Global Legal Insights

Banking Regulation

2019

Contributing Editors:

Peter Hsu & Rashid Bahar

global legal group

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United Kingdom

Simon Lovegrove & Alan Bainbridge
Norton Rose Fulbright LLP

Introduction

The financial services industry constitutes around 7% of United Kingdom ("UK") GDP, directly employs approximately 1.1 million people, and contributes a significant proportion of tax revenue to the UK. The banking sector is an important part of the industry, consisting of UK domestic banks and non-UK banks that have established themselves in the UK (many of which use the EU passport to conduct cross border business).

Brexit has created considerable uncertainty for banks operating in the UK. It was reported in the press that London's 10 biggest investment banks have spent more than £1bn preparing for the UK's departure from the European Union ("EU"). At the time of writing it was still unclear as to whether or not EU and UK politicians could agree on a deal. In light of the political uncertainty, businesses and regulators in both the EU and the UK have stepped up their preparations for a no-deal Brexit.

From a UK perspective no-deal Brexit preparations have been led by the UK Government, principally through HM Treasury producing legislation that 'onshores' (with amendments) existing EU legislation in force immediately before the UK leaves the EU. The UK financial regulators, the Prudential Regulation Authority ("PRA") and Financial Conduct Authority ("FCA") have also been busy producing amendments to their rules and guidance to reflect life outside the EU.

Regulatory architecture: Overview of banking regulators and key regulations

Responsibility for UK bank regulation is divided between the PRA (which is part of the Bank of England ("BoE")) and the FCA. A third body, the Financial Policy Committee, which sits in the BoE, has a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks, with a view to protecting and enhancing the resilience of the UK financial system.

The PRA and FCA both derive their powers from the primary piece of legislation governing UK financial services: the Financial Services and Markets Act 2000 (as amended) ("FSMA"). FSMA makes it a criminal offence to engage in "regulated activities" by way of business in the UK unless authorised or exempt. Secondary legislation which is made under FSMA establishes the list of regulated activities in the UK. This list is updated and amended from time to time for new activities, such as the administration of benchmarks; a regulated activity introduced in 2015. The list was further amended to take into account the implementation on 3 January 2018 of the EU Markets in Financial Instruments Directive (recast) ("MiFID II") and the EU Markets in Financial Instruments Regulation ("MiFIR") (discussed further below). Specifically, a new activity of operating an organised trading facility was added.

For banks, accepting deposits is the defining regulated activity. Accepting deposits is a regulated activity only where deposits are lent to third parties or where any other activity of the firm is financed out of the capital of, or out of interest on, those deposits. This captures banks and building societies in the UK, which must therefore be authorised by the PRA. The PRA and FCA work closely together in the authorisation process, and the PRA is required to obtain the consent of the FCA before granting any permission.

Banks may undertake other regulated activities alongside deposit-taking, such as dealing in investments as principal, arranging deals in investments, safeguarding and administering investments, and certain residential mortgage lending activities. It is important to note that the UK regime regulates most activities only where they are carried on in relation to "specified investments", a list of which (including shares, debentures, options, futures, contracts for differences, etc.) are prescribed in secondary legislation enacted under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "RAO"). Like the list of regulated activities, the list of specified investments is updated from time to time. For example, with the implementation of MiFID II and MiFIR, certain derivatives relating to currencies, binary contracts and emission allowances were added to the list. In addition, the regulated activities of dealing in investments as agent, arranging deals in investments, managing investments and advising on investments have been applied in relation to structured deposits.

PRA

The PRA is the prudential regulator of UK deposit-taking institutions (as well as insurance companies and certain large investment firms). PRA-regulated firms are also regulated by the FCA in respect of conduct of business matters, and are therefore "dual regulated".

FSMA gives the PRA two primary objectives: a general objective to promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system; and an objective specific to insurance firms, to contribute to ensuring that policyholders are appropriately protected. Since 2014, the PRA has had a secondary objective. When discharging its general functions in a way that advances its primary objectives, it must, so far as is reasonably possible, act in a way which facilitates effective competition in the market for services provided by PRA-authorised firms. From 1 January 2019, the way in which the PRA advances its general objective was amended to reflect the aims of bank structural reform (also referred to as ring-fencing, discussed below). This requires the PRA to discharge its functions in a way that seeks to: (i) ensure that the business of ring-fenced bodies ("RFBs") is carried on in a way that avoids any adverse effect on the continuity of the provision in the UK of core services (retail deposits and related payment and overdraft services); (ii) ensure that the business of RFBs is protected from risks (arising in the UK or elsewhere) that could adversely affect the continuity of the provision in the UK of core services; and (iii) minimise the risk that the failure of a RFB or of a member of a RFB's group could affect the continuity of the provision in the UK of core services.

The PRA is a forward-looking and judgment-based prudential regulator. This means that it proactively takes action in order to pursue its objectives. For example, it conducts regular stress-testing for the firms it regulates and has adopted regulatory initiatives like the senior managers' regime (see below). The PRA has different objectives to the FCA but both institutions work together and have agreed to arrangements set out in a Memorandum of Understanding.

Under FSMA, the PRA has a general power to make rules which apply to the firms that it regulates, and to issue related guidance with respect to such firms. The PRA's rules are located in its rulebook, whereas guidance which often supplements these rules is located in supervisory statements. The PRA also publishes statements of policy which set out its approach to exercising certain statutory powers, such as its enforcement and information-gathering powers. The PRA has also published approach documents; these set out its approach to the supervision of firms in the banking and insurance sectors. The approach documents are updated regularly, the last time being October 2018.

The PRA expects firms to engage directly with policy material, including its rules, EU material and supervisory statements, and determine, bearing in mind the overarching principle of safety and soundness, whether they meet the PRA's expectations. The PRA also expects firms not to merely meet the letter of its requirements, nor indeed to game them by engaging in 'creative compliance'.

FCA

The FCA is the UK financial services regulator responsible for the regulation of conduct in retail and wholesale financial markets. It also has a broader ambit: supervising the trading infrastructure which supports those markets and acting as the prudential regulator for firms not authorised by the PRA.

The FCA has a strategic objective to ensure that markets function well. To do this, it has three operational objectives, which are to:

- secure an appropriate degree of protection for consumers;
- protect and enhance the integrity of the UK financial system; and
- promote effective competition in the interests of consumers in the markets for regulated services.

Whatever the FCA does, or actions it takes, it should be in order to achieve one or more of these objectives.

The FCA became a competition regulator (alongside the Competition and Markets Authority under UK competition law) in relation to financial services on 1 April 2015. This is in pursuit of the competition objective referenced above. The FCA's competition objective is therefore embedded in its regulatory approach, which includes looking at whether improving competition would improve consumer outcomes, and weighing up the impact of new measures on competition. Consequently, the FCA conducts market studies that seek to assess whether there are competition concerns and, if so, takes steps to address features that inhibit effective competition.

To pursue its objectives, the FCA has a wide variety of rule-making and supervisory powers, including those relating to enforcement, sanction and prosecution. The FCA may also take action in respect of unfair terms in certain types of financial services contracts under the Consumer Rights Act 2015 and the Unfair Terms in Consumer Contracts Regulations 1999. However, the Financial Services Compensation Scheme and the Financial Ombudsman Service are independent of the FCA.[1]

The FCA aims to be, and this is increasingly evident in practice, a proactive regulator seeking to take action where there is the risk of consumer detriment, but before it takes place. This means that the FCA is increasingly willing to intervene before a product is launched or to use its powers to require a firm to withdraw or amend a misleading financial promotion.

In April 2014, the FCA took over the regulation of consumer credit from the Office of Fair Trading. Various consumer credit activities like credit intermediation (broking) became regulated activities under FSMA requiring prior authorisation. Importantly, agreements that are covered by the FCA consumer credit regime are subject to detailed rules. Such rules apply to the drafting of the agreements and to the substance of pre- and post-contract information. Failure to comply with these rules can be onerous, with UK courts having powers to re-open credit agreements where they consider that the terms create an unfair relationship between the lender and the borrower, and may change the terms (including amounts payable).

The FCA has also established a Payments Systems Regulator ("PSR") which became operational on 1 April 2015. The PSR regulates payment systems, which are the mechanisms through which money is transferred between individuals and business when buying goods and services. It is independent of the FCA in terms of the rules it produces but it sits as a subsidiary of the FCA and leverages off the FCA's existing regulatory infrastructure, such as staff, IT systems, etc.

Recent regulatory themes and key regulatory developments in the UK

European initiatives

(a) *Brexit*

At the time of writing this chapter, the UK was still in the process of negotiating its withdrawal from the EU, despite being scheduled to leave some five weeks away on 29 March 2019.

Both the EU and the UK have been stepping up their contingency preparations for a no-deal Brexit.

From the EU side, the European Commission ("Commission") has issued Brexit preparedness notices on a wide range of areas which summarise how EU policy and law will change. The preparedness notice for banking services reminds UK entities that they will lose passporting rights once the UK leaves the EU.[2] In addition, with the loss of passporting rights, the notice warns that the ability of UK-based entities to perform certain contractual obligations may be impaired. The final part of the notice covers arrangements and exposures, noting in particular that the prudential treatment of exposures to third parties established in the UK may be affected.

In addition to issuing the Brexit preparedness notices, the Commission has adopted temporary equivalence decisions on the future UK legal and supervisory framework for central counterparties ("CCPs") and central securities depositories ("CSDs"). In a no-deal Brexit, these decisions would come into effect from 30 March 2019. Recognition would allow UK CCPs to continue to provide clearing services to their EU members, and EU banks to meet their obligations to UK CCPs.[3]

Each of the three European Supervisory Authorities ("ESAs") – the European Banking Authority ("EBA"), the European Securities and Markets Authority ("ESMA") and the European Insurance and Occupational Pensions Authority – are also playing an important role in the EU's work on Brexit. In particular, each ESA has issued opinions[4] to Member State competent authorities setting out their supervisory expectations as to how financial institutions should prepare for Brexit.

(b) *MiFID II / MiFIR*

On 3 January 2018, the Markets in Financial Instruments Directive ("MiFID") was replaced MiFID II and MiFIR. MiFID II and MiFIR take over the mantle previously held by MiFID as being the cornerstone of EU financial services law, setting out which investment services and activities should be licensed across the EU, and the organisational and conduct standards that those providing such services should comply with. MiFID II and MiFIR upgraded MiFID by introducing new provisions relating to: non-equity market transparency; regulatory product intervention powers; third country provisions; and high-frequency trading controls.

The UK's implementation of MiFID II (being a Regulation, MiFIR is directly applicable whilst the UK is a member of the EU[5]) has taken the form of a combination of legislation made by HM Treasury, in the form of a number of statutory instruments, and rules contained in the FCA Handbook and, to a lesser extent, the PRA Rulebook.

Among other things MiFID II and MiFIR contain a number of provisions relating to the conditions under which non-EU firms may provide investment services to EU-based clients. In respect of access to the EU for third-country firms, the MiFID II/MiFIR regime is divided into two interconnected parts, dealing separately with, on the one hand, *per se* professional clients and eligible counterparties ("ECPs") (in MiFIR), and on the other hand, retail and elective professional clients (in MiFID II).

Under MiFIR, Member State national regimes that apply to third country firms providing business to *per se* professional clients and ECPs will continue until a positive decision is taken by the Commission in respect of the effective equivalence of that third-country jurisdiction to EU prudential and business conduct standards. For three years following this equivalence decision, third-country firms will continue to be able to provide services under the Member State's national regime. Alternatively, the third-country firm may register directly with ESMA. The benefit of registering with ESMA is that the third-country firm may then provide investment services to, or perform activities directly with, *per se* professional clients and ECPs anywhere in the EU without having to establish an EU branch. However, before providing such services and activities, the third-country firm must inform clients that they are not allowed to provide services other than to *per se* professional clients and ECPs, and that they are not subject to supervision in the EU.

MiFID II provides that Member States may require third-country firms seeking to provide investment services and activities to retail and elective professional clients to do so from local branches, which are authorised and supervised in accordance with specified criteria. Where a third-country firm establishes a branch in a Member State that has been authorised in accordance with MiFID II, MiFIR provides that it can "passport" any MiFID II investment services or activities (to *per se* professional clients and ECPs only) into other Member States from that branch once the Commission has adopted a positive equivalence decision in relation to the relevant third-country jurisdiction.

The third-country branch regime set out in MiFID II is optional. The UK has not implemented this regime and therefore its existing domestic regime for third-country branches remains. Importantly, this means that the UK has retained its key exemption under the RAO known as the 'overseas persons exclusion'. This exclusion has played an important part in the access of third-country firms to the London market.

(c) *PSD2 and the Benchmarks Regulation*

The Payment Services Directive was replaced by a new Directive (the revised Payment Services Directive or PSD2) on 13 January 2018. The PSD2 directs banks and credit unions to give open access to their customer data and account information to licensed third party businesses (though with the caveat that this data can only be provided with their customers' explicit consent). It also focuses on reducing barriers to entry for providers of card and internet payment services, and encourages payments innovation in the context of mobile technology. Being a Directive, Member States had to transpose the PSD2 into their national law. The UK did this primarily through legislation, the Payment Services Regulations 2017. The FCA also amended its rules and guidance to reflect these new Regulations.

Most of the provisions of the Benchmarks Regulation[6] came into force on 1 January 2018. Being a Regulation, it is directly applicable in Member States.[7] The UK has introduced statutory amendments to align its regime with the new Regulation. This was primarily through the Financial Services and Markets Act 2000 (Benchmarks) Regulations 2018. The FCA also made changes to its Handbook. The Benchmarks Regulation substantially replaced the UK regime that previously regulated benchmark administrators and contributors.

(d) *Anti-money laundering*

Member States are required to transpose into their domestic regime the provisions of the Fifth Anti-Money Laundering Directive ("5MLD") by 10 January 2020. The 5MLD makes a number of changes to the Fourth Anti-Money Laundering Directive, including extending its scope to include providers engaged in exchange services between virtual currencies and fiat currencies. It also clarifies and harmonises among Member States the enhanced due diligence measures to be taken relating to business relationships or transactions involving countries identified as high-risk by the Commission. Another notable development is the improved identification of politically exposed persons. Member States are required to create and keep updated lists of the specific functions that qualify as prominent public functions in their jurisdictions, and to send their lists to the Commission. The Commission is to create and keep updated an equivalent EU-level list, and to publish a single list of prominent public functions, based on all the lists.

At the time of writing, a draft legislative proposal was being reviewed by the EU institutions which would amend the three Regulations founding the ESAs. The proposal would centralise the tasks relating to the prevention and combating of money-laundering and terrorist financing into the EBA. The EBA's supervisory powers relating to anti-money laundering / combating terrorist financing would be extended from the banking sector to the financial sector as a whole, taking over the supervisory powers currently held by the other two ESAs.

(e) *Significant legislative reviews*

There are significant legislative reviews currently taking place of the EU's regulatory framework. These include measures on banking regulation, being proposed amendments to the CRD IV, the Capital Requirements Regulation ("CRR") and the Bank Recovery and Resolution Directive ("BRRD"). The amendments to the CRD IV and CRR are discussed later in this chapter. In the main, the proposals to amend the BRRD are designed to refine the rules relating to the 'minimum requirement for eligible liabilities' ("MREL"). These refinements apply different MREL requirements to a firm that is a global systemically important institution ("G-SII") as opposed to other non-G-SII banks, which is intended to allow the G-SII MREL framework to align with the Financial Stability Board's 'total loss-absorbing capacity' ("TLAC") standard. Furthermore, amendment to Article 55 of the BRRD is proposed so that it can be applied in a proportionate manner, reflecting the approach taken in a number of Member States under the existing Directive.

Outside of banking regulation, amendments are being proposed to the European Market Infrastructure Regulation, most notably containing the possibility of imposing a location policy on systemically important central counterparties.

Domestic trends

At the time of writing this chapter, the UK was only weeks away from leaving the EU on 29 March 2019. Despite this, uncertainty remained as to whether or not the UK would crash out of the EU without a deal. But whilst Brexit has dominated the headlines, the examples below illustrate that there are also a number of important home-grown regulatory initiatives, but these are by no means exhaustive.

(a) *Brexit*

By virtue of the UK being in the EU, banks and other financial services firms authorised in the UK are able to provide services into and within other Member States without the need for further authorisation. This is commonly known as 'passporting'. The ability to passport services means that a financial services firm can either provide its services directly on a cross-border basis or can establish a branch in another Member State, having received authorisation from its home state regulator and without the additional requirements and costs associated with establishing a subsidiary in that Member State. Subsidiaries, in contrast, may be subject to local governance and regulatory requirements, and may require separate capitalisation, both of which increase costs.

The key issue that banks in the UK face with Brexit is the loss of the passport and the associated costs of creating a subsidiary in an Member State. The Commission has stated that it is not prepared to grant passporting rights to UK firms once the UK leaves the EU on the basis that the 'four freedoms' – freedom of movement of goods, services, persons and capital – are indivisible. Instead the UK will have to rely on so-called equivalence measures in EU legislation – which is different, and less extensive.

The draft Withdrawal Agreement which was announced on 14 November 2018 provides some relief – if both the UK and the EU ratify it. This is because it provides for a transitional period during which existing EU law (unless otherwise agreed) and the passporting regime will continue to apply until 31 December 2020 (which may be further extended once by one or two years).

The draft Withdrawal Agreement was accompanied by a Political Declaration setting out at a high level the framework for the future relationship between the EU and the UK. This includes a reference to financial services. However, whilst it recognises the need for continuing close cooperation between different regulators and regimes, the basis of such cooperation will be equivalence.

If the Withdrawal Agreement is not ratified, the UK will leave the EU without a deal and this is commonly referred to as a 'hard Brexit' or 'no-deal Brexit' scenario. Given that political differences remain on the draft Withdrawal Agreement, both the EU (as discussed previously) and the UK have stepped up their contingency planning for a hard Brexit.

The key piece of primary UK legislation is the European Union (Withdrawal) Act 2018 (the "EUWA 2018"). The EUWA 2018 is designed to address the significant legal challenge that will result from the UK leaving the EU. Essentially the EUWA 2018 cuts off the source of EU law in the UK by repealing the European Communities Act 1972 and removing the competence of EU institutions to legislate for the UK. The EUWA 2018 also seeks to preserve existing EU law as it applies in the UK immediately before Brexit and converting it into UK law.

Approximately 60 financial services related statutory instruments (secondary legislation) are being produced under the EUWA 2018. These are intended to amend deficiencies in UK law and retained EU law that arise from the UK leaving the EU without a deal. The UK

Government has also published draft primary legislation, The Financial Services (Implementation of Legislation) Bill ("IOL Bill"), which provides for the UK onshoring so-called in-flight EU legislation, being EU legislation that is not yet in force or applicable within two years of the UK leaving the EU.

Two important components of the UK's contingency planning for a hard Brexit are the temporary permissions regime ("TPR") and the financial services contracts regime ("FSCR"). The statutory basis for both is the EUWA 2018.

The TPR will enable firms and funds that currently passport into the UK to continue operating in the UK for a limited period of time after the UK has left the EU. However, to take advantage of the TPR, firms must have made a notification to the PRA/FCA before the end of 28 March 2019. Once in the TPR, the PRA or FCA will allocate the firm with a 'landing slot' within which they will need to submit their application for UK authorisation. Landing slots will be allocated after 29 March 2019. The first landing slots are expected to be October to December 2019; the last to be January to March 2021.

The FSCR is a back-stop to the TPR to mitigate contract continuity risks. The FSCR is designed for those EU firms that passport into the UK immediately before exit day which: (i) do not make a notification to enter the TPR; or (ii) make a notification to enter the TPR but exit that regime without full authorisation. The FSCR applies automatically these firms. The FSCR provides limited permissions for these firms to perform existing contracts but, unlike the TPR, does not allow a firm to carry out regulated activities in relation to new contracts, except where necessary to service pre-existing contracts. Firms falling within the scope of the FSCR will be expected to run-off, close out, or transfer obligations arising from contracts that exceed the time limit of the regime (15 years for insurance contracts and five years for other contracts) prior to the end of the regime.

Each of the the BoE, PRA and FCA have been consulting on changes to their rules and guidance stemming from a hard Brexit. However, at the time of writing, they had not published final rules and guidance.

(b) *PRA's supervision of UK branches of international banks*

In March 2018, the PRA issued a policy statement regarding its approach to the authorisation and supervision of UK branches of international banks. The approach came into effect on 29 March 2018. The purpose of the policy statement and accompanying supervisory statement is to deal with some of the uncertainty created by Brexit and provide guidance on the PRA's approach to UK branches of EEA banks once the UK leaves the EU. Significantly, whilst the PRA notes that a branch offers less supervisory control than a subsidiary, it accepts the economic benefits that branches bring. However, the regulator draws a line at branches where there would be risks to UK financial stability.

The PRA's authorisation framework applies to the whole of the international bank of which the branch is part, rather than just the branch itself. The framework is 'anchored' in the PRA's general objective of maintaining UK financial stability and involves an assessment of a range of factors which include the level of supervisory cooperation with the home state supervisor. The PRA expects branches of international banks operating in the UK to primarily focus on wholesale banking activities and has additional expectations where such branches are systemically important. Where the PRA considers a branch conducting wholesale business to be systemically important, it may impose additional specific regulatory requirements – although if it deems these to be insufficient from a financial stability viewpoint, the regulator will instead require the establishment of a subsidiary. Where an international bank is expected to carry out significant retail banking activities in the UK, the

PRA would expect a subsidiary to be established. The PRA approach sets out certain tests to determine what significant retail activities are.

(c) *Ring-fencing*

A key UK initiative is ring-fencing, which UK banks have been obliged to comply with from 1 January 2019. The Financial Services and Markets Act 2000 (Banking Reform) Act 2013 introduced a requirement for UK banking groups with more than £25bn of "core" deposits (i.e. those from individuals and small businesses) to "ring-fence" their core banking services from their wholesale and investment banking operations.

This means that most UK banks are adopting new legal structures and ways of operating through large and complex restructuring programmes. All banks subject to this requirement have completed the process of restructuring their business using the 'ring-fencing transfer scheme' ("RFTS") restructuring tool. To use an RFTS, a bank had to make an application to court. RFTS court directions began in 2017 and were all successfully completed in 2018.

The PRA has finalised the policy required by banks to implement the ring-fencing regime. This included final policies on governance, legal entity structures, operational continuity arrangements, prudential requirements, intra-group arrangements, financial market infrastructures and reporting and residual matters. Banks have been required to comply with the structural reform requirements, as set out in each of the policy areas from 1 January 2019.

(d) *Senior managers' regime*

Since 7 March 2018, the UK banking industry has been subject to the individual accountability regime. The regime, which replaced the approved persons' regime, comprises a senior managers' regime, a certification regime and conduct rules (generally referred to as the "SM&CR"). The SM&CR is being extended to other UK financial services firms from 9 December 2019.

Whilst the FCA's recent focus has been on extending the SM&CR, there have also been important developments for the banking regime. In particular, in January 2019 the FCA followed up on its discussion paper on whether an individual in charge of a firm's legal function required approval under the SM&CR, by publishing a consultation paper.[8] The FCA has proposed to exclude general counsel and heads of legal from the requirement to be a senior manager. However, there are three important caveats:

1. it is only when the individual is acting as general counsel / head of legal that they are excluded. If, for example, the individual has another role, e.g. head of compliance, they will be in scope for that other role;
2. they need to be certified, as they will either meet the test to be a 'material risk taker' or a 'significant harm function'. Most banks have certified their general counsel / head of legal, so this should not be a new change; and
3. they must comply with Senior Manager Conduct Rule 4 – the duty to disclose matters to the regulator when appropriate.

The deadline for comments on the consultation paper is 23 April 2019. The FCA will consider the feedback received and publish final rules and guidance in Q3 2019 with the effective date of the changes being before implementation of the regime to the non-bank industry, namely before 9 December 2019.

In relation to Brexit, the PRA issued a note in January 2019 which contained FAQs which clarified the interaction between its proposals for applying the SM&CR to firms in the TPR and the FCA's equivalent proposals.

(e) *Retail banking business models*

In April 2017, the FCA launched a programme of discovery work – the Strategic Review of Retail Banking Business Models (the "Strategic Review"). In brief, the Strategic Review seeks to review retail banking business models in greater depth, understand how free-if-in-credit banking is paid for, and understand the impact of changes such as reduced use of branches on banks' business models and the potential impact on consumers. The FCA published its findings in December 2018.

The FCA's findings stated that its analysis confirmed that the personal current account ("PCA") is an important source of competitive advantage for major banks. PCAs bring cheap funding from customer deposits and additional revenues from overdraft fees and other charges. As a result of the review, the FCA will be initiating work in three areas: payment services; SME banking; and monitoring of retail banking business models. In addition, it has identified three potential areas which may require co-ordinated action in the future to ensure a retail banking sector that works well for consumers: (i) continued access to banking services; (ii) the appropriate use of consumer data; and (iii) system resilience and effective prevention of financial crime and fraud.

(f) *Securitisation*

On 1 January 2019, a new framework for European securitisations took effect. Two Regulations, which came into force on 17 January 2018, now apply:

- Regulation (EU) 2017/2402 (the "Securitisation Regulation"); and
- Regulation (EU) 2017/2401 (the "Securitisation Prudential Regulation", or "SPR").

Together, this legislative package represents a major milestone in the EU's Capital Markets Union reform agenda.

The Securitisation Regulation generally applies to securitisations issued on or after 1 January 2019, and does two main things. Firstly, it repeals the main securitisation provisions in existing sectoral legislation applicable to banks (the CRR), insurers (Solvency II) and fund managers (the Alternative Investment Fund Managers Directive) and recasts those provisions in a new, harmonised securitisation regime applicable to all institutional investors including UCITS and pension funds. Secondly, it introduces a concept of "simple, transparent and standardised" securitisation that receive more benign regulatory treatment than other securitisations.

On 19 December 2018, the FCA published a policy statement[9] in which it set out final rules and near-final rules and guidance to ensure that its Handbook was consistent with the two Regulations mentioned above.

(g) *LIBOR reform*

In a speech in July 2018, Andrew Bailey (CEO, FCA) stated that firms should treat a London Inter-Bank Offered Rate ("LIBOR") transition to alternative interest rate benchmarks "as something that will happen and which they must be prepared for". On 19 September 2018, the FCA and the PRA wrote to the CEOs of major banks and insurers supervised in the UK, asking for information concerning their preparations for transitioning from LIBOR to alternative interest rate benchmarks. The purpose of the letters was to seek assurance that firms' senior managers and boards understand the risks associated with the transition and are taking action so that their firm can transition to alternative rates ahead of the end of 2021.

(h) *Enforcement*

The FCA continues to pursue its strategy of credible deterrence and takes significant action against firms and individuals who break its rules, reinforcing proper standards of market conduct. In 2017, the FCA issued its largest ever financial penalty for anti-money laundering controls failings at a bank (£163,076,224). The FCA has also levied some significant fines on individuals; at the beginning of 2019, the FCA fined an individual £76,000,000 for certain regulatory breaches.

The FCA also published for consultation in 2018 its revised approach to enforcement. The final document setting out the FCA's approach to enforcement activities is expected in Spring 2019 and is part of the FCA's mission to introduce greater transparency in their operations.

Bank capital requirements

On 1 January 2014, the "CRD IV" package (comprising the CRR and CRD) was transposed into the UK's regulatory regime. This recast the regime for banks largely in line with Basel III capital standards.

CRD IV's detailed regulatory capital rules are predominantly contained in an EU regulation (the CRR), which has direct application in the UK, as it does in all other Member States.[10] Accordingly, the PRA decided not to make its own rules to implement provisions of the CRR except in the, relatively few, areas where it has discretion over the application of a rule or the manner in which a legislative objective is to be achieved. The CRD, on the other hand, takes the form of an EU directive and so its provisions are not directly applicable. The CRD makes provision for many of the EU-specific governance enhancements, and the PRA has implemented provisions in its Rulebook to transpose these requirements.

On 23 November 2016, the Commission released proposals to revise CRD IV through amendments to the CRR and CRD (known together as CRD V). These proposals reach across the spectrum of bank capital requirements and result from both agreements at international level in the Basel Committee and Financial Stability Board as well as the need to address European-specific issues. After much negotiation, the European Parliament and the Council of the EU reached a provisional political agreement on the legislative package on 4 December 2018.

Finally, following a call for technical advice on 13 June 2016, the EBA released a discussion paper on 4 November 2016 on a new prudential regime for investment firms. The outcome of this paper, and the EBA's supplementary market data-gathering exercises, is the 20 December 2017 Commission publication of a legislative proposal, which entirely revises the prudential rules for investment firms and is anticipated to have significant impact on capital and other prudential requirements. At the time of writing, this legislative proposal was still being reviewed by the EU authorities.

(a) *Regulatory capital*

Under the CRR, banks are required, both on a solo and on a consolidated group basis, to calculate and hold capital against:

- *credit risk*, which is, in high-level terms, an estimation of the risk that a debtor or counterparty will fail to meet its obligations as they fall due, calculated for both assets and off-balance sheet exposures. Banks must adopt either a "standardised" or an "advanced" approach to calculating the risk-weighted assets to which capital charges are then applied. The estimation of risk under the standardised approach is mainly based on external credit ratings, whilst the advanced approaches allow banks, with the consent of the PRA, to build internal models to calculate the capital charge for their exposures;

- *market risk*, which is essentially the risk of loss on investments or positions as a result of changes in market prices, is based on a "building block" approach, with capital required to be held against position risk, counterparty risk, foreign exchange risk, commodities risk and large exposures risk (note that there are also restrictions on large exposures). A transaction can give rise to capital charges under more than one heading and, again, with PRA approval, it is possible for banks to use an internal model to calculate market risk; and
- *operational risk*, which is the risk of loss flowing from factors such as internal process or systems failures, or from external events.

Whether an exposure is treated as a market risk or credit risk depends, broadly, on whether the exposure sits on the trading book, i.e. if the purpose is to make a profit or avoid a loss from short-term market changes, then the market risk regime generally applies. Long-term investments, intended to generate an income stream or targeting a capital return from longer-term value appreciation, generally fall within the credit risk rules.

Following the Basel Committee's work on the 'fundamental review of the trading book' ("FRTB"), the CRD V proposals introduce a requirement to have more risk-sensitive market risk capital requirements for trading activity in securities and derivatives. The aim of these revisions to the market risk framework is to improve risk-capture, enhance consistency across banks and prevent regulatory arbitrage. Whilst these proposals generally follow the FRTB standard, certain EU-specific matters are addressed (for example, regarding the treatment of sovereign exposures). The 4 December 2018 update from the EU Council confirmed that agreement had been reached with the Commission, and that the final standards should be implemented as soon as they are finalised at international level.

The so-called 'output floor', which limits the effect of internal models to a lower bound of 72.5% of the Standardised Approach, was agreed at the Basel Committee in December 2017 after prolonged negotiation between EU and US regulators. Though much has been made of the impact on EU (and UK) banks due to their generally higher reliance on models in calculating capital requirements, this may be significantly mitigated by corresponding reductions in the risk weights for mortgages and certain other lending under the revised Standardised Approach. EU policymakers are yet to announce whether the output floor and related risk-weighting amendments will be incorporated into the proposed CRD V package.

The CRR's current regime for restricting banks taking on large exposures to groups of connected counterparties survives largely intact under the CRD V proposals, but amendments are sought to bring it into line with Basel Committee's 2014 standard. This affects the quality of capital accounted for in calculating the large exposures limit (the proposal recommends only Tier 1 capital whilst currently some Tier 2 capital can be used), and introduces a lower limit of 15% (compared to the normal 25% of eligible capital) for the exposures of G-SIIs to other G-SIIs, as well as requiring all banks to use the Standardised Approach for Counterparty Credit Risk ("SA-CCR") to determine exposures to OTC derivative transactions.

(b) *Amount of capital*

UK banks are required to hold base regulatory capital of at least 8% of risk-weighted assets plus additional capital reflecting various capital buffers, which are being phased in. These buffers include the CRD IV combined capital buffer (comprising a capital conservation of 2.5% of risk-weighted assets and an institution-specific countercyclical capital buffer), Pillar 2 capital buffers (intended to capture more idiosyncratic and forward-looking risks not otherwise reflected in the generally applicable requirements), and systemic capital buffers reflecting global or domestic systemic importance. Further, the PRA currently imposes a 'PRA buffer' on top of the CRD IV buffer requirements. In practice, UK banks are required to hold regulatory capital significantly in excess of 10.5%.

(c) *Types of capital*

Against their capital requirement, banks must hold capital displaying certain characteristics in specified minimum proportions. The CRR tightened the definition of the highest quality capital, "common equity Tier 1" capital (broadly ordinary share capital and reserves), and:

- increased the requirement to hold this capital to at least 4.5% of risk-weighted assets; and
- requires all of the buffers introduced by CRD IV referred to above to be satisfied with common equity Tier 1.

Banks may satisfy other elements of their capital requirements with "additional Tier 1" (broadly, perpetual subordinated debt instruments with certain features, including no incentive to redeem and automatic triggers for write-down or conversation to equity) and Tier 2 (broadly, subordinated debt with original maturity of at least five years). Further, revised MREL standards (mentioned above) also effectively create a new class of regulatory capital in cases where subordination to ordinary liabilities is required by resolution authorities (albeit that this would be less subordinated than either Tier 1 or Tier 2 regulatory capital).

(d) *Liquidity*

The CRR codified two liquidity ratios: a "liquidity coverage ratio" ("LCR"), and a "net stable funding ratio" ("NSFR"). The LCR requires banks to maintain sufficient high-quality liquid assets in a liquidity buffer to cover the difference between the expected cash outflows and the expected capped cash inflows over a 30-day stressed period. The PRA began to phase in the LCR on 1 October 2015. The LCR rose to 90% from 1 January 2017 and reached 100% on 1 January 2018, as required by the CRR.

The NSFR is intended to address liquidity mismatches, with the aim of aligning more closely the funding of longer-term (i.e. illiquid) assets with more stable medium- or longer-term liability and equity financing. At present, it remains solely a reporting requirement and does not operate as a constraint on a bank's operations (though the NSFR data reported may be used by the PRA in its consideration of the appropriate level of Pillar 2 liquidity required). In a report published in December 2015, the EBA recommended the introduction of an NSFR on the basis that it could not find strong evidence that an NSFR would have a negative impact on bank lending, financial assets, markets or trading book positions in banks, apart from some possible adjustment in prices.

The November 2016 CRD V proposals seek to introduce a binding NSFR requirement, with the amount of required stable funding to be calculated by multiplying assets and off-balance sheet exposures by factors that reflect their liquidity characteristics and residual maturities over a one-year period. The NSFR seeks to ensure that a bank has sufficient stable funding to meet its funding needs during a one-year period under both normal and stressed conditions and, like the LCR, the NSFR is expressed as a percentage. Though the NSFR is derived from a proposal of the Basel Committee, the European proposals diverge in certain respects (as recommended by the EBA) which the Commission considers necessary to avoid negative impacts on financing of the European real economy. A binding NSFR has not been introduced according to the Basel Committee's timetable (which would introduce the NSFR on 1 January 2018), pending further negotiation of the CRD V proposals.

(e) *Leverage ratio*

At the direction of the Financial Policy Committee, the PRA has implemented a UK leverage ratio framework which took effect from 1 January 2016. The purpose of the leverage ratio is to address the risk of excessive leverage for the group of firms that are the most systemically important in terms of size and critical services provided to the UK economy. The leverage ratio applies on a consolidated basis to PRA-regulated banks and building societies with total retail deposits equal to or greater than £50bn (on an individual or consolidated basis). In-scope firms must hold sufficient Tier 1 capital to maintain a minimum leverage ratio of 3%. As is the case for the NSFR, at the EU level under CRD IV, the leverage ratio is currently only a reporting requirement. Although the Commission's CRD V proposals seek to introduce a binding leverage ratio of 3%, these do not currently contain a threshold of application and so would extend the UK regime if implanted in their current form.

The UK framework also requires firms to consider whether they also hold a further amount of common equity Tier 1 capital that is greater than or equal to their countercyclical leverage ratio buffer and, if the firm is a G-SII, their G-SII additional leverage ratio buffer. The CRD V proposal does not currently contain a leverage ratio buffer regime for G-SIIs as this remains the subject of international discussions.

Bank governance and internal controls

The PRA's approach document to banking supervision (mentioned earlier) is instructive in terms of understanding the regulator's expectations as regards bank governance and internal controls. Whilst there is insufficient room in this chapter to provide a detailed analysis, the following is worth bearing in mind:

- it is the responsibility of each bank's board and management to manage the bank prudently, consistent with its safety and soundness;
- for a bank to be permitted to carry out regulated activities, the bank as a whole must be 'fit and proper'. This requirement, for a bank and those managing its affairs, to be 'fit and proper' is in addition to the need to comply with applicable laws and regulations. In addition, the senior management of the bank must observe all the conduct rules or standards that apply to them;
- the PRA expects banks to have in place clear structures of accountability and delegation of responsibilities for individuals and committees, including checks and balances to prevent dominance by an individual. Senior individuals are to remain accountable for the actions of those to whom they delegate responsibilities, including where the bank uses third parties in respect of outsourced functions;
- banks should have robust frameworks for risk management, including for financial and operational risks. Controls should be commensurate with the nature, scale and complexity of their business, and promote the bank's safety and soundness;
- banks are expected to articulate for themselves the amount of risk they are willing to take across different business lines to achieve their strategic objectives. Banks should pay attention to identifying, measuring and controlling risks, including those arising in unlikely but very severe scenarios, and should be consistent with the PRA's objectives; and
- banks should have in place separate risk management and control functions (notably risk management, finance, and internal audit) to the extent warranted by the nature,

scale and complexity of their business. The PRA expects these functions to support and challenge the management of risks bank-wide, by expressing views within the bank on the appropriateness of the level of risk being run, and the adequacy and integrity of the associated governance, risk management, financial and other control arrangements.

Rules governing banks' relationships with their customers and other third parties

The FCA and PRA have extensive rules dealing with all aspects of banks' relationships with their customers (such as rules on financial promotions) and third parties (such as the detailed rules on outsourcing). Recent themes of note and of particular relevance to banks are anti-money laundering requirements and the possibility of the FCA introducing a duty of care on regulated firms.

(a) *Anti-money laundering requirements*

The UK's anti-money laundering regime underwent significant change during 2017. The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ("UK MLD Regulations") came into effect on 26 June 2017. The UK MLD Regulations replaced the Money Laundering Regulations 2007 and the Transfer of Funds (Information on the Payer) Regulations 2007 with updated provisions that implemented in part the EU Fourth Anti-Money Laundering Directive ("4MLD") and the EU Funds Transfer Regulation. Similarly, The Money Laundering and Terrorist Financing (Miscellaneous Amendments) Regulations 2018 entered into force on 10 January 2019. This statutory instrument amended the UK MLD Regulations in order to implement amendments to the 4MLD made by the 5MLD (discussed earlier). In response to these domestic changes, the Joint Money Laundering Steering Group (a body made up of leading UK trade associations in the financial services industry) updated its anti-money laundering guidance.

The FCA published finalised guidance concerning the treatment of politically exposed persons ("PEPs") during the summer of 2017.[11] Prior to that, in March 2017 most FCA-regulated firms filed their first-ever financial crime data returns. The report on the data collected (published in November 2018) revealed that almost 120,000 customers fall into the PEP category, with firms having a further 1.6 million other 'high-risk customers'. Firms are required to subject these 'high-risk customers' to enhanced due diligence checks.

The Financial Action Task Force ("FATF") published in December 2018 the results of its assessment into the UK's anti-money laundering / counter-terrorist financing regime ("AML/CTF"). The FATF found the UK's overall AML/CTF regime to be effective in many respects, although certain areas of weakness, such as the supervision and reporting/ investigation of suspicious transactions require addressing.

(b) *Vulnerable customers and new duty of care*

On 17 July 2018, the FCA published "FCA Mission: Approach to consumers" which outlines the regulator's approach to consumers. The document sets out the FCA's vision for well-functioning markets for consumers. The FCA also stated that in 2019 it would consult on guidance for firms on the identification and treatment of vulnerable customers.

At the same time as publishing the Mission document, the FCA also published a discussion paper seeking stakeholder views on the case for and against introducing a duty of care on firms, and seeking views on what form such a provision might take. The deadline for comments on the discussion paper was 2 November 2018. In February 2019, the FCA stated that it would announce its next steps in Spring 2019.

Conclusion

Many banks have already activated their contingency plans to deal with a no-deal Brexit scenario. But whilst Brexit will no doubt continue to preoccupy everyone, it is important to remain conscious of forthcoming regulatory reforms such as CRD V, CRR II, UK senior managers' regime and the UK duty of care.

Endnotes

1. The Financial Services Compensation Scheme is the UK's statutory fund of last resort for customers of financial services firms. It can compensate consumers if a financial services firm has stopped trading or does not have enough assets to pay the claims made against it. It is an independent body set up under FSMA. The Financial Ombudsman Service ("FOS") operates a scheme to resolve disputes, as an alternative to the civil courts. The FOS is operationally independent from the FCA. It provides consumers with a free, independent service for resolving disputes between consumers and businesses quickly and informally.
2. Discussed further in the Brexit section of 'Domestic trends'.
3. The UK Government has also put in place a temporary recognition regime for non-UK CCPs and a transitional regime for non-UK CSDs. These will enable EU CCPs and CSDs to continue to provide services in the UK in a no-deal Brexit scenario.
4. See, for example, the EBA opinion of 25 June 2018 on preparations for the withdrawal of the UK from the EU.
5. In the event of a no-deal Brexit the UK will onshore, with certain amendments, MiFIR and, where necessary, MiFID II using secondary legislation made under the European Union (Withdrawal) Act 2018. The secondary legislation is the Markets in Financial Instruments (EU Exit) Regulations 2019. At the time of writing, the FCA and PRA were also consulting on changes to their rules and guidance in the event of a no-deal Brexit.
6. Regulation on indices used as benchmarks in financial instruments and financial contracts, or to measure the performance of investment funds.
7. In the event of a no-deal Brexit the UK will onshore, with certain amendments, the Benchmarks Regulation using secondary legislation made under the European Union (Withdrawal) Act 2018. The secondary legislation is the Benchmarks (Amendment) (EU Exit) Regulations 2019. The FCA and PRA are also consulting on updating their rules and guidance.
8. FCA Consultation Paper 19/4: Optimising the Senior Managers & Certification Regime and feedback to DP16/4 – Overall responsibility and the legal function.
9. FCA Policy Statement 18/25: EU Securitisation Regulation.
10. In the event of a no-deal Brexit, the UK will still onshore, with certain amendments, the CRR and where necessary the CRD IV using secondary legislation made under the European Union (Withdrawal) Act 2018. The secondary legislation is the Capital Requirements (Amendment) (EU Exit) Regulations 2018. At the time of writing, the FCA and PRA were consulting on changes to their rules and guidance in the event of a no deal Brexit.
11. Finalised Guidance 17/6: The treatment of politically exposed persons for anti-money laundering purposes.

Simon Lovegrove
Tel: +44 20 7444 3110 / Email: simon.lovegrove@nortonrosefulbright.com
Simon Lovegrove is global head of financial services knowledge, innovation and products at Norton Rose Fulbright LLP. He specialises in knowledge management and financial services regulation. Simon has led a number of knowledge initiatives including designing a training programme for a regulator. He is also widely published in the financial services field. Since 2008 he has written the financial regulation update that appears in *Butterworth's Journal of International Banking and Financial Law*. He is the assistant editor of A Practitioner's Guide to MiFID II and co-authored the chapter on third country firms. He is also the co-editor of *A Practitioner's Guide to Individual Accountability*, and authored the chapters on non-executive directors and Branches of overseas banks. He is co-author of the UK chapter in GLI's *Blockchain & Cryptocurrency Regulation* 2019 (first edition). In 2018, he co-authored the chapter on bank recovery and resolution laws in Africa which appeared in the European Investment Bank report, *Banking in Africa: Delivering on Financial Inclusion, Support and Financial Stability.*

Alan Bainbridge
Tel: +44 20 7444 3279 / Email: alan.bainbridge@nortonrosefulbright.com
Alan Bainbridge is a corporate partner based in London. He focuses on strategic M&A and corporate advisory and has a particular focus on financial institutions. Alan regulatory advises on bank specific legislation and is co-author of the Banking Reform Act chapter of Thomson Reuters' *Compliance Officer* publication, which provides an in-depth analysis of the key areas of the Act.

Norton Rose Fulbright LLP

3 More London Riverside, London SE1 2AQ, United Kingdom
Tel: +44 20 7283 6000 / Fax: +44 20 7283 6500 / URL: www.nortonrosefulbright.com