large FBO with US$50 billion or more in US assets (including US branch and agency assets) must also employ a US chief risk officer with specified risk management expertise and responsibilities, and must adopt a risk management framework for its combined US operations. The US risk committee of a large FBO with less than US$50 billion in US assets or a public mid-size FBO is not subject to the independent committee member requirement, but must have at least one committee member with experience in identifying, assessing and managing risk exposures of large, complex firms, which may be acquired in a non-banking or non-financial field.

The Federal Reserve must still finalise an early remediation framework that would apply to US operations of an FBO.

vi Regulatory capital

Regulatory capital emerged from the global financial crisis of 2008 as one of bank regulators' primary areas of supervisory focus. This part focuses on the US implementation of the Basel Committee on Banking Supervision's (Basel Committee) third accord on regulatory capital, known as Basel III, and related provisions in the Dodd–Frank Act.

Federal Reserve policy and regulations traditionally required a BHC to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This policy became a statutory requirement pursuant to the Dodd–Frank Act. Section 616(d) of the Dodd–Frank Act requires all companies that directly or indirectly control an IDI to serve as a source of strength for the institution.[33] US banking agencies were required to issue regulations implementing this requirement not later than 21 July 2012, but as of 31 December 2018 had not proposed such regulations.

Under the Dodd–Frank Act, as amended by the EGRRCPA, US BHCs with consolidated assets of US$100 billion or more (large BHCs) and non-bank SIFIs are subject to periodic (or in the case of US G-SIBs and US BHCs with consolidated assets of US$250 billion or more, annual) supervisory and company-run stress tests.[34] Supervisory stress tests, along with related capital plans required by Federal Reserve rules, are part of the supervisory process for large US BHCs.[35] Companies subject to stress test requirements must publish summaries of their company-run stress test results, and the Federal Reserve must publish summaries of its supervisory stress test results.

The Federal Reserve has integrated capital planning and DFAST requirements into its CCAR, an annual exercise designed to ensure that large BHCs have robust, forward-looking capital planning processes and sufficient capital to continue operations throughout times of economic and financial stress.[36] Capital plans incorporate projected capital distributions over a planning horizon of at least nine quarters and are submitted to the Federal Reserve for

33 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 616(d) (2010).

34 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 165(i) (2010), as amended by the EGRRCPA, Pub L No. 115-174, S 2155, 115th Cong Sections Section 402 (2018).

35 Federal Reserve, Capital Plans, 76 Fed Reg 74631 (1 December 2011), www.gpo.gov/fdsys/pkg/FR-2011-12-01/pdf/2011-30665.pdf.

36 For a discussion of the 2018 capital planning and stress testing process for large BHCs, see Davis Polk & Wardwell LLP, 'Visuals of 2018 CCAR and DFAST Results' (3 July 2018), https://www.finregreform.com/wp-content/uploads/sites/32/2018/07/DPW-CCAR-DFAST-2018-Visual-Summary.pdf.

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non-objection. Among other things, the capital plan must demonstrate a large BHC's ability to maintain capital above each minimum regulatory capital ratio on a *pro forma* basis after taking planned capital actions, such as planned distributions, under baseline, adverse and severely adverse economic conditions throughout the planning horizon. Large BHCs must submit their capital plans by April 5 of the year of the applicable capital planning cycle, and the Federal Reserve must take action by 30 June.[37] If the Federal Reserve objects to a capital plan on either quantitative or qualitative grounds, the company generally may not increase dividends or make other changes to capital distributions.[38] In January 2017, the Federal Reserve adopted a rule that removed certain large and non-complex firms from the scope of the Federal Reserve's qualitative assessment of their capital plans and that reduced certain reporting requirements for these firms.[39]

US Basel III

US Basel III is the most complete overhaul of US bank capital standards in nearly a quarter of a century. It comprehensively revises the regulatory capital framework for the entire US banking sector, and has significant implications for all US banking organisations from business, operations, M&A and regulatory compliance perspectives.

US Basel III applies to all national banks, state member and non-member banks, and state and federal savings associations regardless of size. The regulation also applies to all BHCs and covered SLHCs other than certain BHCs and SLHCs with less than US$1 billion in total assets. However, the bank and thrift subsidiaries of these small BHCs and SLHCs are still subject to US Basel III.

US Basel III implements many aspects of the Basel Committee's Basel III capital standards, including higher minimum risk-based capital ratios, capital buffers, revised eligibility criteria for Common Equity Tier 1, Additional Tier 1 and Tier 2 capital instruments, certain deductions from and adjustments to regulatory capital, and the recognition of minority interests. US Basel III introduces a revised and expanded standardised approach for calculating risk-weighted assets (RWAs), the denominator of the risk-based capital ratios, which replaced the previously applicable Basel I-based rules. In addition to the standardised approach, large and internationally active US banking organisations (i.e., those with US$250 billion or more in total consolidated assets or US$10 billion or more in total on-balance sheet foreign exposure) must calculate RWAs using the advanced internal ratings-based approach for credit risk and advanced measurement approaches for operational risk (together, advanced approaches). A key difference between the standardised approach and advanced approaches is that the former mandates the use of standardised risk weights and methodologies for

37 Federal Reserve, Capital Plan and Stress Test Rules, 12 CFR Parts 225 and 252, www.gpo.gov/fdsys/pkg/FR-2014-10-27/pdf/2014-25170.pdf. Previously, large BHCs were required to submit their capital plans by early January of each year, and the Federal Reserve was required to take action by March. Ibid.

38 Even if a large BHC receives a non-objection, it may not pay a dividend or make other capital distributions without Federal Reserve approval under specified circumstances, such as if the distribution would result in the BHC not meeting a minimum regulatory capital ratio on a *pro forma* basis under expected and stressful conditions throughout a planning horizon.

39 Federal Reserve, Amendments to the Capital Plan and Stress Test Rules, 82 Fed Reg 9308 (proposed 3 Feb 2017), www.gpo.gov/fdsys/pkg/FR-2017-02-03/pdf/2017-02257.pdf. The Federal Reserve's final rule removed the qualitative assessment for BHCs or IHCs of FBOs with total consolidated assets of US$50 billion or greater but less than US$250 billion, and non-bank assets of less than US$75 billion that are not identified as US G-SIBs.

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calculating RWAs, whereas the latter permit the use of supervisor-approved internal models and methodologies that meet specified qualitative and quantitative requirements, which generally give rise to more risk-sensitive measurements.

US Basel III implements the capital floor requirement of Section 171 of the Dodd–Frank Act (known as the Collins Amendment) by requiring advanced approaches banking organisations to calculate their risk-based capital ratios using both the standardised approach and the advanced approaches. An advanced approaches banking organisation's risk-based capital ratios for regulatory purposes, including for calculating capital buffers, are the lower of each ratio calculated under the standardised approach and advanced approaches.

As of January 2018, advanced approaches banking organisations must also maintain a minimum supplementary leverage ratio of 3 per cent. The supplementary leverage ratio is based on the Basel Committee's Basel III leverage ratio. The US banking agencies have established enhanced supplementary leverage ratio standards for the eight US BHCs identified by the Financial Stability Board as G-SIBs as well as their IDI subsidiaries.[40] Under the enhanced supplementary leverage ratio standards, a US G-SIB's IDI subsidiaries must maintain a supplementary leverage ratio of at least 6 per cent to be considered well-capitalised for regulatory purposes. A US G-SIB, on a global consolidated basis, must maintain a leverage capital buffer that functions in a similar way to US Basel III's risk-based capital buffers – the capital conservation buffer, the countercyclical buffer and the G-SIB capital surcharge. Specifically, a US G-SIB that does not maintain a supplementary leverage ratio of greater than 5 per cent (i.e., a buffer of more than 2 per cent on top of the 3 per cent minimum) will be subject to increasingly stringent restrictions on its ability to make capital distributions and discretionary bonus payments.[41]

Besides the enhanced supplementary leverage ratio requirements, US G-SIBs are also subject to a risk-based capital surcharge buffer under US Basel III, which implements the Basel Committee's G-SIB capital surcharge standard with certain modifications. The G-SIB capital surcharge functions as an extension of the Basel III capital conservation buffer, requiring each G-SIB to hold an additional buffer of Common Equity Tier 1 capital, on top of the capital conservation and countercyclical buffers, to avoid limitations on making capital distributions and discretionary bonus payments. Under the US implementation of the G-SIB capital surcharge, the resulting buffers for the eight US G-SIBs currently range from 1.5 to 3.5 per cent of RWAs, depending on the size of the G-SIB's systemic footprint.[42] The US implementation modifies the measure of each US G-SIB's systemic footprint to include a component linked to the G-SIB's reliance on short-term wholesale funding.[43]

US banking agencies proposed further amendments to US Basel III and the Federal Reserve's capital planning and stress testing rules that would simplify and tailor requirements

40 Federal Reserve, OCC and FDIC, Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions, 79 Fed Reg 24528 (1 May 2014), www.gpo.gov/fdsys/pkg/FR-2014-05-01/pdf/2014-09367.pdf.

41 In April 2018, the Federal Reserve and the OCC proposed a rule that would tailor the calibration of the enhanced supplementary leverage ratio requirement for each firm, changing it from a fixed 2 per cent buffer for all firms to a firm-specific buffer determined annually and based on the firm's risk-based G-SIB capital surcharge discussed below. Federal Reserve and OCC, Enhanced Supplementary Leverage Ratio Standards for US G-SIBs, 83 Fed Reg 17317 (19 Apr 2018).

42 These numbers reflect currently available public reporting.

43 See 12 CFR Section 217.405–06.

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for non-advanced approaches banking organisations; enhance the transparency of supervisory scenarios, models and assumptions used in capital planning and stress testing; simplify the interactions between capital requirements and capital planning requirements for certain large banking or other financial organisations; and recalibrate the enhanced supplementary leverage ratio requirement for US G-SIBs and their US IDI subsidiaries.[44] In November 2017, in connection with the proposal to simplify and tailor requirements for non-advanced approaches, the US banking agencies finalised a rule to freeze the final step of the transition provisions for certain US Basel III requirements applicable to non-advanced approaches banking organisations. The Federal Reserve in April 2018 proposed a rule that would change how stress testing is used to impose capital requirements for large BHCs by incorporating a firm's modelled stress losses directly into the firm's point-in-time capital requirements. The proposal would replace the 2.5 per cent fixed portion of the capital conservation buffer with a new stress capital buffer (on top of the G-SIB surcharge and any applicable countercyclical capital buffer) and would impose a new stress leverage buffer, each based on a firm's peak-to-trough stress losses and four quarters of planned dividends.

In December 2017, the Basel Committee finalised revisions to the international Basel III standards, marking the finalisation and completion by the Basel Committee of all remaining components of the Basel III framework.[45] The primary purpose of this final set of revisions was to reduce excessive variability in RWAs and to restore credibility in the calculation of RWAs by enhancing the robustness and risk sensitivity of the standardised approaches for credit risk and operational risk, constraining the use of internally modelled approaches and complementing the risk-weighted capital ratio with a finalised leverage ratio and a revised capital floor. In January 2019, following its fundamental review of the trading book, the Basel Committee finalised updated minimum capital requirements for market risk. As of 31 December 2018, the US banking agencies have not proposed rules to implement the revisions to the international Basel III standards, including the market risk requirements, in the United States.

vii Resolution planning

Section 165(d) under Title I of the Dodd–Frank Act requires all BHCs and FBOs with assets of US$50 billion or more, or any non-bank financial institution that has been designated as systemically important,[46] to prepare and regularly update a resolution plan (Title I resolution

44 See Federal Reserve, FDIC, OCC, Proposed Rule on Simplifications to the Capital Rule, 82 Fed. Reg. 49984 (27 Oct 2017); Federal Reserve, Proposed Rule on Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, 82 Fed. Reg. 59547 (15 Dec 2017); Federal Reserve, Proposed Policy Statement on the Scenario Design Framework for Stress Testing, 82 Fed. Reg. 59533 (15 Dec 2017); Federal Reserve, Proposed Stress Testing Policy Statement, 82 Fed. Reg. 59528 (15 Dec 2017); Federal Reserve, Proposed Amendments to the Regulatory Capital, Capital Plan and Stress Test Rules (10 April 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a2.pdf; Federal Reserve and OCC, Proposed Rule on Enhanced Supplementary Leverage Ratio Standards for US G-SIBs (11 Apr 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180411a2.pdf.

45 Basel Committee, Basel III: Finalising Post-Crisis Reforms (December 2017), available at https://www.bis.org/bcbs/publ/d424.htm.

46 See Dodd–Frank Act, US Public Law No. 111-203, Section 113, 124 US Statutes at Large 1375, 1398 (2010); 77 Federal Register 21637 (11 April 2012). See also Davis Polk & Wardwell LLP, 'FSOC

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plan).[47] Under the final rules implementing this provision, these entities must each periodically submit a report regarding the company's plan for rapid and orderly resolution under the US Bankruptcy Code or other applicable insolvency law in the event of material financial distress at or failure of the company.[48] In May 2018, the EGRRCPA raised the asset threshold for financial institutions that need to submit resolution plans – resolution plans are now statutorily required for BHCs with assets of US$250 billion or more; any BHC, regardless of asset size, that has been identified as a G-SIB; any BHC with assets of US$100 billion or more for which the Federal Reserve by order or rule chooses to require a resolution plan; and any non-bank financial institution that has been designated as systemically important.[49] The EGRRCPA also made clear that its changes do not alter the Federal Reserve's treatment of FBOs with assets of US$100 billion or more under pre-existing regulations.[50] Although regulators have indicated that they will enforce resolution planning requirements consistently with the new thresholds established in the EGRRCPA,[51] revised implementing regulations have not yet been proposed as of 31 December 2018.

The resolution plan is submitted to and evaluated by the Federal Reserve and the FDIC. If the plan were deficient, or deemed not credible, the Federal Reserve and the FDIC could jointly agree to impose increasingly onerous restrictions on the company until the plan is determined to be credible. The FDIC separately requires all US IDIs with assets of US$50 billion or more to also submit and regularly update a resolution plan.[52] Resolution planning is one of the areas that has frequently been identified by the Federal Reserve and the FDIC as one of potential financial regulatory reform and tailoring, including by extending the filing deadlines between resolution plan submissions.[53] On 20 December 2018, the Federal Reserve and FDIC issued guidance for the largest US financial institutions regarding their 2019 resolution plan submissions,[54] and senior officials of the Federal Reserve and FDIC, including FDIC Chair Jelena McWilliams in November 2018, publicly discussed Federal

Issues Final Rule on Designation of Systemically Important Nonbank Financial Companies' (4 Apr 2012), www.davispolk.com/files/Publication/bd4d269c-ecc1-4757-a5ae-007f26f378e1/Presentation/PublicationAttachment/c6a028ce-271b-4aef-b140-02f4b9094236/040412_FSOC.Final.Rules.pdf.

47 Dodd–Frank Act, US Public Law No. 111-203, Section 165(d), 124 US Statutes at Large 1375, 1426 (2010).

48 Federal Reserve, FDIC, Final Rule, Resolution Plans Required, 76 Federal Register 67323 (1 Nov 2011).

49 Economic Growth, Regulatory Relief, and Consumer Protection Act, US Public Law No. 115-174, Section 402, 132 US Statutes at Large 1296, 1356 (2018).

50 Ibid; see also Federal Reserve, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed Reg 17240 (27 Mar 2014).

51 See Federal Reserve, FDIC, and OCC, Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) (6 July 2018), www.occ.treas.gov/news-issuances/news-releases/2018/nr-ia-2018-69a.pdf; Federal Reserve, Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) (6 July 2018), www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706b1.pdf.

52 FDIC, Final Rule, Resolution Plans Required for Insured Depository Institutions with $50 Billion or More in Total Assets, 77 Federal Register 3075 (23 Jan 2012).

53 For example, in September 2017, the Federal Reserve and the FDIC gave a one-year filing extension for the eight large domestic banks, following the Treasury's banking report which recommended that the agencies change the living wills process by moving to a two-year cycle, see https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171219a.htm.

54 Federal Reserve, FDIC, Final Guidance for the 2019, 84 Federal Register 1438 (4 Feb 2019).

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Reserve and FDIC efforts to propose amendments to tailor and focus their resolution planning regulations in light of the EGRRCPA, suggesting the likelihood of changes in the near future.[55]

viii Orderly liquidation authority

Title II of the Dodd–Frank Act includes an orderly liquidation authority (OLA), modelled on the US bank resolution authority in the Federal Deposit Insurance Act, which would allow the government, under certain circumstances, to resolve a US financial company outside the bankruptcy process.

Specifically, if a determination to place a financial company under this resolution regime were made, the FDIC would step in as receiver of the company, with the authority to sell all or any assets and liabilities to a third party, or establish one or more bridge financial companies to hold the part of the business worth preserving until it could be recapitalised, sold or liquidated in an orderly fashion. The Act provides for an orderly liquidation fund to be used to provide liquidity to the covered financial company or bridge financial company. That fund would not be pre-funded, but rather would be funded initially through borrowing from the US Treasury. Any loss in the fund would be paid back over time, either through a clawback from creditors who received additional benefits or through assessments on eligible financial companies.

On 15 July 2011, the FDIC issued a final rule implementing certain provisions of OLA, including:

a how the preferential transfer and fraudulent transfer provisions of OLA will be harmonised with the Bankruptcy Code;

b the priorities of administrative expenses and unsecured claims;

c the obligations of bridge financial companies with respect to assumed claims and the use of any proceeds realised from the sale or other disposition of the bridge;

d certain details of the FDIC's administrative claims process;

e special rules for secured claims;

f proposals for determining whether senior executives or directors of a covered financial company were substantially responsible for its failure and may therefore be ordered to return up to two years of their remuneration; and

g the treatment of claimants whose set-off rights are destroyed by the FDIC.[56]

After public statements by the FDIC chair indicating that the FDIC's preferred method for resolving the largest and most complex banking groups under Title II is the single-point-of-entry (SPOE) recapitalisation model,[57] the FDIC released a notice providing information about how the FDIC would carry out an SPOE recapitalisation in resolving a US G-SIB under Title II.[58] Under the SPOE model, only the parent BHC of a banking group would be

55 Jelena McWilliams, Keynote Remarks to 2018 Annual Conference of The Clearing House (TCH) and Bank Policy Institute (BPI) (28 Nov 2018), www.fdic.gov/news/news/speeches/spnov2818.html.

56 FDIC, Final Rule: Certain Orderly Liquidation Authority Provisions under Title II of the Dodd–Frank Act, 76 Fed. Reg. 41626 (15 Jul 2011).

57 Martin J Gruenberg, acting chair, FDIC, 'Remarks to the Federal Reserve Bank of Chicago Bank Structure Conference' (10 May 2012), www.fdic.gov/news/news/speeches/chairman/spmay1012.html.

58 FDIC, Notice and Request for Comment, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy', 78 Fed Reg 76614 (18 Dec 2013).

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put into a resolution proceeding. All the parent's assets, including its ownership interests in operating subsidiaries, would be transferred to a bridge financial company. The transferred business would be recapitalised by leaving behind the failed company's equity capital and a sufficient amount of its unsecured long-term debt in a receivership. The operating subsidiaries would be recapitalised and kept out of insolvency proceedings by converting loans or other extensions of credit from the parent into new equity in the operating subsidiaries or otherwise downstreaming available parent assets to the subsidiaries. If the bridge financial holding company (FHC) or any of its operating subsidiaries were unable to obtain sufficient liquidity from the market, the Federal Reserve's discount window[59] or Section 13(3) of the FRA,[60] the FDIC could provide such liquidity with an orderly liquidation fund by borrowing from the US Treasury, subject to certain limits.[61]

ix Total loss-absorbing capacity

To facilitate an SPOE recapitalisation, the parent BHC of a banking group must have a sufficient amount of long-term debt or other resources capable of absorbing losses to be left behind in a receivership or bankruptcy proceeding. To that end, the application of a minimum requirement of total loss-absorbing capacity (TLAC) for G-SIBs was discussed by the international regulatory community for several years, resulting in the publication by the Financial Stability Board of a statement of principles and a term sheet for an international TLAC standard.[62] On 15 December 2016, the Federal Reserve released a final rule implementing the international TLAC standard for the parent BHCs of US G-SIBs and IHCs created pursuant to EPS that are controlled by foreign G-SIBs.[63] Under the rule, beginning on 1 January 2019, parent BHCs of US G-SIBs and IHCs that are controlled by foreign G-SIBs became subject to minimum TLAC requirements, separate minimum long-term debt requirements and clean holding company requirements intended to simplify holding company balance sheets. The BHCs and IHCs subject to the rule are generally able to satisfy TLAC requirements with a combination of Tier 1 capital instruments and unsecured long-term debt that, unlike short-term debt, would not run off as a G-SIB experiences financial distress. Separately, the rule requires parent BHCs of US G-SIBs and IHCs that are controlled by foreign G-SIBs to hold certain minimum amounts of unsecured long-term debt. The clean holding company requirements prohibit parent BHCs of US G-SIBs and IHCs that are controlled by foreign G-SIBs from entering into certain transactions that might impede an orderly resolution, such as issuing short-term debt to or entering into certain types of financial contracts with third parties, and limit the amount of operational liabilities and liabilities such as structured notes

59 See, e.g., 12 US Code of Federal Regulations Part 201; the Federal Reserve Discount Window (21 Jul 2010), www.frbdiscountwindow.org/Home/Pages/General-Information/The-Discount-Window#eligibilityps.

60 12 USC Section 343.

61 See Dodd–Frank Act, US Public Law No. 111-203, Section 210(n), 124 US Statutes at Large 1375, 1506-09 (2010).

62 Financial Stability Board, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet (9 November 2015).

63 Federal Reserve, Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important US Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed Reg 8266 (15 Dec 2016).

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that rank *pari passu* or junior to TLAC in part to limit the risk of successful legal challenge to losses being imposed on holders of TLAC instruments.

x Qualified financial contracts

One potential impediment to an SPOE recapitalisation is the inclusion of cross-default provisions in qualified financial contracts (QFCs) that would not be automatically stayed in a resolution of the parent BHC under ordinary insolvency proceedings. This would mean that a counterparty could terminate a QFC against a subsidiary based on the entry of its parent into resolution proceedings, even if the subsidiary otherwise remains operational and able to perform on its obligations, which could impair the continued viability of the subsidiary. This would defeat the purpose of an SPOE resolution, which is meant to enable subsidiaries of the parent BHC to continue operating without entering into their own bankruptcy or resolution proceedings.

The US banking agencies have issued final rules that would require US G-SIBs and the US operations of non-US G-SIBs to remediate certain QFCs to eliminate the ability of a counterparty to exercise any cross-default right against a G-SIB entity based on the top-tier parent's or any other affiliate's entry into insolvency, resolution, or similar proceedings, subject to certain creditor protections, and to eliminate the right of counterparties to object to the transfer of any related credit enhancements provided by an affiliate following the entry into any such proceedings. In addition, US G-SIBs and the US operations of non-US G-SIBs must amend certain QFCs to expressly recognise the FDIC's authority under the Federal Deposit Insurance Act and Title II of the Dodd–Frank Act (the OLA provisions described in Section III.viii) to impose a temporary stay on the ability of counterparties to exercise certain default rights, and to transfer the contracts of the failed institution to a third party or bridge institution. There is a phased-in compliance schedule based on counterparty type, beginning with 1 January 2019 for contracts with other US G-SIBs or the US operations of non-US G-SIBs, 1 July 2019 for contracts with certain other financial counterparties and 1 January 2020 for contracts with all other counterparties. The requirements apply to new and existing QFCs.[64]

These rules complement the international protocol developed by the International Swaps and Derivatives Association (ISDA) at the request of various financial regulators around the world, including the Federal Reserve and the FDIC (ISDA Protocol). The ISDA Protocol provides for the contractual recognition of statutory stays under certain special resolution regimes and contractual limitations on early termination rights based on cross-defaults under ISDA master agreements and certain other types of financial contracts. The rules would enable relevant G-SIBs to comply with the requirements through adherence to the ISDA Protocol and its annexes or through a new US Protocol that is substantively similar to the ISDA Protocol, which was published by ISDA on 31 July 2018.[65]

64 Federal Reserve, Restrictions on Qualified Financial Contracts of Systemically Important US Banking Organizations and the US Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 Fed. Reg. 42,882 (12 Sep 2017); FDIC, Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 Fed. Reg. 50,228 (30 Oct 2017); OCC, Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 82 Fed. Reg. 56,630 (29 Nov 2017).

65 12 CFR Section 252.85(a); 12 CFR Section 382.5(a); 12 CFR Section 47.6.

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xi Enhanced cyber risk management standards

As a result of recent high-profile cyberattacks on banks and other financial institutions, state and federal regulators[66] have proposed new cybersecurity regulations to protect financial institutions and consumers to supplement the already expansive web of regulator-issued cybersecurity rules and guidance to which BHCs and banks are currently subject.[67] In March 2017, the New York Department of Financial Services' (NYDFS) new cybersecurity regulations[68] that apply to banks (including New York branches and agencies of foreign banks) and certain other financial institutions chartered or licensed in New York State became effective. The rules require covered entities to, among other things, establish and maintain a cybersecurity programme with a written cybersecurity policy, appoint a chief information security officer, conduct regular penetration testing and vulnerability assessments, create a written incident response plan, encrypt non-public information in transit and at rest, and certify compliance with the rules annually. The regulation includes a phase-in schedule, with the final compliance date being 1 March 2019.[69] Covered entities will be required to certify compliance with the phase four requirements by 15 February 2020.[70] We expect cybersecurity to continue to be an area of focus by lawmakers and regulatory agencies in the United States.

xii Fintech charters

Fintech charters continue to be an area of interest in the United States. On 31 July 2018, the OCC issued a policy statement announcing that it would consider applications from fintech companies to become special purpose national banks.[71] In contrast to the regulatory sandbox initiatives by some non-US regulators, the OCC's special-purpose charter, like all national bank charters, comes with a host of regulatory obligations and activity limitations. The special purpose national bank charter is available to qualifying companies engaged in a limited range of banking activities, including paying cheques or lending money, but that do not take deposits. Concurrent with the announcement, the OCC issued a supplement to its licensing manual to provide guidance for evaluating special purpose national bank charters

66 In October 2016, the US federal banking agencies issued an advance notice of proposed rule-making on enhanced cyber risk management standards (Enhanced Standards) for large and interconnected entities and their third-party service providers. The proposed rule addressed five broad categories of cyber standards: cyber risk governance; cyber risk management; internal dependency management; external dependency management; and incident response, cyber resilience and situational awareness. In January 2017, the comment period for the proposed rule was extended. The US federal banking agencies have yet to issue a final rule.

67 See, e.g., Federal Financial Institutions Examination Council Information Technology Examination Handbook, Internet Security (Sep 2016), ithandbook.ffiec.gov/media/216407/informationsecurity2016booklet.pdf.

68 NYCRR Part 500.

69 The first three phases of requirements include penetration testing and vulnerability assessments, a risk assessment, multi-factor authentication, cybersecurity awareness training, audit trails, application security, limitations on data retention, monitoring and encryption of non-public information.

70 The final phase of compliance includes a third-party service provider policy.

71 OCC, Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters (31 July 2018), https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-occ-policy-statement-fintech.pdf.

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for fintech companies.[72] Following the announcement, the NYDFS and the Conference of State Bank Supervisors separately filed suit against the OCC to stop it from granting applications for the special purpose national bank charter, arguing that the agency lacks the legal authority to charter non-depository institutions. As of 31 December 2018, the OCC had not received any applications for the special purpose national bank charter.

xiii Virtual currencies

As digital assets have grown in both popularity and market size, the US Congress and a number of US federal and state agencies, including the SEC, the US Commodity Futures Trading Commission (CFTC) and the CFPB, have examined the operations of digital asset networks, with particular focus on the extent to which digital assets can be used to launder the proceeds of illegal activities or fund criminal or terrorist enterprises and the safety and soundness of exchanges or other service providers that take custody of digital assets for users.[73] Many of these state and federal agencies have issued consumer advisories regarding the risks posed to investors in digital assets. The SEC and US state securities regulators have issued warnings that digital assets sold in initial coin offerings (ICOs) may be classified as securities and that both those digital assets and ICOs may be subject to securities regulations.[74] In addition, federal and state agencies have issued rules or guidance about the treatment of digital asset transactions or requirements for businesses engaged in digital asset activity.[75]

IV CONDUCT OF BUSINESS

The activities of banks, BHCs and FHCs are subject to a number of overlapping legal requirements. While chartered banks and their subsidiaries are restricted to engaging in the business of banking, BHCs and their subsidiaries are permitted to engage in a broader range of financial activities 'so closely related to banking as to be a proper incident thereto'. BHCs that elect to become FHCs are permitted to engage in an even broader range of activities that are financial in nature or incidental to such financial activity or complementary to a financial activity. Some of the most important legal requirements defining the relationship between banks, BHCs and FHCs are summarised below.

72 OCC, Comptroller's Licensing Manual Supplement: Considering Charter Applications from Financial Technology Companies (July 2018), https://www.occ.treas.gov/publications/publications-by-type/licensing-manuals/pub-considering-charter-apps-from-fin-tech-co.pdf.

73 See, e.g., Government Accountability Office, Virtual Currencies – Emerging Regulatory, Law Enforcement, and Consumer Protection Challenges (May 2014), https://www.gao.gov/assets/670/663678.pdf.

74 SEC, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (7 Mar 2018), https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

75 For example, in 2015, the NYDFS finalised a rule that requires most businesses involved in digital asset business activity in or involving New York, excluding merchants and consumers, to apply for a licence, commonly known as a BitLicense, from the NYDFS and to comply with anti-money laundering (AML), cyber security, consumer protection, and financial and reporting requirements, among others, see, https://www.dfs.ny.gov/legal/regulations/bitlicense_reg_framework.htm.

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i Permissible activities

Banks

The types of activities that are permissible for banks in the United States depend on banks' charter type. The baseline is the activities permissible for nationally chartered banks, which are set forth in the National Banking Act and pursuant to which national banks may engage in the business of banking and any activities that are incidental to banking.[76] State law, which generally governs the permissibility of activities in which state-chartered banks may engage, varies from state to state, but tends to be consistent with or slightly broader in scope in terms of permissible activities for banks chartered in the relevant state.

Pursuant to the National Banking Act, a national bank's permitted activities expressly include securities brokerage[77] and investments in certain debt securities.[78] In addition to the activities expressly permitted under the National Banking Act, the OCC has the power to authorise activities beyond those that are specifically enumerated.[79] The OCC has exercised this authority by issuing numerous interpretations concluding that specific activities are permissible for national banks, and has summarised many of these interpretations in a publication entitled 'Activities Permissible for National Banks and Federal Savings Associations, Cumulative'.[80]

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76 See 12 USC Section 24. The specific authorising language is contained in Section 24(7) of the National Banking Act, pursuant to which a national banking association has the power to 'exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes'.

77 12 USC Section 24(7) permits the 'purchasing and selling [of securities and stock] without recourse, solely upon the order, and for the account of, customers'. In contrast, securities underwriting and dealing are expressly prohibited by the National Banking Act – 'The business of dealing in securities and stock by the association shall be limited to purchasing and selling [such securities as agent] and in no case for its own account, and the association shall not underwrite any issue of securities or stock' – except that the association may deal in US government or agency securities and purchase for its own account certain other investment securities.

78 12 USC Section 24(7) also permits 'the association [to] purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe', subject to certain limits on the amount of investment securities issued by any single issuer, other than the United States and certain agencies and other bodies specified in the statute. The term investment securities is defined as 'marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency'. The OCC has further defined investment securities in 12 CFR Part 1.

79 It was debated for many years whether the business of banking was limited to the activities enumerated in 12 USC Section 24(7), or whether those activities were merely illustrative of the activities included within the business of banking. The US Supreme Court settled this debate in 1995 by holding that 'the business of banking is not limited to the enumerated powers in [12 USC Section 24(7)] and that the [OCC] therefore has discretion to authorise activities beyond those specifically enumerated. The exercise of the [OCC]'s discretion, however, must be kept within reasonable bounds'. See footnote 2 in *NationsBank of North Carolina v. Variable Annuity Life Insurance Co*, 513 US 252 (1995).

80 OCC, Activities Permissible for National Banks and Federal Savings Associations, Cumulative (Oct 2017), https://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/pub-other-activities-permissible-october-2017.pdf.

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Bank holding companies

The BHC Act generally prohibits a BHC from owning or controlling any company other than a US bank, or from engaging in, or directly or indirectly owning or controlling any company engaged in, any activities that are not 'so closely related to banking as to be a proper incident thereto'.[81] The BHC Act's general prohibition is subject to a series of exemptions, which are principally contained in Sections 4(c) and 4(k) of the BHC Act.

The activities permitted to BHCs pursuant to the exemptions in Section 4(c) of the BHC Act are divided into several categories, the most important of which was enacted in 1999 through the Gramm–Leach–Bliley Act (GLB Act), when Congress amended the BHC Act to codify a list of non-banking activities that the Federal Reserve approved by regulation prior to 12 November 1999 as being 'so closely related to banking as to be a proper incident thereto'.[82] BHCs and their subsidiaries may thus engage in activities contained in the Federal Reserve's Regulation Y (informally known as the laundry list),[83] subject to any applicable notice or other procedures. This list is now frozen in the sense that, pursuant to the GLB Act, no new non-banking activities may be determined to be so closely related to banking as to be a proper incident thereto and thus permissible for BHCs. There are some additional activities that were approved by specific orders issued by the Federal Reserve,[84] and staff of the Federal Reserve have issued interpretations that particular activities fall within one or more existing laundry list activities.[85] Activities that are considered so closely related to banking as to be a proper incident thereto include:[86]

a extending credit and servicing loans, and activities related to extending credit;
b leasing personal or real property;
c operating non-bank depository institutions and performing trust company functions;
d financial and investment advisory activities, and management consulting and counselling activities;
e agency transactional services for customer investments, and investment transactions as principal;
f insurance agency; and
g data processing.

81 See 12 USC Section 1843(a), (c)(8). The BHC Act also contains various narrow exemptions from this general prohibition, including exemptions that allow a BHC to make non-controlling investments for its own account or an investment fund controlled by it in up to 4.9 per cent of any class of voting securities and up to 24.9 per cent of the total equity (including voting, non-voting securities and subordinated debt) of any non-banking company; invest in a subsidiary that does not have any office or direct or indirect subsidiary or otherwise engage in any activities directly or indirectly in the United States, other than those that are incidental to its foreign or international business; hold investments as a fiduciary; or furnish services to its subsidiaries (12 USC Sections 1843(c)(1)(C), (c)(4), (c)(6), (c)(7), (c)(13)).

82 12 USC Section 1843(a), (c)(8).

83 12 CFR Part 225.

84 For a comprehensive description of these activities in general, see the 1997 Federal Reserve revision of Regulation Y, available at www.federalreserve.gov/boarddocs/press/boardacts/1997/19970220/R-0935-36.pdf.

85 For example, flood zone determination services were found to be permissible under extending credit pursuant to 12 CFR Section 225.28(b)(2) and variable production payments and certain spot purchase-forward sale transactions have been interpreted as extending credit under 12 CFR Section 225.28(b)(1), (2).

86 See 12 USC Section 1843(a), (c)(8); 12 CFR Section 225.28(b).

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Financial holding companies

The BHC Act was further amended in 1999 by the GLB Act to permit BHCs to exercise certain expanded powers if they qualify for and elect to be treated as FHCs.[87] In contrast to ordinary BHCs, FHCs are not limited to owning and controlling banks and engaging in, or owning or controlling companies engaged in, activities that are closely related to banking. FHCs may also engage in, or own or control companies engaged in, any activity that is financial in nature, incidental to a financial activity or complementary to a financial activity.[88] This category of financial and financial-related activities includes everything deemed to be closely related to banking and much more.[89] In particular, FHCs may make controlling and non-controlling investments in companies engaged exclusively in financial activities or activities that are incidental or complementary to financial activities, including securities underwriting and dealing beyond that permitted for banks, insurance underwriting, merchant banking, insurance company portfolio investments and certain commodities trading.[90] Under the merchant banking authority, FHCs may make controlling and non-controlling investments in non-financial and mixed financial or non-financial companies, including companies engaged in owning and managing real estate, subject to certain conditions.[91]

The GLB Act also permits FHCs to engage within or outside the United States in activities determined to be usual in connection with the transaction of banking abroad.[92] FHCs may engage in any activity permissible for US BHCs outside the United States under the Federal Reserve's Regulation K,[93] including management consulting services, travel agency services, and organising, sponsoring and managing mutual funds, subject to certain limitations.[94]

ii Changes in permissible activities

Volcker Rule

Section 13 of the BHC Act, popularly known as the Volcker Rule,[95] as implemented in final regulations issued by the five US federal financial regulatory agencies with rulemaking

87 Gramm–Leach–Bliley Act of 1999, Pub L No 106-102, 106th Cong, 1st Sess (12 Nov 1999), 113 Stat 1338–1481 (1999). Although the GLB Act softened the US policy of maintaining an appropriate separation between banking and commerce, it did not eliminate that separation. To become an FHC, a BHC and each of its IDI subsidiaries must be well capitalised and well managed as those terms are defined in the Federal Reserve's Regulation Y. See 12 CFR Section 225.2(r) and (s).

88 12 USC Section 1843(k)(1).

89 12 USC Section 1843(k)(4), especially (k)(4)(F).

90 12 USC Sections 1843(k)(4)(B) (insurance underwriting); (k)(4)(E) (securities underwriting and dealing); (k)(4)(H) (merchant banking); (k)(4)(I) (insurance company portfolio investments). See, e.g., The Royal Bank of Scotland, 94 Federal Reserve Bulletin C60 (2008) (certain energy commodities trading as a complement to energy derivatives trading).

91 12 USC Section 1843(k)(4)(H) (merchant banking).

92 12 USC Section 1843(k)(4)(G).

93 See 12 CFR Part 211, Subpart A.

94 See 12 CFR Section 225.86(b).

95 Former Federal Reserve Chair Paul Volcker, although not formally involved in the Dodd–Frank Act legislative process that added Section 13 to the BHC Act, was among the leading advocates for imposing restrictions on proprietary trading and private funds activities by banks and their affiliates in the Act.

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authority under Section 13 (Volcker Agencies) on 10 December 2013 (2013 Regulations),[96] prohibits any banking entity[97] from engaging in proprietary trading, or sponsoring, investing in or having a certain relationship with a covered fund, the definition of which is intended to cover hedge funds and private equity funds, subject to certain exceptions for permitted activities.[98] The prohibitions and other restrictions imposed by the Volcker Rule and the 2013 Regulations affect not only the worldwide activities of US banking organisations but also the US activities of FBOs that engage in the prohibited or restricted activities as well as certain of their non-US activities. The following discussion summarises the key terms of the Volcker Rule as set forth in the statutory text and 2013 Regulations along with certain recent developments, including a proposal to amend the 2013 Regulations.

Prohibition on proprietary trading

Under the 2013 Regulations, proprietary trading is defined broadly to include, with limited exceptions, the purchase or sale as principal of any securities, derivatives, futures contracts or options on futures contracts, for the trading account of the banking entity.[99] Trading account is defined as any account used by a banking entity to purchase or sell any such financial instruments principally for the purpose of short-term resale, benefiting from short-term price movements, realising short-term arbitrage profits or hedging one of those positions (purpose test).[100] The 2013 Regulations also include within the definition of trading account certain purchases or sales of financial instruments by banking entities that are subject to the US market risk capital rule (market risk capital rule test), and purchases or sales of financial instruments by banking entities that are registered or licensed (or required to be registered or licensed) to conduct certain dealing activities, provided that the purchases or sales occur in connection with activities that require such registration or licensing (status test).[101]

Certain definitions, exclusions and exemptions limit the scope of the proprietary trading prohibition. First, the prohibition applies only to financial instruments, including

96 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed Reg 5536 (31 Jan 2014).

97 As originally enacted, Section 13 defined banking entity as 'any insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act (12 USCA [Section] 1813)), any company that controls an IDI, or that is treated as a BHC for purposes of Section 8 of the International Banking Act (IBA), and any affiliate or subsidiary of any such entity', not including certain institutions that function solely in a trust or fiduciary capacity, under certain conditions. 12 USCA Section 1851(h)(1). Under Section 8 of the IBA, a foreign bank with a US commercial banking presence, and any company deemed to control such a foreign bank, is treated as a BHC. 12 USCA Section 3106(a). The 2013 Regulations largely conformed to the statutory definition of banking entity but expanded the exclusions from banking entity to include any covered fund, portfolio company held under the merchant banking or insurance company investment authorities of Section 4(k) of the BHC Act, or portfolio concern controlled by a small business investment company, in each case, that is not itself a banking entity under the definition of such term, as well as the FDIC acting in its corporate capacity or as conservator or receiver. 12 CFR Section 248.2(c)(2). As discussed below, the EGRRCPA revised Section 13's definition of banking entity to exclude (and thus exempt from the Volcker Rule) certain community banking organisations with limited trading activities.

98 12 USCA Section 1851(a).

99 12 CFR Section 248.3(a). The regulations provide a more detailed definition of the term proprietary trading than in the statute. 12 USCA Section 1851(h)(4).

100 12 CFR Section 248.3(b)(1)(i).

101 12 CFR Section 248.3(b)(1)(ii)-(iii).

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securities, derivatives, futures and options on futures,[102] and a number of instruments are explicitly excluded from the definition of financial instrument.[103] Second, certain activities in financial instruments are excluded from the definition of proprietary trading, including, subject to certain conditions, purchases or sales of financial instruments.[104] Lastly, there are also conditional permitted activity exemptions, which include:[105]

a trading in US government obligations and, in the case of non-US banking entities, trading in certain foreign government obligations;

b trading in connection with underwriting or market-making-related activities;

c risk-mitigating hedging activities;

d trading on behalf of customers;

e certain trading activities outside the United States by non-US banking entities;

f trading by a regulated insurance company or its affiliate solely for the general account of the regulated insurance company in compliance with applicable insurance company investment laws; and

g such other activity as the agencies determine would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

Prohibition on certain relationships with hedge funds and private equity funds

The Volcker Rule and the 2013 Regulations prohibit a banking entity from, as principal, acquiring or retaining any ownership interest in or sponsoring a covered fund, subject to certain exclusions and permitted activities.[106] Covered fund is defined broadly in the 2013 Regulations as an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (1940 Act),[107] but for Section 3(c)(1) or 3(c)(7) of the 1940 Act;[108] certain funds organised or established outside the United States in which a US banking entity

102 The term derivatives includes swaps, security-based swaps (SBSs), foreign exchange forwards and swaps, physical commodity forwards, and retail foreign exchange and retail commodity transactions. See 12 CFR Section 248.3(c)(2).

103 The exclusions cover, for example, loans, non-financial spot commodities, and foreign exchange and currency. See 12 CFR Section 248.3(c)(2).

104 See 12 CFR Section 248.3(d).

105 See 12 USCA Section 1851(d)(1)(A)-(J). Permitted activities may not include, however, any activity that would involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties; result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; or pose a threat to US financial stability or the safety and soundness of the banking entity (backstop provisions). See 12 USCA Section 1851(d)(2)(A).

106 12 USCA Section 1851(a)(1).

107 15 USCA Section 80a-3.

108 Investment Company Act of 1940 Section 3(c)(1), (7), 15 USCA Section 80a-3. This definition is very broad. The exemptions under Section 3(c)(1) and (7) of the 1940 Act can be used to exempt any entity from the definition of investment company regardless of how it invests or what it invests in, so long as certain limits on the number or financial characteristics of its investors are satisfied.

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invests or which a US banking entity sponsors;[109] and certain commodity pools.[110] The 2013 Regulations, however, expressly exclude certain categories of entities from the definition of covered fund, provided they meet certain conditions.[111]

An ownership interest is defined in the 2013 Regulations as any equity, partnership or other similar interest.[112] An other similar interest is any interest, other than certain restricted profit interests,[113] that has or exhibits certain characteristics, such as the right to participate in the selection or removal of a covered fund's general partner, investment manager or similar party,[114] certain economic rights commonly present in equity[115] or synthetic rights to these rights.[116] Subject to certain conditions, the prohibition on acquiring or retaining an ownership interest in a covered fund does not apply to an interest acquired by a banking entity not acting as principal.[117]

A banking entity is a sponsor of a covered fund if, generally, it serves as a covered fund's general partner, managing member, trustee with investment discretion over the covered fund[118] or commodity pool operator;[119] selects or controls a majority of a covered fund's directors, trustees or management; or shares the same name or a variation thereof with a covered fund.[120] Subject to the same backstop provisions limiting permitted activities

109 A fund that is organised or established outside the United States that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, and all the ownership interests of which are offered and sold solely outside the United States, is a covered fund with respect to a banking entity that is located in or organised under US law, and any banking entity directly or indirectly controlled by such a banking entity, if that banking entity or an affiliate sponsors or directly or indirectly holds an ownership interest in that fund. 12 CFR Section 248.10(b)(1)(iii). A fund that is organised or established outside the United States but that relies on Section 3(c)(1) or 3(c)(7) of the 1940 Act is also a covered fund.

110 A commodity pool, as defined in Section 1a(10) of the Commodity Exchange Act (CEA), 7 USC Section 1a(10), is a covered fund if the commodity pool operator has claimed exempt pool status under 17 CFR Section 4.7, or if the operator is registered with the CFTC as a commodity pool operator in connection with the operation of the pool in question, and the pool's participation units are substantially all owned by qualified eligible persons (QEPs), as defined in 17 CFR Section 4.7(a)(2) and (3), and have not been publicly offered to persons that are not QEPs. 12 CFR Section 248.10(b)(1)(ii).

111 See 12 CFR Section 248.10(c).

112 12 CFR Section 248.10(d)(6)(i).

113 12 CFR Section 248.10(d)(6)(ii).

114 12 CFR Section 248.10(d)(6)(i)(A).

115 12 CFR Section 248.10(d)(6)(i)(B)-(F).

116 12 CFR Section 248.10(d)(6)(i)(G).

117 See 12 CFR Section 248.10(a)(2).

118 A banking entity that serves as a trustee that does not exercise investment discretion is not a sponsor of a covered fund. See 12 CFR Section 248.10(d)(10)(i). With respect to such a covered fund, however, a banking entity that directs such a trustee or that otherwise possesses investment discretion with respect to the fund will be considered a sponsor of the fund. See 12 CFR Section 248.10(d)(10)(ii).

119 Serving as a commodity pool operator will only cause a banking entity to be a sponsor of a covered fund if the fund is a covered fund under 12 CFR Section 248.10(b)(1)(ii).

120 The EGRRCPA revised Section 13's covered fund name-sharing restriction to allow a covered fund to share the same name, or a variation of the same name, as a banking entity that is an investment adviser to the fund, if the investment adviser is not and does not share the same name as an IDI, a company that controls an IDI, or a foreign company treated as a BHC under the IBA, and the fund's name does not contain the word bank. Pub. L. 115-174, Section 204 (amending 12 USCA Section 1851(d)(1)(G)(vi)).

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as described in the discussion of proprietary trading above, the Volcker Rule and the 2013 Regulations provide conditional permitted activity exemptions from the prohibition on acquiring or retaining ownership interests in or sponsoring a covered fund.[121]

Limitations on certain transactions with sponsored, advised, managed or organised and offered covered funds

The Volcker Rule and the 2013 Regulations prohibit any banking entity that serves as the investment manager or adviser, commodity trading adviser or sponsor of a covered fund, or that organises and offers a covered fund pursuant to the permitted activity exemptions for asset management and similar customer services or for issuers of ABS (or that holds an interest under the exemption for ABS issuers), and any affiliate of that banking entity, from entering into a covered transaction as defined in Section 23A of the FRA with any such fund, or any covered fund controlled by that fund, as if the banking entity were a member bank and the fund were its affiliate. In addition, any transactions between any such banking entity and any such fund are subject to Section 23B of the FRA as if the banking entity were a member bank and the fund were its affiliate.[122]

This prohibition is commonly referred to as Super 23A to distinguish it from the regular provisions of Section 23A of the FRA. Regular Section 23A applies only to covered transactions between an IDI and its affiliates, whereas Super 23A applies to covered transactions between any banking entity (including a BHC, an FBO and any of their subsidiaries or affiliates) and any sponsored or advised covered fund. In addition, Super 23A imposes an absolute ban on any covered transactions that fall within its scope, whereas regular Section 23A generally imposes only certain numerical limitations and collateral requirements on covered transactions.[123]

Subject to certain conditions, the Volcker Rule and the 2013 Regulations grant an exemption from the Super 23A prohibition for the purposes of permitting a banking entity to enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored or advised by the banking entity has taken an ownership interest.[124] Prime brokerage transactions are defined as 'any transaction that would be a covered transaction . . . that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational and administrative support'.[125]

121 These exemptions include (1) organising and offering a covered fund in connection with asset management or similar customer services, see 12 CFR Section 248.11(a), (2) organising and offering an issuer of asset-backed securities (ABS), see 12 CFR Section 248.11(b), (3) underwriting and market making in ownership interests in covered funds, see 12 CFR Section 248.11(c), (4) risk-mitigating hedging of employee compensation arrangements, see 12 CFR Section 248.13(a), (5) certain covered fund activities and investments outside the United States by non-US banking entities, see 12 CFR Section 248.13(b), (6) covered fund activities and investments by a regulated insurance company, see 12 CFR Section 248.11(c), and (7) such other activity as the agencies determine 'would promote and protect the safety and soundness of the banking entity and the financial stability of the United States', see 12 USCA Section 1851(d)(1)(J).

122 Section 23B requires that many transactions between a bank and an affiliate, including any covered transaction under Section 23A, be conducted on market terms. 12 USCA Section 371c-1(a). For more information on Section 23B, see 'Transactions with affiliates' (subsection iii).

123 For a detailed discussion of regular Section 23A, see 'Transactions with affiliates' (subsection iii).

124 12 USCA Section 1851(f)(3); 12 CFR Section 248.14(a)(2)(ii).

125 12 CFR Section 248.10(d)(7).

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Application to FBOs and extraterritorial application

The Volcker Rule and the 2013 Regulations generally apply to FBOs in the same manner as banking entities organised under US law. Nevertheless, the statutory text of the Volcker Rule specifically permits FBOs to engage in proprietary trading pursuant to Section 4(c)(9)[126] or (13)[127] of the BHC Act, provided that the trading occurs solely outside the United States (known as TOTUS).[128] Likewise, the statutory text specifically permits sponsorship of and investments in covered funds conducted by a banking entity pursuant to the Section 4(c)(9) or (13) exemptions solely outside the United States (known as SOTUS) provided that 'no ownership interest in such hedge fund or private equity fund is offered for sale or sold' to a US resident.[129] In both cases, the banking entity must also not be directly or indirectly controlled by a banking entity organised under US federal or state law.[130] The 2013 Regulations state that the SOTUS exemption applies to interests and activities related to both US and non-US based funds and, critically, no ownership interest in the covered fund may be sold to a US person in an offering that targets US persons.[131] The Volcker Agencies clarified this marketing restriction in an FAQ that explicitly noted the restriction's scope is limited to activities of the relevant banking entity.[132] Thus, offerings targeted at or sales to US persons by someone other than the banking entity would not preclude the banking entity from investing in the fund.[133]

Recent developments

In June 2018, the Volcker Agencies issued a proposal meant to simplify and tailor the application of the 2013 Regulations (2018 Proposal).[134] The 2018 Proposal, which has not yet been finalised and remains subject to further revision, would modify the definition of trading account in the 2013 Regulations by eliminating the purpose test and replacing it with an accounting test.[135] Under the proposed accounting test, the purchase or sale of a financial instrument would be included within the Volcker Rule trading account if that financial instrument is recorded at fair value on a recurring basis under applicable accounting standards. In addition, among other changes, the 2018 Proposal would streamline the requirements of the TOTUS and SOTUS exemptions by eliminating certain conditions that the Volcker Agencies believe to have proven burdensome and inefficient. The Volcker

126 12 USCA Section 1843(c)(9).

127 12 USCA Section 1843(c)(13).

128 12 USCA Section 1851(d)(1)(H).

129 12 USCA Section 1851(d)(1)(I).

130 12 USCA Section 1851(d)(1)(H) to (I).

131 12 CFR Section 248.13(b).

132 See Volcker Rule Frequently Asked Questions (27 Feb 2015), https://www.federalreserve.gov/supervisionreg/faq.htm#13.

133 Where the fund is a related covered fund, i.e., because the FBO sponsors or serves, directly or indirectly, as the investment manager, investment adviser, or commodity trading adviser to the covered fund, the fund's own participation in an offering targeting US persons would preclude the use of the SOTUS exemption.

134 CFTC, FDIC, Federal Reserve, OCC and SEC, Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed Reg 33432 (17 July 2018).

135 The 2018 Proposal would retain the market risk capital rule test and the status test, although the market risk capital rule test would be broadened to apply not only to banking entities subject to the US market risk capital rule but also to FBOs subject to market risk capital rules in their home countries, provided that those rules are consistent with the market risk framework published by the Basel Committee.

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Agencies also sought comment in the 2018 Proposal on other potential changes, such as changes to the definition of banking entity, to the definition of covered fund and exclusions from that definition, and to Super 23A.

In addition, recent Congressional action has revised Section 13 to exclude from the definition of banking entity (and thus from the Volcker Rule) certain community banking organisations with limited trading activities. As a result of changes enacted by the EGRRCPA, Section 13's definition of banking entity now excludes an institution that does not have, and is not controlled by a company that has, more than US$10 billion in total consolidated assets, and total trading assets and trading liabilities that are more than 5 per cent of total consolidated assets. The EGRRCPA also revised Section 13's covered fund name-sharing restriction to allow a covered fund to share the same name, or a variation of the same name, as a banking entity that is an investment adviser to the fund, subject to certain conditions.[136] The Volcker Agencies have proposed, but have not yet finalised, revisions to the 2013 Regulations to implement the EGRRCPA's changes to the definition of banking entity and the covered fund name-sharing restriction.[137]

Derivatives

Title VII of the Dodd–Frank Act created a new, comprehensive regulatory system for the previously mostly unregulated over-the-counter derivatives market. While a full treatment of this topic is beyond the scope of this chapter, the most significant aspects of Title VII for BHCs and banks are provisions that:

a require standardised swaps[138] and SBS[139] (collectively referred to here as swaps) to be cleared through regulated central clearing houses and executed on regulated trade execution platforms;

b provide for the registration and comprehensive regulation (including capital, margin, business conduct, documentation, risk management, corporate governance and

136 See footnote 120 for more detail on the applicable conditions.

137 See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 84 Fed Reg 2778 (8 Feb 2019).

138 The definition of swap includes a wide range of agreements, contracts and transactions. In general, a swap includes swaps and options on non-securities, such as interest rate swaps and options, energy and metal swaps, agricultural swaps, commodity swaps and options, cross-currency swaps and non-deliverable forwards, foreign exchange options, swaps on broad-based indices and swaps on government securities, subject to certain exclusions. See CEA Section 1a(47). In November 2012, the US Treasury Secretary issued, pursuant to Title VII, a determination that deliverable FX swaps and FX forwards, as such terms are defined in the CEA, are not swaps and are exempt from many Title VII requirements. Department of the Treasury, Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed Reg 69694 (20 Nov 2012), www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

139 SBS are defined as instruments that otherwise would be swaps, but have certain specified characteristics. Specifically, SBS are instruments that would otherwise be swaps but are based on certain underlying assets, including a single security, a loan, a narrow-based group or index of securities, or events relating to a single issuer or issuers of securities in a narrow-based security index, with exceptions for certain types of government-issued securities. Securities Exchange Act of 1934 (Exchange Act) Section 3(a)(68). In August 2012, the CFTC and SEC jointly issued a final regulation to further define the terms swap and security-based swap. CFTC and SEC, Further Definition of 'Swap', 'Security-Based Swap' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed Reg 48208 (13 Aug 2012), www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf.

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record-keeping requirements) of swap dealers, SBS dealers, major swap participants and major SBS participants (collectively referred to as swaps entities) by the CFTC and the SEC;

c require data concerning all swaps to be reported to trade repositories or regulators and require certain of that data, including price and volume, to be publicly disseminated in an anonymous manner as soon as technologically practicable after a swap transaction is executed; and

d require IDIs and US branches and agencies of non-US banks to push certain limited swap dealing activities out of their banking institutions and into separately capitalised affiliates, subject to important exceptions (referred to as the Swaps Pushout Rule).

The Dodd–Frank Act contains very little about the extraterritorial reach of its swap provisions.[140] In July 2013, the CFTC issued final guidance regarding the cross-border application of its Title VII rules and, in May 2016, it issued a rule-making regarding the cross-border application of its margin requirements for uncleared swaps.[141] Very generally, the CFTC's final cross-border guidance applies Title VII swap rules based on the status of counterparties to the swap transaction, including whether either counterparty is a US person, or is guaranteed by a US person, and has the effect of minimising the application of the CFTC's Title VII regulations to swaps entered into between a non-US person counterparty (such as a non-US swap dealer) and another non-US person counterparty that is neither guaranteed by a US person nor acting as a conduit for the swap activities of its US affiliates. CFTC staff subsequently provided further guidance on these issues, some of which imposes Title VII requirements on non-US persons based on the location of their conduct.[142] The

140 Section 2(i) of the CEA states that the CFTC's swap rules added by the Dodd–Frank Act will not apply 'to activities outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States, or (2) contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this chapter that was enacted by the [Dodd–Frank Act]'. Section 30(c) of the Exchange Act states that the SEC's SBS rules added by the Dodd–Frank Act will not apply 'to any person insofar as such person transacts a business in SBS without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent the evasion of any provision of this chapter that was added by the [Dodd–Frank Act]'.

141 Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed Reg 45292 (26 Jul 2013); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements, 81 Fed Reg 34818 (31 May 2016). The CFTC issued on 11 October 2016 a proposed rule that addresses the cross-border application of certain of its swaps rules that, if adopted, would generally supersede a number of the provisions in the CFTC's cross-border guidance. See Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants; Proposed Rule, Interpretations, 81 Fed Reg 71946 (18 Oct 2016). In October 2018, the Chair of the CFTC, J Christopher Giancarlo, issued a White Paper that sets out guiding principles for the CFTC in interpreting its statutory authority to regulate cross-border swaps activities. J Christopher Giancarlo, Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation (1 Oct 2018), available at https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118_0.pdf. The White Paper is not a rule proposal and does not have any immediate effect, but is instead intended for consideration by the full Commission.

142 See CFTC Staff Advisory No. 13-69, Division of Swap Dealer and Intermediary Oversight Advisory Applicability of Transaction-Level Requirements to Activity in the United States (14 Nov 2013),

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SEC has finalised most of its rules on the cross-border application of its Title VII rules.[143] Very generally, the SEC applies its Title VII rules based on the status of counterparties to SBS transactions, and on whether SBS transactions are arranged, negotiated or executed by personnel located in the United States on behalf of personnel located outside the United States.

Clearing and exchange trading

Title VII of the Dodd–Frank Act requires swaps that the CFTC or SEC determines are required to be cleared to be submitted for central clearing to a regulated clearing house or one that is explicitly exempt from registration.[144] This requirement is meant to reduce systemic risk posed by swaps. The mandatory clearing requirement applies to all persons engaging in such swaps that meet the territorial nexus described in the Commissions' cross-border guidance and rule-makings, except for certain end users that use these swaps to hedge or mitigate commercial risk.[145] Procedures relating to these requirements, and further exceptions to them, have been adopted through rule-making by the CFTC.[146] Title VII sets forth comprehensive requirements with which clearing houses must comply to obtain and maintain regulation. As of 31 December 2018, swap clearing is mandatory under these rules for certain liquid and standardised interest rate swaps and index credit default swaps subject to the CFTC's jurisdiction.[147]

Title VII also requires the execution of those swaps that are required to be cleared to occur on regulated trade execution platforms. It introduces a regulated trade execution platform, known as a swap execution facility, which provides for various modes of execution of swaps between multiple buyers and multiple sellers.[148] There is an exception to this execution

www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf. Advisory 13-69 is subject to no-action relief until the effective date of any CFTC action addressing whether a particular requirement covered by Advisory 13-69 is or is not applicable to a swap transaction covered by the Advisory. See CFTC Letter No. 17-36, Extension of No-Action Relief: Transaction-Level Requirements for Non-US Swap Dealers (25 Jul 2017), www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/17-36.pdf. The CFTC's proposed cross-border rule described in note 141, if adopted, would modify certain aspects of the cross-border regime outlined in CFTC Staff Advisory No. 13-69.

143 See Application of 'Security-Based Swap Dealer' and 'Major Security-Based Swap Participant' Definitions to Cross-Border Security-Based Swap Activities, 79 Fed Reg 47278 (12 Aug 2014). Security-Based Swap Transactions Connected with a Non-US Person's Dealing Activity That Are Arranged, Negotiated, or Executed By Personnel Located in a US Branch or Office or in a US Branch or Office of an Agent; Security-Based Swap Dealer *De Minimis* Exception, 81 Fed Reg 8598 (19 Feb 2016).

144 See CEA Section 2(h) and Exchange Act Section 3C, as amended by the Dodd–Frank Act.

145 CEA Section 2(h)(7) and Exchange Act Section 3C(g) provide an exception from the mandatory clearing requirement for swaps if one of the swap counterparties is not a financial entity; is using swaps to hedge or mitigate commercial risk; and notifies the CFTC (for swaps) or the SEC (for SBS) how the counterparty generally meets its financial obligations associated with entering into non-cleared swaps.

146 The SEC has proposed, but not finalised, rules implementing end-user exceptions from the mandatory clearing requirement for SBSs. End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed Reg 79992 (21 Dec 2010).

147 See 17 CFR 50.4.

148 CEA Section 1a(50) defines a swap execution facility as 'a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (A) facilitates the execution of swaps between persons; and (B) is not a designated contract

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requirement where no such platforms make these swaps available to trade, which is a technical determination relating to the liquidity and other features of the swaps in question.[149] As of 31 December 2018, certain interest rate swaps and credit default swaps subject to the CFTC's jurisdiction are subject to the mandatory execution requirements. These interest rate swaps and credit default swaps constitute a subset of those subject to mandatory clearing. In addition, the statute sets forth comprehensive registration, operational and self-regulatory requirements with which trade execution platforms must comply.

Registration and regulation of swap dealers and major swap participants

Title VII defines new classes of swap market participants: swap dealers and major swap participants with respect to CFTC-regulated swaps, and SBS dealers and major SBS participants with respect to SEC-regulated SBS. The concepts of swap dealer and SBS dealer are meant to capture market participants that serve as dealers in their relevant markets. The statute defines swap dealer and SBS dealer in terms of whether an entity engages in certain types of activities:

a holding oneself out as a dealer in swaps;

b making a market in swaps;

c regularly entering into swaps with counterparties as an ordinary course of business for one's own account; or

d engaging in activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps.[150]

In addition, the swap dealer definition (but not the definition of SBS dealer) provides that an IDI is not to be considered a swap dealer to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer. The statute also provides for a *de minimis* exception that permits entities to engage in a minimal amount of swap dealing activity without being deemed a swap or SBS dealer. These definitions and exceptions were further defined through a joint CFTC and SEC rule-making on the topic.[151]

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market'. The CFTC has proposed changes to its swap execution facility rules, which would require certain additional brokers and aggregators of single-dealer execution platforms to register with the CFTC as swap execution facilities or to seek an exemption. See Swap Execution Facilities and Trade Execution Requirement, 83 Fed Reg 61949 (30 Nov 2018).

149 See CEA Section 2(h)(8) and Exchange Act Section 3C, as amended by the Dodd–Frank Act. See also Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement under the Commodity Exchange Act, 78 Fed Reg 33606 (4 Jun 2013). The CFTC has proposed changes to its trade execution requirement rules, which would eliminate the made available to trade determination process and expand the scope of products that would be required to be executed on a swap execution facility to include swaps that are both subject to the CFTC's clearing requirement and listed by a swap execution facility for trading. See Swap Execution Facilities and Trade Execution Requirement, 83 Fed Reg 61949 (30 Nov 2018).

150 Entities that enter into swaps or SBS for their own accounts, either individually or in a fiduciary capacity but not as part of a regular business, are not included within the definitions.

151 CFTC and SEC, Further Definition of 'Swap Dealer', 'Security-Based Swap Dealer', 'Major Swap Participant', 'Major Security-Based Swap Participant' and 'Eligible Contract Participant;' 77 Fed Reg 30596 (23 May 2012), www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf. These rules initially established the threshold for the *de minimis* exception from swap dealer registration requirements at US$8 billion notional for CFTC-regulated swaps connected with dealing activity effected within

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As of 31 December 2018, 101 entities were provisionally registered with the CFTC as swap dealers. The SEC has finalised its SBS dealer registration requirement, but the registration compliance date is based on the SEC's finalisation of certain fundamental SBS rules, some of which are still in proposed form.[152]

The concept of a major swap participant in the swaps markets is meant to capture entities that are not dealers but have a sufficiently large position in swaps as to threaten systemic stability. The statutory definitions of major swap participant and major SBS participant focus on the market impacts and risks associated with an entity's swap positions. These definitions were further defined through a joint CFTC and SEC rule-making, which introduced a complex quantitative test for determining whether an entity must register as a major swap participant or as a major SBS participant. As of 31 December 2018, no entities were registered as major swap participants.

Entities that act as swap dealers or SBS dealers must register as such with the CFTC or the SEC. In addition, Title VII requires comprehensive regulation of these registered swaps entities. Specifically, swaps entities must comply with minimum capital and minimum initial and variation margin requirements with respect to non-cleared swaps.[153] The five prudential regulators and the CFTC have finalised uncleared swap margin requirements[154] that largely mirror the international standards outlined in September 2013 (and as modified in March 2015) by the Basel Committee and the International Organization of Securities Commissions. The variation margin compliance deadline was either 1 September 2016 or 1 March 2017 and the initial margin compliance deadline is subject to a phase-in period that began on 1 September 2016 and continues until 1 September 2020, with the applicable compliance date depending upon the size of the swaps entity's (and its affiliates') combined swap positions with the counterparty. As of 31 December 2018, the SEC has proposed, but not yet finalised, its uncleared swap margin collection rules.[155]

Additionally, swap dealers must establish comprehensive risk-management programmes that are adequate for managing their businesses, and must designate a chief compliance officer to carry out certain enumerated duties and prepare annual compliance reports. Registered swaps entities must also comply with business conduct requirements that address, inter alia, interactions with counterparties, disclosure, supervision, reporting, record-keeping, documentation, confirmation, valuation, conflicts of interest, and avoidance of fraud and

12 months, and the *de minimis* exception from SBS dealer registration requirements at US$8 billion notional for SEC-regulated credit default swaps and US$400 million notional for other SBS connected with dealing activity effected within 12 months. The swap threshold was set to decrease to US$3 billion on 31 December 2019, but the CFTC subsequently issued a rule permanently setting the swap threshold at US$8 billion. *De Minimis* Exception to the Swap Dealer Definition, 83 Fed Reg 56666 (13 Nov 2018).

152 Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, 80 Fed Reg 48964 (14 August 2015).

153 See generally CEA Section 4s and Exchange Act Section 15F.

154 See Margin and Capital Requirements for Covered Swap Entities, 80 Fed Reg 74840 (30 Nov 2015); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed Reg 636 (6 Jan 2016); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements, 81 Fed Reg 34818 (31 May 2016).

155 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 83 Fed Reg 53007 (19 Oct 2018).

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other abusive practices. Heightened business conduct requirements apply to dealings with special entities, including US federal or state agencies, municipalities, pension plans and endowments.

Reporting

Title VII requires all swaps that meet the territorial nexus described in the Commissions' cross-border guidance and rule-makings to be reported to a registered data repository. Under the CFTC's reporting rules, the reporting counterparty to a swap must report transaction and other specified information about a swap to a swap data repository. This information includes creation data (all primary economic terms of a swap and confirmation data for the swap) and continuation data (all the data elements that must be reported during a swap's existence to ensure that all data in the swap data repository remain current and accurate, including all subsequent changes to the swap's primary economic terms).[156] Title VII also requires public dissemination of certain data relating to a swap transaction, including price and volume, as soon as technologically practicable after the transaction has been executed. In addition, Title VII sets forth comprehensive requirements with which data repositories must comply. The SEC issued final reporting rules in February 2015 and July 2016 but as of 31 December 2018, compliance is not yet required.[157]

The Swaps Pushout Rule

The Swaps Pushout Rule, as amended in December 2014,[158] requires IDIs and US branches and agencies of non-US banks that are swap dealers or SBS dealers (collectively, covered depository institutions (CDIs)) to push out certain swaps based on an ABS or a group or index primarily composed of ABS (structured finance swaps) to their affiliates.[159] An exception to this requirement allows CDIs to enter into structured finance swaps as principal for hedging and risk management purposes or if the ABS underlying such swaps is of a type authorised jointly by the prudential regulators in future uncompleted regulation, although until the prudential regulators jointly adopt rules permitting ABS swaps, the scope of the Swaps Pushout Rule remains unclear.[160] In addition, the amended rule confirmed that uninsured branches of foreign banks are entitled to the same exceptions as IDIs and are similarly required to push out only certain structured finance swaps.

iii Transactions with affiliates

Sections 23A and 23B of the FRA and the Federal Reserve's Regulation W impose quantitative and qualitative limits on a variety of transactions between a bank and an affiliate, including

156 See 17 CFR Part 45.

157 See Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, 81 Fed Reg 53546 (12 Aug 2016); Regulation SBSR– Reporting and Dissemination of Security-Based Swap Information, 80 Fed Reg 14563 (19 Mar 2015).

158 Consolidated and Further Continuing Appropriations Act of 2015 Pub L No 113-235, HR 83, 113th Cong Section 630 (2015).

159 The Swaps Pushout Rule permits an IDI to have a swaps entity affiliate as long as there is compliance with Sections 23A and 23B of the FRA (discussed below), as well as any additional requirements that the CFTC or SEC, as applicable, and the Federal Reserve, determine to be necessary and appropriate.

160 As of 31 December 2018, the prudential regulations have not adopted joint rules as to authorised ABS swap activity for CDIs.

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loans and other extensions of credit (collectively referred to as covered transactions). Section 23A of the FRA limits a bank's covered transactions[161] with any single affiliate to no more than 10 per cent of the bank's capital stock and surplus, and limits its covered transactions with all affiliates combined to no more than 20 per cent of the bank's capital stock and surplus.[162] In addition, certain covered transactions must be secured at all times[163] by a statutorily defined amount of collateral.[164] Section 23B of the FRA requires that covered transactions[165] between a bank and its affiliates be on market terms and at arm's length. The Federal Reserve implements Sections 23A and 23B of the FRA for all depository institutions and, jointly with the FDIC, has the power to grant exemptions from these provisions in addition to the exemptions contained in the statute itself.[166]

The Dodd–Frank Act further constrains the ability of banks to engage in derivatives and securities financing transactions with affiliates, and imposes more stringent collateral requirements on transactions with affiliates, all of which may require changes to banking organisations' risk-management systems and practices related to inter-company derivatives.[167] Sections 23A and 23B of the FRA were modified by the Dodd–Frank Act to cover derivatives and securities lending and financing transactions with affiliates to the extent that they create

161 For the purposes of Section 23A of the FRA, covered transactions include (1) a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase, (2) a purchase of or an investment in securities issued by the affiliate, (3) a purchase of assets from the affiliate, (4) the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company, (5) the issuance of a guarantee, acceptance or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate, (6) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a bank or subsidiary to have credit exposure to the affiliate, or (7) a derivative transaction with an affiliate, to the extent that the transaction causes a bank or a subsidiary to have credit exposure to the affiliate. Section 23A of the FRA also contains an attribution rule whereby a transaction with any person is considered to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate.

162 Capital stock and surplus is essentially the sum of a bank's Tier 1 capital and Tier 2 capital, and the balance of the bank's allowance for loan and lease losses not included in its Tier 2 capital.

163 The Dodd–Frank Act added the at all times requirement, effective 21 July 2012. Previously, such transactions had to be secured by a statutorily defined amount of collateral at the time of the transaction.

164 Transactions that are subject to the collateral requirement in Section 23A include a loan or extension of credit to, or guarantee, acceptance or letter of credit issued on behalf of, an affiliate by a bank or its subsidiary, and, after 21 July 2012, any credit exposure of a bank or a subsidiary to an affiliate resulting from a securities borrowing or lending transaction or a derivative transaction.

165 Covered transactions for the purposes of Section 23B of the FRA include all Section 23A covered transactions (identified above) as well as any sale of assets by a bank to an affiliate; any payment of money or furnishing of services by a bank to an affiliate; any transaction in which an affiliate acts as an agent or broker for a bank or for any other person if the bank is a participant in the transaction; and any transaction by a bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction. Section 23B of the FRA contains the same attribution rule as Section 23A.

166 The statutory and regulatory exemptions from Section 23A of the FRA include, inter alia, entering into certain covered transactions that are fully secured by obligations of the United States or its agencies; intra-day extensions of credit to an affiliate (if certain risk-management and monitoring systems are in place); and giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.

167 Dodd–Frank Act of 2010 Pub L No 111-203, HR 4173, 111th Cong Section 608 (2010).

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bank credit exposure[168] to the affiliate and, as a result, such transactions have been subject to quantitative limits and collateral requirements under these sections since 21 July 2012. The Dodd–Frank Act further requires that collateral must be maintained at all times on a mark-to-market basis for credit transactions, rather than only at the time the transactions are entered into, and debt obligations issued by an affiliate cannot be used to satisfy Section 23A collateral requirements. The Federal Reserve has indicated that it will issue regulations to implement the Dodd–Frank Act's revisions to Sections 23A and 23B. However, as of 31 December 2018, the Federal Reserve has not proposed any such regulations.

iv Consumer protection regulation

Overview

Traditional bank activities such as lending and deposit taking are subject to a broad range of consumer protection statutes and regulations at the federal and state levels. Consumer protection statutes can generally be grouped into three categories: disclosure laws, civil rights laws and privacy laws. Disclosure laws include the Truth in Lending Act,[169] the Truth in Savings Act[170] and the Electronic Fund Transfer Act.[171] Civil rights laws include the Equal Credit Opportunity Act[172] and the Community Reinvestment Act (CRA). The CRA is intended to encourage depository institutions to help meet the credit and development needs of their communities, especially low and moderate-income neighbourhoods, with potentially significant penalties for noncompliance.[173] The federal banking regulators are currently reviewing the CRA's implementing regulations to determine how those regulations can be

168 The Dodd–Frank Act does not define credit exposure for purposes of Sections 23A and 23B. This and other aspects of the Dodd–Frank Act's amendments to Sections 23A and 23B will most likely need to be addressed through amendments to Regulation W. The Dodd–Frank Act explicitly authorises the Federal Reserve to issue regulations or interpretations with respect to the manner in which a bank may take netting agreements into account under Section 23A in determining the amount of a covered transaction with an affiliate, including whether a covered transaction is fully secured. See Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 608(a) (2010).

169 The Truth in Lending Act of 1968 establishes standard disclosures for consumer creditors nationwide. See Pub L No 90-321, 90th Cong, 2nd Sess (29 May 1968) 82 Stat 146 (1968).

170 Truth in Savings Act of 1991 requires that consumers receive written information about the terms of their deposit accounts and also governs the advertising of deposits and interest computations. See Pub L No 102-242, 102nd Cong, 1st Sess (19 Dec 1991) 105 Stat 2236 (1991).

171 The Electronic Fund Transfer Act of 1978 requires certain disclosures and provides other protections for consumers engaging in electronic fund transfers and remittance transfers. See Pub L No 95-630, 95th Cong, 2nd Sess (10 Nov 1978) 92 Stat 3641 (1978).

172 The Equal Credit Opportunity Act of 1974 prohibits certain types of discrimination in personal and commercial transactions. See Pub L No 93-495, 93rd Cong, 1st Sess (28 Oct 1974) 88 Stat 1521 (1974). In addition, creditors may not discriminate against an applicant, or discourage a potential applicant, on the basis of race, colour, religion, national origin, sex, marital status, age, receipt of income from public assistance programmes or good faith exercise of rights under the Consumer Credit Protection Act.

173 Community Reinvestment Act of 1977, Pub L No 95-128, 95th Cong, 1st Sess (12 Oct 1977), 91 Stat 1111 (1977). If a depository institution does not receive at least a satisfactory rating for its CRA compliance, the institution or its holding company may be prevented from engaging in certain permissible activities for FHCs or acquiring other financial institutions.

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modernised, and the OCC has released an advanced notice of proposed rulemaking seeking comments on the best ways in which to do so.[174]

Banks are also subject to laws regarding consumer privacy and the use of certain consumer information. Title V of the GLB Act[175] requires initial and periodic communications with consumers about institutions' privacy policies and the sharing of customer information, as well as an opportunity for customers to opt out of having their non-public personal information disclosed to non-affiliated third parties. The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, requires disclosures to consumers about the use of credit report information in certain credit decisions, and requires lenders to undertake remedial actions if there is a breach in the lender's data security. Regulatory guidelines require financial institutions to implement and maintain a comprehensive written information security programme designed to ensure the security and confidentiality of customer information, and protect against unauthorised access to or use of such information that could result in substantial harm or inconvenience to any customer.[176]

Depository institutions normally correct consumer protection violations voluntarily during the course of regulators' examinations. However, if institutions do not voluntarily comply or the violations are particularly severe or pervasive, regulators may bring enforcement actions, including the imposition of civil money penalties. A number of federal and state consumer protection laws can also be enforced by consumers through civil lawsuits.

Consumer Financial Protection Bureau

The CFPB has broad regulatory, supervisory and enforcement authority with respect to consumer financial services or products. The CFPB is authorised to write regulations under federal consumer financial protection laws, including with respect to small dollar lending, prepaid cards, payday lending, mortgage-related issues and debt collection. Carved out from the CFPB's authority are a number of entities and activities, including persons regulated by the SEC and the CFTC, and the business of insurance.[177]

The CFPB examines and supervises large depository institutions regarding compliance with federal consumer protection laws and regulations.[178] In addition, the CFPB may supervise certain non-bank entities of any size engaged in certain consumer finance-related activities.[179] Under its enforcement authority, the CFPB may investigate potential violations

174 OCC, Advanced Notice of Proposed Rulemaking: Reforming the Community Reinvestment Act Regulatory Framework, 83 Fed Reg 45053 (9 Sept 2018), https://www.govinfo.gov/content/pkg/FR-2018-09-05/pdf/2018-19169.pdf.

175 GLB Act of 1999, Pub L No 106-102, 106th Cong, 1st Sess (12 Nov 1999), 113 Stat 1338–1481 (1999). The GLB Act and its regulations apply to individuals who acquire financial products or services primarily for personal, family or household purposes.

176 Interagency Guidelines Establishing Standards for Safeguarding Customer Information and Rescission of Year 2000 Standards for Safety and Soundness; Final Rule, 66 Fed Reg 8616 (1 Feb 2001), https://www.gpo.gov/fdsys/pkg/FR-2001-02-01/pdf/01-1114.pdf.

177 For a discussion of excluded entities and activities, see Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 1027 (2010).

178 Large depository institutions in this context are those with greater than US$10 billion in assets. See Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 1025 (2010).

179 For example, the CFPB has promulgated regulations extending its supervision authority to larger participants in the consumer reporting, consumer debt collection, international money transfer, student loan servicing and auto finance markets.

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of federal consumer financial protection laws (including unfair, deceptive and abusive acts and practices) and may initiate enforcement actions. CFPB enforcement actions may result in, among other consequences, the assessment of significant civil monetary penalties.[180] In the years following its creation, the CFPB actively investigated and brought enforcement actions against persons subject to its jurisdiction, but has adopted a comparatively less aggressive approach under new leadership appointed by President Trump.

The director of the CFPB is removable by the President only for cause. Persons subject to the CFPB's jurisdiction have brought several actions challenging the constitutionality of this CFPB leadership structure. Although the United States Court of Appeals for the District of Columbia Circuit, sitting *en banc*, has held that the structure of the CFPB is not constitutionally impermissible,[181] challenges to the CFPB's authority on these grounds remain under consideration in a number of federal courts of appeal.

Pre-emption

Pre-emption in the context of consumer protection regulation refers to the degree to which the activities of a federally chartered IDI are regulated by federal law rather than by the laws of any individual state in which the IDI may have a branch or otherwise conduct activities. The OCC may determine that federal law pre-empts state consumer financial laws only on a case-by-case basis, on the basis of substantial evidence and 'in accordance with the holding of the Supreme Court in *Barnett Bank v. Nelson*'.[182] Even where the OCC has made a pre-emption determination with respect to state consumer financial laws as applied to a national bank, those state laws remain applicable to the national bank's operating subsidiaries and affiliates. Further, no provision of the National Bank Act relating to state visitorial authority may be construed to limit the authority of state attorneys general to bring actions to enforce any applicable law against a national bank.

v Bank Secrecy Act and anti-money laundering

The Bank Secrecy Act (BSA),[183] as amended by the USA PATRIOT Act in 2001,[184] requires all financial institutions, including banks, to establish a risk-based system of internal controls reasonably designed to prevent money laundering and the financing of terrorism. The BSA includes a variety of record-keeping and reporting requirements (such as currency and suspicious activity reporting) as well as due diligence and know-your-customer documentation requirements. Bank regulators and the Financial Crimes Enforcement Network (FinCEN),

180 For example, in a coordinated action with the OCC, the CFPB in April 2018 assessed a US$1 billion penalty against a large US financial institution. See CFPB, Bureau of Consumer Financial Protection Announces Settlement With Wells Fargo For Auto-Loan Administration and Mortgage Practices (20 Apr 2018), https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-announces-settlement-wells-fargo-auto-loan-administration-and-mortgage-practices.

181 *Wall Street Journal*, 'Appeals Court Rules CFPB Structure Is Constitutional' (31 Jan 2018), https://www.wsj.com/articles/appeals-court-rules-cfpb-structure-is-constitutional-1517415363.

182 517 US 25 (1996).

183 Currency and Foreign Transactions Reporting Act, Pub L No 91-508, Title II (1970).

184 The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub L No 107-56, 115 Stat 272 (2001).

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a bureau of the US Treasury Department, issue and enforce BSA implementing regulations. Additionally, criminal AML violations may be prosecuted by the Department of Justice (DOJ).

Beneficial ownership identification

FinCEN continues to focus on enhancing access to beneficial ownership information to combat the abuse of legal entities by those engaging in financial crimes.[185] On 11 May 2016, FinCEN issued a final rule that (among other things) added a new requirement for covered financial institutions to identify, and verify the identity of, the beneficial owners of legal entity customers (CDD Rule).[186] The CDD Rule became effective on 11 July 2016, and covered financial institutions were required to comply by 11 May 2018. The CDD Rule defines a legal entity customer as a corporation, limited liability company, other entity created by the filing of a public document with a secretary of state or similar office, general partnership, or any similar entity formed under the laws of a foreign jurisdiction, that opens an account. The CDD Rule excludes certain types of legal entities from the definition of legal entity customer, including:

a financial institutions regulated by a federal functional regulator and banks regulated by a state bank regulator;

b publicly held companies traded on the New York, American or NASDAQ stock exchange;

c SEC-registered investment companies, investment advisers, exchanges and clearing agencies;

d US bank holding companies; and

e state-regulated insurance companies.

The definition of beneficial owner is two-pronged, focusing on the ownership and control of customers that are legal entities: under the ownership prong, a beneficial owner is any individual who, directly or indirectly, owns 25 per cent or more of the equity interests of a legal entity customer; and the control prong requires identification of one individual with significant responsibility to control, manage or direct a legal entity, including an executive officer, senior manager or any other individual who regularly performs similar functions.

Information to be collected with respect to the beneficial owners is name (and title for the controlling individual or individuals), date of birth, address; and social security number (for US persons); or passport number and country of issuance, or other similar identification number (for non-US persons).

185 Keeping Foreign Corruption Out of the United States: Hearing before the S. Comm. on Homeland Security and Governmental Affairs, Subcomm. on Investigations, 111th Cong (4 Feb 2010) (statement of James Freis, former director of FinCEN); remarks of Jennifer Shasky Calvery, Director of FinCEN, 2014 Mid-Atlantic AML Conference, Washington, DC (12 Aug 2014), www.fincen.gov/news_room/speech/pdf/20140812.pdf.

186 FinCEN Final Rule: Customer Due Diligence Requirements for Financial Institutions, 81 Fed Reg 29,398, 29,451 (11 May 2016) (codified at 31 CFR pts 1010, 1020, 1023, 1024, 1026), www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.

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The CDD Rule currently covers only those financial institutions subject to a customer identification programme requirement – banks, brokers or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities – but the CDD requirements may be extended to other types of financial institutions in the future.

US economic sanctions

The Office of Foreign Assets Control of the US Department of the Treasury (OFAC) administers US economic sanctions against foreign countries, entities and individuals to counter threats to the national security, foreign policy or economy of the United States. The goal of these programmes is to deny, wholly or partly, the benefits of the US economy to targets of sanctions, by denying access to the financial system, capital markets and import and export markets for goods, services and technology. There are more than 25 separately imposed OFAC sanctions programmes. While OFAC is responsible for promulgating and administering the sanctions, all the bank regulatory agencies cooperate in ensuring that financial institutions comply with the sanctions. Wilful sanctions violations may also carry criminal penalties enforced by the DOJ. In addition, violations can result in the imposition of penalties by banking regulators. A number of bank settlements with OFAC have been part of global settlements with state and federal prosecutors and banking regulators.

The countries and territories that are currently targets of territorial US sanctions are Crimea, Cuba, Iran, North Korea and Syria (target countries). In most cases, individuals and entities located, organised or resident in a target country are also targets of sanctions. Target countries are subject to various trade embargoes that ban imports or exports, or both, of goods and services (including financial services) and technology into the United States or from the United States or by US persons.[187]

OFAC also administers list-based sanctions that are imposed on individuals and entities designated under various programmes for certain activities. These specially designated nationals and blocked persons (SDNs) include those involved in narcotics trafficking, terrorism and terrorist financing, transnational crime, proliferation of weapons of mass destruction, piracy, and malicious cyber activities; persons related to former or current regimes of certain countries; and persons engaged in certain targeted activities in specified countries.

US persons are generally prohibited from conducting financial or commercial transactions with SDNs, and any assets the SDNs may have within the United States or within the possession or control of any US person are blocked. In addition, any property that is 50 per cent or more owned, directly or indirectly, by one or more SDNs is blocked property. This includes entities; thus, a company that is 50 per cent or more owned by one or more SDNs is also a sanctions target, regardless of whether the entity is placed on the SDN list.

Starting in July 2014, the US government has imposed targeted, non-blocking, less comprehensive sectoral sanctions on certain Russian energy and defence companies and financial institutions. OFAC has included these companies' names on its Sectoral Sanctions

187 US persons are defined as individual US citizens and permanent US resident aliens, wherever located; entities organised under US law, including their non-US branches (even when operating outside the United States); and individuals and entities located in the United States (even temporarily) regardless of the individual's citizenship or the entity's jurisdiction of incorporation (thus including branches of non-US organisations that are located in the United States). Non-US subsidiaries of US companies are also required to comply with US sanctions on Cuba and Iran.

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Identifications List (SSI List). US persons are generally prohibited from dealing in new debt of greater than a specified maturity[188] of the listed companies and of companies that are (50 per cent or more) owned, directly or indirectly, by one or more SSI Listed entities. In addition, US persons are generally prohibited from dealing in new equity of the SSI Listed financial institutions. Further, the sectoral sanctions prohibit US persons from providing goods, non-financial services or technology to certain entities in the Russian energy sector identified on the SSI List that are involved in Russian deep-water, Arctic offshore and shale-oil projects and in certain projects outside Russia that meet specified criteria. On 2 August 2017, President Trump signed into law the Countering America's Adversaries Through Sanctions Act of 2017 (CAATSA), which, among other things, codifies certain sanctions against Russia previously imposed by Executive Order and establishes new congressional review procedures for terminating or waiving sanctions against Russia.[189]

Starting in 2015, the government imposed sanctions on certain persons associated with the government of Venezuela.[190] On 31 July 2017, OFAC designated Venezuelan President Maduro as an SDN pursuant to that 2015 Executive Order. Other executive orders issued in 2017 and 2018 imposed financial sanctions on the government of Venezuela intended to deny a critical source of funding to the Maduro regime.[191] In 2018, President Trump issued additional executive orders that ban US transactions in Venezuela's 'petro' digital currency, and block the property of persons determined to operate in the gold sector of the Venezuelan economy, or to engage in deceptive or corrupt transactions involving the government of Venezuela, among other things.[192]

The United States implemented significant sanctions relief with respect to Iran on 16 January 2016, pursuant to the Joint Comprehensive Plan of Action (JCPOA) among the permanent members of the United Nations Security Council plus Germany, the European Union, Iran and the United States. Specifically, the United States lifted its secondary sanctions predicated on Iran's nuclear programme. Secondary sanctions target non-US persons for engaging in certain business with Iran and Iranian parties. They are distinct from direct sanctions, which generally prohibit US persons from dealing with Iranian parties.

However, on 8 May 2018, President Trump announced that he was terminating the United States' participation in the JCPOA. In June 2018, OFAC revoked General License H, issued on 16 January 2016 (Implementation Day under the JCPOA), which had authorised US-owned or US-controlled foreign entities to engage in most transactions with the government of Iran and persons subject to the jurisdiction of the government of Iran, subject to certain conditions and restrictions. As of 5 November 2018, following the conclusion of certain wind-down periods, all US sanctions (both direct and secondary) that

188 The permissible tenor is 14 days or fewer for the affected financial institutions, 30 days or fewer for the affected defence companies, and 60 days or fewer for the affected energy companies.

189 Pub. L. 115-44, HR 3364, 115th Cong. CAATSA also provides authority for additional sanctions against Iran and North Korea.

190 See Executive Order 13692, Blocking Property and Suspending Entry of Certain Persons Contributing to the Situation in Venezuela (8 March 2015).

191 See Executive Order 13808, Imposing Additional Sanctions With Respect to the Situation in Venezuela, (24 Aug. 2017) and Executive Order 13835, Prohibiting Certain Additional Transactions With Respect to. Venezuela, (21 May 2018).

192 See Executive Order 13827, Taking Additional Steps to Address the Situation in Venezuela, (19 March 2018), and Executive Order 13580, Blocking Property of Additional Persons Contributing to the Situation in Venezuela, (1 November 2018).

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had been waived or lifted under the JCPOA were reimposed and fully effective. Also on 5 November 2018, OFAC added back to the SDN List a number of persons that had been removed on Implementation Day from such list.

The US government revoked comprehensive sanctions with respect to Sudan and the government of Sudan with effect from 12 October 2017. The revocation of sanctions came after the conclusion of the period established by Executive Order 13762, as amended by Executive Order 13804, during which the US government assessed whether the government of Sudan had sustained positive developments that would justify permanent sanctions relief. This review period was originally scheduled to conclude in July 2017 but was extended to October by Executive Order 13804.

The United States has also expanded sanctions against North Korea in recent years. CAATSA includes a number of secondary sanctions provisions and other measures targeting sources of economic support for the North Korean government. In addition, Executive Order 13810, 'Imposing Additional Sanctions With Respect to North Korea' (20 September 2017), expanded OFAC's authority to target those who enable the North Korean regime's economic activity.

OFAC civil penalties, which vary depending on the authorising statute, can reach a maximum of US$86,976 per violation (as of 19 March 2018) under the Trading With the Enemy Act (the primary authorising statute for the Cuba sanctions programme), or the greater of US$295,141 per violation (as of 19 March 2018) or twice the value of the violative transaction or transactions under the International Emergency Economic Powers Act (IEEPA).[193] Most US sanctions programmes are authorised by IEEPA.[194]

OFAC's enforcement guidelines[195] note that the Office will consider certain general factors in determining the appropriate enforcement response to an apparent violation and, if a civil monetary penalty is warranted, in establishing the amount of that penalty. If it is determined that a civil penalty is appropriate, OFAC will generally mitigate the penalty based upon certain factors such as voluntary self-disclosure, cooperation with OFAC and whether the case involved is a first-time violation.

V FUNDING

i Traditional funding sources

BHCs and banks have a number of different funding sources, including consumer-driven bank products and services such as demand deposit accounts, certificates of deposit and

193 In July 2016, OFAC published an interim final rule to amend its regulations for the relevant sanctions programmes it administers to implement adjustments made by the Federal Civil Penalties Inflation Adjustment Act Improvements of 2015. This rule adjusts for inflation the maximum amount of the civil monetary penalties that may be assessed under relevant OFAC regulations. This rule became effective on 1 August 2016. See 81 Fed Reg 43070 (1 Jul 2016).

194 OFAC also has penalty authority under certain special-purpose economic sanctions statutes, such as the Foreign Narcotics Designation Act (Kingpin Act). The Kingpin Act provides for penalties up to US$1,466,485 (as of 19 Mar 2018).

195 OFAC, Economic Sanctions Enforcement Guidelines, 74 Fed Reg 215, 57,593 (9 Nov 2009), edocket.access.gpo.gov/2009/pdf/E9-26754.pdf.

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deposit sweeps; interbank borrowing through agreements such as repurchase agreements; and capital markets activities, including commercial paper, subordinated debt, preferred securities, and equity issuances and offerings.

BHCs and banks also have access to additional funding and liquidity sources during strained credit markets when traditional funding sources may either be prohibitively expensive or unavailable. The Federal Reserve's discount window, available only to member banks and other depository institutions, which has existed since the Federal Reserve System was created in 1913, has long served the banking industry 'as a safety valve in relieving pressures in reserve markets'.[196] Its overnight extensions of credit to depository institutions can 'relieve liquidity strains in a depository institution and in the banking system as a whole',[197] and ensure 'the basic stability of the payment system more generally by supplying liquidity during times of systemic stress'.[198] Almost all discount window credit has been extended as secured advances for many years.[199]

The Dodd–Frank Act enacted a variety of changes to the Federal Reserve's emergency financial stabilisation powers. The Act limits emergency assistance to a 'program or facility with broad-based eligibility' rather than to any single and specific individual, partnership or corporation that is not part of such a broad-based programme.[200] In addition, the Federal Reserve must establish by regulation, in consultation with the Treasury Secretary, policies and procedures designed to ensure that any emergency lending is to provide liquidity to the financial system and not to aid a single and specific failing financial company; that collateral for emergency loans is sufficient to protect taxpayers from losses; and that any such programme is terminated in a timely and orderly fashion. In addition, the Federal Reserve is required to obtain the Treasury Secretary's approval before establishing a programme or facility under Section 13(3).[201]

The Dodd–Frank Act also changed the FDIC's emergency financial stabilisation powers and imposed new substantive and procedural requirements over the FDIC's ability to establish programmes such as the Temporary Liquidity Guarantee Program. The Act limits the FDIC's authority to provide assistance to individual banks upon a systemic risk finding to only those banks that have been placed in receivership and only for the purpose of winding up the institution.

In the case of future guarantee programmes, the Act provides that upon a written determination of the FDIC and the Federal Reserve that a liquidity event exists, the FDIC would create a widely available programme to guarantee obligations of solvent depository institutions, depository institution holding companies and affiliates during times of severe economic distress. Such a determination requires a vote of two-thirds of the members of the boards of the Federal Reserve and the FDIC and the written consent of the Treasury

196 Fed Reserve, The Federal Reserve Discount Window 1 (2008), www.frbdiscountwindow.org/discountwindowbook.cfm?hdrID=14&dtlID=43.

197 Ibid.

198 Ibid.

199 See James Clouse, Recent Developments in Discount Window Policy, 80 Fed Reserve Bull. 966 (Nov 1994).

200 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 1101(a)(2) (amending Section 13(a) of the FRA). The final implementing regulations issued by the Federal Reserve became effective on 1 January 2016. See Federal Reserve, Final Rule: Extensions of Credit by Federal Reserve Banks, 80 Fed Reg 78959 (18 Dec 2015).

201 Ibid.

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Secretary. The Treasury Secretary, in consultation with the President, would determine the maximum amount of debt that the FDIC may guarantee. The Treasury Secretary must provide notice to Congress and the FDIC could exercise its authority only upon passage of a joint congressional resolution of approval.

ii Post-financial crisis funding developments

In 2010, bank regulators issued two significant policy statements on their expectations regarding how BHCs and banks manage their funding and liquidity risks.

On 22 March 2010, federal bank regulators issued an inter-agency policy statement on funding and liquidity risk management.[202] In the preamble to the guidance, regulators noted that they had observed deficiencies in liquidity risk management, including 'funding risky or illiquid asset portfolios with potentially volatile short-term liabilities and a lack of meaningful . . . liquidity contingency plans'. The guidance clarifies the processes that institutions should implement to identify, measure, monitor and control their funding and liquidity risk, such as having cash-flow projections, diversified funding sources, stress testing, a cushion of liquid assets and a formal well-developed contingency funding plan. Aside from overall funding needs, the guidance was specific in highlighting the importance of monitoring and managing intra-day liquidity positions.

On 30 April 2010, the federal regulatory agencies issued final guidance addressing the risks associated with funding and credit concentrations arising from correspondent interbank relationships.[203] The guidance highlights the need for institutions to identify, monitor and manage correspondent concentration risk on a stand-alone and organisation-wide basis. Notably, the guidance states that a financial institution should consider credit exposures[204] of over 25 per cent of total capital and funding exposures as low as 5 per cent of total liabilities indicative of correspondent concentration risk.

Pursuant to the guidance, financial institutions are to establish written policies and procedures to monitor and prevent such correspondent concentration risk. The guidance also highlights regulators' concern with financial institutions conducting proper due diligence on all credit and funding relationships, including confirmation that terms for all credit and funding transactions are on an arm's-length basis and that they avoid potential conflicts of interest.[205]

On 2 September 2014, the OCC adopted final guidelines that establish minimum standards for the design and implementation of a risk-governance framework for large insured national banks, insured federal savings associations and insured federal branches of foreign banks with US$50 billion or more in average total consolidated assets, and minimum

202 Fed Reserve, FDIC, US Dep't of the Treasury, OCC, OTS, Final Guidance on Correspondent Concentration Risks, 75 Fed Reg 23764 (4 May 2010), www.fdic.gov/regulations/laws/federal/2010/10noticeMay4.pdf.

203 Fed Reserve press release, Interagency Guidance on Correspondent Concentration Risk (30 Apr 2010), www.federalreserve.gov/boarddocs/srletters/2010/sr1010.pdf.

204 Credit exposures include, due from bank accounts, federal funds sold on a principal basis, the over-collateralised amount on repurchase agreements, the under-collateralised portion of reverse repurchase agreements, net current credit exposure on derivatives contracts, unrealised gains on unsettled securities transactions, direct or indirect loans to or for the benefit of the correspondent, and investments, such as trust preferred securities, subordinated debt and stock purchases in the correspondent.

205 The guidance does not elaborate on exactly what conflicts of interests means within this context.

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standards for a board of directors in overseeing the framework's design and implementation.[206] The final guidelines also apply to banks with less than US$50 billion in average total consolidated assets if that bank's parent company controls at least one bank with assets greater than or equal to US$50 billion, and the OCC explicitly reserved authority to apply the guidelines to an entity with less than US$50 billion in average total consolidated assets entity not under such common control if it determines its operations to be highly complex or to otherwise present a heightened risk, but will only exercise this authority in extraordinary circumstances.[207] The guidelines supersede the OCC heightened expectations programme initially formulated after the financial crisis, and include requirements for risk-governance frameworks to cover liquidity risk and concentration risk, concentration risk limits, and the definition and communication of an acceptable risk appetite with respect to, inter alia, liquidity and liquidity buffers.[208]

As discussed in Section III.v, a large FBO with US$50 billion or more in US assets (including US branch and agency assets) is subject to a qualitative liquidity framework that includes liquidity risk management and related governance requirements, and a requirement to maintain separate US liquidity buffers (based on results of internal liquidity stress tests) for its US branches or agencies and IHC.

In 2014, the US banking agencies issued a final rule implementing the Basel Committee's quantitative liquidity standards, known as the liquidity coverage ratio (LCR), in the United States.[209] The US LCR rule is designed 'to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations'.[210] Banking organisations subject to the rule are required to hold an amount of high-quality liquid assets sufficient to meet their total net cash outflows, as modelled over a 30-day period based on prescribed assumptions about the average outflow and inflow rates for specified categories of funding sources and funding needs. The US LCR rule is generally consistent with the Basel Committee's standards, but is more stringent in certain respects.

In 2016, bank regulators proposed a rule that would implement a net stable funding ratio (NSFR) requirement.[211] The proposed rule takes a binary approach in that it applies the full NSFR requirements to certain large banking organisations,[212] whereas certain smaller banking organisations would be subject to modified NSFR requirements.[213] The NSFR is designed to reduce the likelihood that disruptions to a banking organisation's regular

206 12 CFR Part 30.

207 The Honourable Thomas J Curry, Comptroller of the Currency, Address at the American Bankers Association Risk Management Forum (10 Apr 2014).

208 12 CFR Part 30.

209 OCC, Federal Reserve, and FDIC, Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed Reg 61440 (10 Oct 2014).

210 Ibid.

211 OCC, Federal Reserve, FDIC, Notice of Proposed Rulemaking, Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed Reg 35124 (1 Jun 2016).

212 The full NSFR requirements would apply to BHCs, certain savings and loan holding companies, and depository institutions that, in each case, have US$250 billion or more in total consolidated assets or US$10 billion or more in total on-balance sheet foreign exposure, and to their consolidated subsidiaries that are depository institutions with US$10 billion or more in total consolidated assets.

213 BHC and certain savings and loan holding companies that, in each case, have US$50 billion or more, but less than US$250 billion, in total consolidated assets and less than US$10 billion in total on-balance sheet foreign exposure would be subject to the modified NSFR requirements.

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source of funding will compromise its liquidity position. The proposed rule requires bank organisations to maintain a stable funding profile relative to the liquidity of their assets, derivatives and commitments over a one-year period. As of 31 December 2018, the proposed NSFR has not been finalised.

In 2018, US banking agencies proposed rules that would tailor certain enhanced prudential standard requirements, including the US LCR and the proposed NSFR, based on the size of firms as well as other financial measures.[214] Under the proposed rules, the full US LCR and proposed NSFR would apply to US G-SIBs and US BHCs that have either US$700 billion or more in total consolidated assets, or US$100 billion or more in total consolidated assets and US$75 billion or more in cross-jurisdictional activity. Less stringent, modified versions of the US LCR and proposed NSFR would apply to firms with either US$250 billion or more in total consolidated assets, or US$100 billion or more in total consolidated assets and US$75 billion or more of one of three other measures of financial activity, provided that firms have less than US$75 billion of a weighted measure of short-term wholesale funding. The proposed rules would also reduce the frequency of internal liquidity stress testing requirements and tailor certain qualitative liquidity risk management requirements for US BHCs with US$100 billion or more in total consolidated assets that do not meet the proposed size threshold or other financial criteria for the US LCR and proposed NSFR requirements.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

Investing in banks or BHCs has long been a strictly regulated process in the United States. There are three federal statutes that may potentially govern the acquisition of a bank or BHC, depending on the structure of the acquisition and the type of bank or holding company to be acquired:[215]

a the BHC Act: Section 3(a) of the BHC Act requires the prior approval of the Federal Reserve for transactions that result in the formation of a BHC or that cause a bank to become a subsidiary of a BHC; acquisitions by a BHC of more than 5 per cent of any class of voting shares of a bank or another BHC; acquisitions of all or substantially all of a bank's assets; and mergers of BHCs.[216] Under the BHC Act, a controlling investment in a bank or BHC will generally cause the investor (and any controlling person of that investor) to become a BHC and subject it to Federal Reserve regulation.[217] Control is presumed if a person or entity, acting alone or in concert with others, controls or has the power to vote 25 per cent or more of the outstanding shares of any class of voting

214 Federal Reserve, OCC, FDIC, Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements (21 Dec 2018); Federal Reserve, Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed Reg 61408 (29 Nov 2018).

215 This chapter does not address the requirements for the acquisition of thrifts or thrift holding companies. In connection with the abolition of the OTS, the power to regulate thrifts was transferred to the OCC, and the power to regulate thrift holding companies was transferred to the Federal Reserve in 2011. For a further discussion of the current state of thrift and thrift holding company regulation, see Section II.

216 12 USC Section 1842(a).

217 12 USC Section 1841(a)(1).

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stock of a bank or company; has the power to control the election of a majority of the board of directors of a bank or company; or has the power to exercise a controlling influence over the management or policies of a bank or company;[218]

b the Bank Merger Act: the Bank Merger Act requires the approval of the appropriate federal bank regulator for any merger involving two or more IDIs, transfers of assets by an IDI to an uninsured bank (or uninsured branch of a non-US bank) in consideration for the assumption of deposits, an insured bank's acquisition of assets of another insured bank and assumptions of liabilities of any depository institution (insured or uninsured) by an IDI.[219] The appropriate federal bank regulator is that of the surviving entity in a merger;[220] and

c the Change in Bank Control Act (CIBC Act): the CIBC Act applies primarily to the acquisition of control of a US bank or BHC and requires that prior written notice be given to the bank regulator of the target bank or BHC.[221] Control (defined as the power, directly or indirectly, to direct the management or policies of an IDI or to vote 25 per cent or more of any class of voting securities of an IDI)[222] is presumed, but may be rebutted, and a filing under the CIBC Act is required if a person (including a bank or company) will, immediately after the transaction, own or control 10 per cent or more of any class of voting securities of a US bank and either no other person owns or controls a greater percentage of the same class of voting securities, or the shares of the bank or its holding company are registered with the SEC.[223] The CIBC Act does not apply to transactions requiring approval under the BHC Act or the Bank Merger Act.[224]

On 22 September 2008, the Federal Reserve issued its Policy Statement on Equity Investments in Banks and BHCs,[225] clarifying the Federal Reserve's views with respect to how a minority equity investment can be structured to prevent an investor from being deemed to exercise a controlling influence over a bank or BHC for the purposes of the BHC Act, including with respect to the following issues:

a director representation: a minority investor may generally have one representative on the board of directors of a bank or BHC, provided the representative is not the chair of the board or any committee of the board, and does not represent more than 25 per cent of the seats on any board committee. A minority investor may have up to two representatives on the board if its aggregate director representation is proportionate to its total equity interest in the bank or BHC but does not exceed 25 per cent of the membership of the board, and another shareholder is a BHC that controls the bank or BHC under the BHC Act;

218 12 USC Section 1841(a)(2).

219 12 USC Section 1828(c)(1).

220 12 USC Section 1828(c)(2).

221 12 USC Section 1817(j).

222 12 USC Section 1817(j)(8)(B).

223 See, e.g., 12 CFR Section 225.41(c)(2).

224 12 USC Section 1817(j)(17).

225 12 CFR Section 225.144, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20080922c.htm.

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b total equity interest: a minority investor may generally own up to 24.9 per cent of any class of voting securities of a bank or BHC, or a combination of voting and non-voting securities that, in the aggregate, represents less than one-third of the total equity and less than 15 per cent of any class of voting securities of the bank or BHC;

c consultations with management: although a minority investor may generally communicate with management of a bank or BHC about the organisation's policies and operations, just like any other shareholder, the decision whether to adopt a particular position or take a particular action must remain with the organisation's shareholders as a group, its board of directors or management, as applicable. A minority investor may not accompany its communications with explicit or implicit threats to dispose of its shares or to sponsor a proxy solicitation if the organisation or its management does not follow the minority investor's recommendations. This and other limitations on a minority investor's actions are generally reflected in written 'passivity commitments', which the Federal Reserve requires the minority investor to make as a condition for determining that the investor does not control the bank or BHC;

d business relationships: a minority investor is generally required to limit its business relationships with the bank or BHC in which it holds its investment, particularly when its voting stake is above 10 (and typically 5) per cent, and to ensure that those relationships are on market terms, non-exclusive and terminable without penalty by the banking organisation. A minority investor's written passivity commitments will frequently contain a quantitative limit to business relationships (whether a fixed dollar amount or a percentage of revenues) above which prior approval of the Federal Reserve would be required for any transaction; and

e covenants: a minority investor is generally not able to impose covenants or contractual terms on a bank or BHC that substantially limit management's discretion over major policies and decisions, such as the hiring, firing and remuneration of executive officers; engaging in new business lines or making substantial changes to a bank's or BHC's operations; raising additional debt or equity capital; merging or consolidating; selling, leasing, transferring or disposing of material subsidiaries or major assets; or acquiring significant assets or control of another firm.

i Dodd–Frank Act

The Dodd–Frank Act introduced significant changes to the regulation of investments in banks and BHCs in the United States.

Capital and management requirements

The Federal Reserve may approve a Section 3 application by a BHC to acquire control of all, or substantially all, the assets of a bank only if the BHC is well capitalised and well managed.[226] The federal banking agencies may approve interstate merger transactions only if the resulting bank will be well capitalised and well managed after the transaction.

226 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Sections 606–607 (2010).

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Financial stability factor

The Federal Reserve must consider the extent to which a proposed acquisition would result in greater or more concentrated risks to the stability of the US banking or financial system.[227]

The Federal Reserve has considered the financial stability factor in its review of several recent applications. It uses the following non-exhaustive criteria, both individually and in combination, in evaluating an acquisition's risk to the broader economy:

a the size of the resulting firm;

b the availability of substitute providers for any critical products and services offered by the resulting firm;

c the interconnectedness of the resulting firm with the banking or financial system;

d the extent to which the resulting firm contributes to the complexity of the financial system; and

e the extent of the cross-border activities of the resulting firm.[228]

In addition, the Federal Reserve has considered qualitative factors indicative of the difficulty of resolving the resulting firm, such as the opaqueness and complexity of the institution's internal organisation.[229] In considering the financial stability factor in its order approving the merger of People's United Financial, Inc with Suffolk Bancorp and People's United's indirect acquisition of The Suffolk County National Bank of Riverhead, the Federal Reserve further explained that its experience has shown that proposals involving an acquisition of less than US$10 billion in assets, or that result in a firm with less than US$100 billion in total assets, are generally not likely to pose systemic risks.[230] Accordingly, the Federal Reserve presumes that a proposal does not raise material financial stability concerns if the total assets involved fall below either of these size thresholds, absent evidence that the transaction would result in a significant increase in interconnectedness, complexity, cross-border activities or other risk factors.[231]

Limitations on non-bank acquisitions by systemically important companies

Systemically important companies, including systemically important BHCs and nonbank financial companies supervised by the Federal Reserve, must provide prior notice to the Federal Reserve before acquiring control of voting shares of a company engaged in activities that are financial in nature or incidental thereto that has US$10 billion or more of consolidated assets.[232] Such acquisitions also may not rely on the statutory exemption from Hart–Scott–Rodino Act filing requirements for transactions that require prior approval of the Federal Reserve.

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227 Ibid. Section 604(d) (2010).

228 Cadence Bancorporation, Fed Res Bd Order No. 2018-26 at 20–21 (7 Dec 2018); Synovus Financial Corp and Synovus Bank, Fed Res Bd Order No. 2018-25 at 21–22 (7 Dec 2018); HarborOne Mutual Bancshares and HarborOne Bancorp, Inc, Fed Res Bd Order No. 2018-18 at 15–16 (12 Sept 2018).

229 Ibid.

230 People's United Financial, Inc, Fed Res Bd Order No. 2017-6 at 25–26 (16 Mar 2017).

231 Ibid.; Cadence Bancorporation, Fed Res Bd Order No. 2018-26 at 21 (7 Dec 2018); Synovus Financial Corp and Synovus Bank, Fed Res Bd Order No. 2018-25 at 22 (7 Dec 2018); HarborOne Mutual Bancshares and HarborOne Bancorp, Inc, Fed Res Bd Order No. 2018-18 at 16 (12 Sept 2018).

232 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 163. When initially passed, the prior notice requirement established by Dodd–Frank applied to BHCs with total consolidated assets of at least US$50 billion and nonbank financial companies subject to Federal Reserve supervision. The

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The Dodd–Frank Act states that the prior notice requirement does not apply to an acquisition permitted under Section 4(c) of the BHC Act, thus exempting, among certain other types of investments, investments of less than 5 per cent and investments in companies the activities of which are closely related to banking, and an acquisition made in the course of a systemically important company's underwriting, dealing or market-making activities.[233] This provision is already in effect; however, as at 31 December 2018, no implementing regulations had been issued.

Expansion of nationwide deposit cap

The Dodd–Frank Act prohibits acquisitions by IDIs and their holding companies of additional depository institutions that would result in the applicant controlling more than 10 per cent of the total amount of deposits of US IDIs.[234] Current law imposes a deposit cap on BHCs and SLHCs.[235] Exemptions are provided for acquisitions by BHCs or SLHCs of IDIs in default or in danger of default.

Concentration limits

A financial company is prohibited from merging with or acquiring substantially all the assets or control of another company if the resulting company's total consolidated liabilities would exceed 10 per cent of the aggregate consolidated liabilities of all financial companies at the end of the prior calendar year.[236] There are exceptions for acquisitions of a bank in default or in danger of default, FDIC-assisted transactions, acquisitions that would result in only a *de minimis* increase in the liabilities of the financial company and certain securitisation transactions. The term financial company is defined as an IDI, a BHC, an SLHC, a company that controls an IDI, a systemically important non-bank financial company, and a foreign bank or company treated as a BHC for purposes of the BHC Act. While the majority of merger and acquisition deals are not likely to trigger this provision, the concentration limits imposed by the Act may affect the prospects of much larger mergers between financial institutions.

The Act required the FSOC to complete a study of concentration limits and make recommendations regarding their implementation, including any modifications that would more effectively implement the concentration limits. The FSOC issued its study and recommendations on 18 January 2011.[237] The Federal Reserve issued final rules implementing

EGRRCPA changed the asset threshold from US$50 billion to US$250 billion, but the change is not fully effective as of 31 December 2018. The EGRRCPA § 401(d)(2) states that the increased threshold is immediately applicable to BHCs with under US$100 billion – meaning that BHCs with assets of US$50 billion or more and less than US$100 billion are no longer subject to this requirement. However, the EGRRCPA § 401(d)(1) states that the increased threshold of US$250 billion is otherwise effective 18 months from the date of the bill's enactment, which occurred on 24 May 2018. This means that the change will not take effect until November 2019 for BHCs with assets of US$100 billion or more and less than US$250 billion.

233 Ibid. Section 163(b) (2010).

234 Dodd–Frank Act, Pub L No. 111-203, HR 4173, 111th Cong Section 623 (2010).

235 12 USC Sections 1842(d)(2)(A) and 1843(i)(8)(A) for BHCs and 12 USC Sections 1467a(e)(2)(E) for SLHCs.

236 Ibid. 622 (2010).

237 FSOC, Study & Recommendations Regarding Concentration Limits on Large Financial Companies (2011), www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf.

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the concentration limits in light of the FSOC's recommendations on 14 November 2014.[238] Pursuant to the methodology set forth in the final rules, the Federal Reserve calculated aggregate financial sector liabilities for the initial period between 1 July 2015 and 30 June 2016 using financial companies' consolidated financial sector liabilities as of 31 December 2014.[239] For all subsequent periods, aggregate financial sector liabilities are calculated as the average of financial companies' aggregate financial sector liabilities as at 31 December of the previous two years.

Additionally, for a US company subject to applicable risk-based capital rules, consolidated liabilities are equal to its total RWAs minus its regulatory capital, calculated pursuant to the applicable rules. For companies not subject to applicable risk-based capital rules, consolidated liabilities are calculated using applicable accounting standards, specifically US generally accepted accounting principles or other standard approved by the Federal Reserve.[240] The liabilities of an FBO are calculated with reference solely to the FBO's US operations, enumerated as the total liabilities of all the FBO's US branches, agencies, and subsidiaries domiciled in the United States.[241] The concentration limit rules establish a *de minimis* exception to engage in transactions exceeding the limit by up to US$2 billion in the aggregate during any 12-month period, but to rely on this exception the financial company must obtain prior consent from the Federal Reserve to ensure the particular transaction does not pose a threat to financial stability.[242] In the alternative, if the financial company's transactions in the aggregate during any 12-month period do not exceed US$100 million, the financial company can meet the *de minimis* exception by providing notice to the Federal Reserve within 10 days after an acquisition.[243] The rules do subject transactions made in the ordinary course of business that are structured as controlling investments to the concentration limit, and include merchant banking investments as covered acquisitions, explicitly distinguishing between intentional investment decisions covered by the limits and less-targeted investment activities such as collecting a previously contracted debt or *bona fide* underwriting or market making activity.[244]

VII OUTLOOK AND CONCLUSIONS

Financial regulatory reform as well as technological and market changes continue to shape the regulatory environment in the United States. Further, regulatory implementation, including the tailoring of rules and regulations according to a banking organisation's business model, size and risk profile in the United States, has been, and is likely to remain, a significant focus in reforms to the financial regulatory framework in the United States. With a divided Congress following the midterm elections, momentum in financial regulatory reform going forward is unlikely to continue through statutory reform, but is expected to be driven by regulatory

238 Federal Reserve, Final Rule: Concentration Limits on Large Financial Companies, 79 Fed Reg 68,095 (14 Nov 2014), www.gpo.gov/fdsys/pkg/FR-2014-11-14/pdf/2014-26747.pdf.

239 Federal Reserve, Announcement of Financial Sector Liabilities, 80 Fed Reg 38,686 (7 July 2015), www.gpo.gov/fdsys/pkg/FR-2015-07-07/pdf/2015-16658.pdf.

240 See 12 CFR Section 251.3(c), (e).

241 12 CFR Section 251.3(d).

242 12 CFR Section 251.4(a), (b).

243 12 CFR Section 251.4(c).

244 See Federal Reserve, Final Rule: Concentration Limits on Large Financial Companies, 79 Fed Reg 68,095, 68,101-102 (14 Nov 2014), www.gpo.gov/fdsys/pkg/FR-2014-11-14/pdf/2014-26747.pdf.

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agencies under new leadership. Despite these reforms and tailoring efforts, the post-crisis regulatory framework will continue to structure, constrain and channel the behaviour of financial institutions, markets and individuals for the foreseeable future, given its broad scope and significant impact on financial regulation in the United States.

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Appendix 1

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She advises companies, banks and financial institutions on their financial activities, including plain vanilla and structured financings, loan syndication and guarantee structures, securitisation structures, and the issue of non-convertible debentures and masala bonds.

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He graduated from Tokyo University in 1986 and received his LLM from the University of London, London School of Economics and Political Science in 1993. He was seconded to Slaughter and May in London and Brussels in 1993 and 1994.

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Andrea advises domestic and foreign institutions on acquiring financial services and credit licences and exemptions, and specialises in advising on structuring and establishing financial services and credit businesses, including drafting plain English documents, procedures, systems audits and online web application processes.

Andrea's experience includes advising clients on financial products and channels, including peer to peer lending platforms, crowd funding, payment systems, cryptocurrencies, reward programmes, gift cards and financial services acquisitions, disposals and alliances.

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He graduated from the University of Edinburgh with a degree in mathematics and statistics, and qualified as a solicitor in England and Wales in 2009.

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Robert Cain graduated from Oxford University (St Peter's College) and was admitted as a solicitor (England and Wales) in 2002. He worked in the financial regulation group of Clifford Chance LLP in London and at the UK Financial Services Authority. He was admitted as a solicitor in Ireland in 2008.

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Sir Trevor Carmichael is a former Deputy Secretary General of the International Bar Association and a life fellow of the Institute for Advanced Legal Studies in the United Kingdom. He is one of the two founders of the University of the West Indies Faculty of Law's

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Sir Trevor was appointed as one of eight Organisation of American States (OAS) experts responsible for drafting a new OAS Convention on International Contracts. He is co-author of the book *Land Use Under The Law – A Commentary and Compilation of Select Legislation in Small Island Developing States and of Commonwealth Caribbean Trusts Law*, the editor of *Barbados: Thirty Years of Independence*, and the author of *Passport to the Heart: Reflections on Canada Caribbean Relations* and *Gully Adventures: A Stream of Barbadian Life*.

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ALFA Monaco is a member of the Chamber of Monaco Legal Advisers, and Mireille Chauvet is on the board of directors of the Monegasque Association of Compliance Officers.

Her career spans as follows: in-house lawyer at Colgate-Palmolive from 1986 to 1988 in Courbevoie; associate at White & Case LLP in Paris from 1988 to 1991; senior associate at Ernst & Young International in Monaco from 1992 to 1998; lecturer at EDHEC Business School in Nice from 2004 to 2005; and partner at ALFA Monaco since 1998.

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Mr De Ghenghi received his BA, *magna cum laude*, from McGill University in 1980 and in 1982 received his BA in law from Oxford University. In 1985, he received his JD, *cum laude*, from Northwestern University School of Law, where he was an articles editor for the *Northwestern University Law Review*.

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Chambers Global Guide 2015 says 'Clients praise Anne Fontaine for her accessibility and responsiveness, in addition to her strategic thinking'.

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Mr Köves obtained a diploma in law from the Faculty of Law and Politics at the Eötvös Loránd University in 1983. In 1991, he established Köves & Partners, then joined Clifford Chance in 1993, where he was a partner between 1995 and 2009. In 2009, he became a founding partner of Lakatos, Köves and Partners Ügyvédi Iroda.

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Janne Lauha specialises in capital markets, financial regulation and corporate law. He has been involved as legal counsel in numerous transactions relating to capital markets, listed companies and regulated institutions. He advises domestic and international financial institutions, insurance companies, issuers and significant shareholders in regulatory matters. He is a recognised legal expert on securities transactions, derivatives and the Finnish system for dematerialised securities.

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Mr Machuca's practice focuses on corporate law, banking, finance, regulatory, investment funds, private equity and capital markets. He also advises clients on M&A transactions and on insolvency and restructuring proceedings.

In 2007, Mr Machuca was one of the winners of the *Iberian Lawyer* 40 Under Forty awards, which recognise the achievements of the new generation of top lawyers in Spain and Portugal.

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Didier Martin is a partner and one of the leading specialists in French corporate law, in particular French public tender offers, securities law and privatisations. He is a member of several committees and associations, including the recently created Haut Comité Juridique de la Place Financière de Paris, which brings together the French Financial Markets Authority, the French National Bank, the French Treasury, the Prudential Control and Resolution Authority (ACPR) and the French Chancellery. A member of the Paris Bar since 1977, he has published numerous books and articles on a wide variety of corporate law subjects, including a commentary version of the Monetary and Financial Code.

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Szabolcs Mestyán is a partner and head of the firm's banking and finance practice. He has developed expertise in asset and project finance and the Hungarian law aspects of securitisation

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matters. He is regarded as an up-and-coming and cutting-edge expert in capital markets transactions, aircraft finance and banking consumer protection matters.

He obtained a diploma in law from the Faculty of Law and Politics at Eötvös Loránd University in 2005. He obtained an LLM in banking and finance from the University of London. He joined the firm in 2005 and became a partner in 2014.

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Francis is co-head of the financial services department at Allen & Gledhill. He specialises in regulatory issues, in particular financial services and commodities regulations.

He regularly advises banks, financial institutions, investment banks, securities dealers, futures brokers and fund managers. His expertise also includes the structuring and documentation of derivatives transactions.

Francis is ranked Band 1 in *Chambers Global* and *Chambers Asia-Pacific* for 'Banking & Finance: Regulatory', where he is described as 'well known for his work in the area of financial services and commodities regulations' and "clients and peers alike confirm his leading position in the market, explaining that his 'regulatory knowledge and proactiveness are second to none.'" Francis is also ranked Band 1 in *Chambers Asia-Pacific* for 'Capital Markets: Securitisation & Derivatives', and is listed as a 'Leading Individual' in *The Legal 500 Asia-Pacific* for 'Financial Services Regulatory'.

Francis graduated from the National University of Singapore with an LLB (Hons) degree (first class) in 1996. He was called to the Singapore Bar in 1997 and joined Allen & Gledhill in 1998.

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Rafael A Morales is the managing partner at Morales & Justiniano. Before that he was managing partner at SyCip Salazar Hernandez & Gatmaitan and the head of its banking, finance and securities department.

He is a professorial lecturer at the College of Law of the University of the Philippines, as well as the author of two books, *The Philippine General Banking Law (Annotated)* and *The Philippine Securities Regulation Code (Annotated)*, and numerous legal articles. Among many accolades, he was cited in *Euromoney Legal Media Group Guide to the World's Leading Banking Lawyers* and included in *Asian Legal Business'* list of 100 pre-eminent Asia-Pacific lawyers. He is a past president of the Inter-Pacific Bar Association.

Mr Morales finished his bachelor of arts in political science (*cum laude*, 1970) at the University of the Philippines, where he also took his bachelor of laws (*cum laude* and class valedictorian, 1974).

He holds a master of law degree (1978) from the University of Michigan, where he was a DeWitt Fellow. While in the United States, he trained as a foreign attorney at Rosenman Colin Freund Lewis & Cohen in New York City. He later became a foreign attorney at Anderson Mori & Rabinowitz in Tokyo.

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Ms Pelzer studied law at Cologne University, Germany, and graduated, with honours, in 1999. She received her PhD in law, *magna cum laude*, from the University of Bonn, Germany, in 2003, and clerked at the Higher Regional Court in Cologne, Germany. In 2011, she received her LLM from Columbia University and graduated as a Harlan Fiske Stone scholar.

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Since 2006, Mr Rumi has been involved in some of the most important mergers and acquisitions in the Italian banking industry, and has specific experience in advising international companies interested in working in Italian regulated sectors. He assisted on wide governance reforms and internal audit investigations of credit institutions following changes in their corporate bodies and requests from the supervisory authorities. From 2015 to 2017, he assisted the new corporate bodies of the four bridge banks (Nuova Banca delle Marche, Nuova Banca dell'Etruria e del Lazio, Nuova Cassa di Risparmio di Ferrara and Nuova Cassa di Risparmio di Chieti) established in the first application of the Bank Recovery

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and Resolution Directive in Italy. Currently, he is working on the reorganisation of banks and investment firms (as a result of the Single Supervisory Mechanism).

Mr Rumi regularly sits on panels of Italian associations that deal with prudential supervision and complex and innovative financial techniques for both banking sector and finance companies. Mr Rumi is also in charge of the coordination of BonelliErede's outpost in Frankfurt at Hengeler Mueller's premises.

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Karima Seyam is an associate in the banking and finance department in Cairo. Karima joined the firm in 2017; she has a notable knowledge of different areas of Egyptian law, including banking matters, as well as commercial and capital market matters.

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In March 2015, Gunjan was included on the list of 'India's Hottest Young Executives' (2015), *Business Today's* ninth listing of the best and the brightest corporate performers under 40. She was recognised as one of India's top 40 business leaders under the age of 40 by *The Economic Times* (Spencer Stuart Survey, 2014). She has also been recognised by *AsiaOne* as being among the 50 most influential Indians under 50 (2016–2017). In February 2018, Gunjan was profiled in *The Economic Times* 'Women Ahead' listing.

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Pablo J Torretta was born in Luján, Argentina, in 1971. He graduated as a lawyer from Universidad de Buenos Aires in 1995 and obtained a master's degree in finance, with distinction, from Universidad del CEMA in 1998. Mr. Torretta is the head of the financial regulations department of Estudio Beccar Varela. He has over 20 years of professional experience in banking and financial institutions, and foreign exchange and financial regulatory matters. He has excelled in international transactions of indebtedness and investment processes, and has extensive experience in debt restructuring processes, as well as financial and banking regulatory disputes.

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Mr Vece graduated *magna cum laude* from the LUISS University of Rome in 2011 and was admitted to the Italian Bar in 2014. In 2016 and 2017, he served as visiting foreign associate at Hengeler Mueller's financial regulation group in Frankfurt am Main.

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Mr Walker is the co-author of the UAE chapter of *Financial Services Regulation in the Middle East* (Oxford University Press, 2008) and has contributed articles to various publications, including *International Financial Law Review*. He is a regular contributor to Euromoney's *Global Banking & Financial Policy Review*.

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Shengzhe is often asked to comment on recent market and practice trends in China by publications such as *Bloomberg*, *Finance Asia*, *Global Capital Asia* and *Global RMB*. She

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speaks frequently on financial trends and regularly provides insight on regulatory changes in China.

Prior to joining Hogan Lovells, Shengzhe worked for an international law firm in the banking and finance and corporate M&A group for eight years, and for two years as in-house counsel at UniCredit Bank AG. Shengzhe was admitted to the Chinese Bar (as an attorney) in China in 1998 and as a solicitor in England and Wales in 2010. She speaks Chinese (Mandarin), English and German.

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At Bun & Associates, Youdy serves as the firm's practice leader of the banking and finance, corporate and dispute resolution practice groups. He is currently a panel lawyer for numerous foreign banks operating in Cambodia. His expertise includes market entry for financial institutions, project finance, offshore financing as well as other complex financial products and regulatory matters in the financial sector. He has a vast range of clientele from large financial institutions, foreign EXIM banks, fund managers, and foreign and international development agencies. He has provided advice to some of the largest financial institutions and security firms in Asia relating to their business expansion and market entry strategies into Cambodia. Youdy regularly represents lenders in large financing transactions granted to Cambodian entities operating in various industries. Youdy recently advised a mega Japanese bank in the acquisition of a substantial stake in Cambodia's largest bank. He also counselled an Irish company in the financing and purchase of several Airbuses that were subleased to a Cambodian carrier and a Chinese lender in relation to restructuring the financing granted to a hydropower plant project.

Youdy is one of the first commercial arbitrators admitted to the National Commercial Arbitration Center (NCAC) and a fellow of the Singapore Institute of Arbitrators (SIArb). He formerly served as an executive board member of the NCAC, and is currently a board member of the European Chamber of Commerce in Cambodia (EuroCham). He is a former Secretary-General of the Bar Association of the Kingdom of Cambodia. Youdy has been consistently ranked as a leading lawyer (first tier) in Cambodia by *IFLR1000*, *Asialaw* and *Chambers & Partners*. In the *Chambers & Partners Asia-Pacific 2014* guide, according to an interviewee: 'Youdy is well qualified, and his broad experience and knowledge in the banking industry allow us to move efficiently in our financing transactions. He is extremely intelligent and his advice is always of high quality.' He is fluent in Khmer, English and French.

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Appendix 2

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