

Banking regulation

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Introduction

1. This appendix provides background information on the regulation of banks in Northern Ireland. The paper does not cover ‘conduct of business’¹ regulation which is largely covered by the Banking Code (the Code) and described in Appendix 2.2.

¹The FSA’s Conduct of Business rules apply to investment business. In relation to deposit taking, the Conduct of Business rules only have limited application as deposit taking is subject to the Code which is a voluntary code devised by the industry to set standards of good banking practice.

Summary

2. Regulation has an impact on all banks' costs and ways of working. It also bears particularly strongly on barriers to entry. It appears that:

- There are high regulatory entry barriers for a company entering banking in the EEA for the first time.
- A bank operating in Great Britain will already have satisfied UK regulatory requirements and will face no further regulatory barriers to operating in Northern Ireland.
- Prudential regulatory requirements in other EU countries are generally very similar to UK requirements as they are all based on the same EC directives and regulations. Conduct of business requirements may differ in other EU countries as the Code is specific to the UK. (The Republic of Ireland does not, for example, have a banking code, although it has recently introduced standards for switching and a consumer protection code for buyers of financial products and services.)
- A bank operating in the Republic of Ireland or another EU or EEA country will already have been authorised and satisfied regulatory requirements in its home country. This will enable it to open a branch business in Northern Ireland on a passported basis (see paragraph 57). The bank does not have to be authorised by the FSA but is subject to its regulation in areas such as the rules applying to liquidity and money laundering.
- As regards banks based elsewhere in the world and not yet established in the EEA, in considering whether to authorize such a bank, the FSA seeks to apply its threshold conditions to the 'whole-bank' corporate entity, after taking account of supervisory work done by overseas regulators, where it has reasonable grounds to do so. The FSA considers that entry into the UK by banks in this category is unlikely.

Application of regulatory arrangements to banks operating in Northern Ireland

3. All the banks operating in Northern Ireland subscribe to the Code² and are subject to a range of FSA regulations including the FSA Handbook, the 'approved-persons' regime and money laundering regulations (see paragraphs 18 to 23). The other regulatory arrangements for the banks operating in Northern Ireland differ according to the home country of the group concerned (see paragraphs 54 to 62) and their corporate structure.

Banks with parent companies registered in the UK

4. Ulster Bank Ltd is a subsidiary of The Royal Bank of Scotland Group plc. Halifax plc is a subsidiary of HBOS plc. Alliance and Leicester plc is a UK-registered company. All these banks are thus UK-registered companies or UK-registered subsidiaries of UK-registered groups. They therefore need to be authorized as deposit takers by the FSA and are regulated by it.
5. The Nationwide Building Society is mutually-owned and registered in the UK under the Building Societies Act 1986. It is authorized as a deposit taker by the FSA and regulated by it in the same way as the banks. The FSA also enforces additional legal requirements under the Building Societies Act 1986.

Banks with parent companies registered in the Republic of Ireland

6. The Governor and Company of the Bank of Ireland (the BoI) is incorporated in the Republic of Ireland. Its prudential regulation is therefore the responsibility of the Irish Financial Services Regulatory Authority (the Irish Financial Regulator, see paragraph 65) as the consolidated supervisor.³ The retail banking businesses of the BoI in the UK are not separately incorporated; they are treated as branches operating in the

²The Post Office, which is not a bank and is not regulated by the FSA, is negotiating arrangements.

³That is the national banking supervisor in the group's home state (see paragraph 57).

UK. Under the EU passporting regime (see paragraph 57), they do not require any further authorization by the FSA.

7. First Trust Bank is a trading name of the UK-registered AIB (UK) plc, itself a subsidiary of Allied Irish Banks plc, which is registered in the Republic of Ireland. The Irish Financial Regulator is therefore the consolidated supervisor (see paragraph 57) responsible for the prudential regulation of the group, although the FSA has prudential responsibility for the liquidity of the UK registered subsidiary. As it has a UK-based subsidiary, Allied Irish Banks plc does not need to make use of EU passporting rights: AIB (UK) plc (and thus First Trust Bank) is authorized as a deposit taker in the UK by the FSA and subject to regulation by the FSA.

Banks with parent companies registered in other EU countries

8. Northern Bank Ltd (Northern) is a UK-registered subsidiary of the Danish-registered Danske Bank A/S (Danske). Therefore the Finanstilsynet (the Danish Financial Supervisory Authority) is its consolidated supervisor. Danske does not, however, make use of EU passporting rights: Northern is authorized as a deposit taker in the UK by the FSA and subject to regulation by the FSA.
9. Abbey National plc (Abbey) is a UK-registered subsidiary of the Spanish-registered Banco Santander Hispano Central SA (Santander). Its consolidated supervisor is therefore the Banco de España. Santander does not, however, make use of EU passporting rights for personal banking activities: Abbey is authorized as a deposit taker in the UK by the FSA and subject to regulation by the FSA.

Objectives of regulation and supervision

10. Banking is a heavily regulated activity and banks traditionally have close working relationships with regulators and governments. The main reason is the concern of

governments to maintain the stability of the financial system and to protect depositors from loss. Banks are potentially exposed to risks caused by their unusual capital structure compared with most other industries. Their equity bases are typically small in relation to customers' deposits and loans; debt capital is effectively provided by customers. Also banks' liabilities (eg deposits and borrowings) are more liquid than their assets (eg loans and investments). As a result they are potentially vulnerable to liquidity problems triggered by a loss of depositor confidence or the simultaneous failure of customers with a large amount of outstanding loans.

11. The four main categories of risk faced by banks can be described as follows:
- Operational risk: the potential, common to all businesses, for financial and reputational losses resulting from inadequate or failed internal processes, people and systems or from external events.
 - Liquidity risk: the potential for losses to arise from a failure to meet funding requirements, for example the replacement of existing funds when they mature or are withdrawn, and/or a failure to satisfy the demands of customers for additional borrowings.
 - Market risk: the potential for losses to arise from adverse movements in market prices in the money, foreign exchange, equity and commodity markets.
 - Credit risk: the risk that companies, financial institutions, individuals and other counterparties will be unable to meet their obligations to the bank.

The regulation of banking in the UK

12. The Financial Services and Markets Act 2000 (the FSMA) provided the FSA with its powers and established the overall regulatory framework for the financial services sector, including banking. A key provision of the FSMA is a general prohibition⁴

⁴Section 19 of the FSMA.

against any person carrying on a regulated activity in the UK unless they are either specifically authorized to carry it out or exempt. Regulated activities are defined in the FSMA and the Regulated Activities Order 2001.

13. Responsibilities for overall financial stability issues are divided between the FSA, the Bank of England (BoE) and the Treasury. These three bodies have adopted a memorandum of understanding setting out their respective responsibilities in the field of financial stability;⁵ a standing committee representing all three bodies meets frequently to coordinate the overall regulation of the financial system. The FSA also works closely with other bodies, such as the OFT, the Banking Code Standards Board and the Financial Ombudsman, in the delivery of its consumer protection, financial crime and public awareness statutory objectives.

14. The FSA is responsible for the authorization and prudential supervision of banks, building societies, investment firms, insurance and mortgage companies and brokers, credit unions and friendly societies and for the conduct of business aspects of banks' investment business.⁶ The BoE is responsible for the overall stability of the financial system (see paragraph 29).⁷ The Treasury has responsibility for the overall institutional structure of financial regulation and the legislation that governs it; it has no operational responsibility for the activities of the FSA or the BoE. The FSA and the BoE are, however, expected to alert the Treasury when a serious problem occurs that might, for example, cause wider financial and economic disruption or the need for a support operation. The OFT has responsibility for regulating lending to consumers (see paragraph 37). The roles of the Banking Code Standards Board and the Financial Ombudsman are discussed in Appendix 2.2.

⁵Memorandum of Understanding between HM Treasury, the Bank of England and the FSA, 1997, see www.bankofengland.co.uk/legislation/mou.pdf; updated in March 2006, and <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/025.shtml>

The Financial Services Authority

15. The FSA is the independent statutory body that regulates most aspects of the financial services industry in the UK. It has four statutory objectives, which are set out in sections 3 to 6 of the FSMA. They are:

- to maintain confidence in the financial system;
- to promote public understanding of the financial system;
- to secure the appropriate degree of protection for consumers; and
- to reduce the extent to which it is possible for a financial services business, whether carried on by a regulated person or in breach of the general prohibition, to be used for a purpose connected with financial crime.

Powers of the FSA

16. The FSA has been given a wide range of rule-making, investigatory and enforcement powers to discharge its functions. In using them, it has regard to the principles of good regulation set out in section 2 of the FSMA. These, for example, encourage the FSA to be efficient in the use of resources and proportionate in its dealings with firms and other regulated entities. The principles of good regulation also require the FSA to have regard to (a) the need to minimize any adverse effects on competition arising from regulation and (b) the desirability of facilitating competition and innovation. Finally, they recognize the international character of markets and the UK's competitive position.

17. Although the principles of good regulation are not absolute requirements, they guide the FSA's actions and encourage it to consider the impact of its rules on competition.

The FSA's main powers are to vary or cancel a permission to carry out an activity, to

⁶ The Bank of England Act 1998 transferred responsibility for the authorisation and supervision of banks within the UK from the BoE to the FSA.

⁷ Although the Memorandum of Understanding gives the BoE responsibility for overall financial stability, it does not provide it with any statutory objectives or regulatory powers.

set Individual Capital Ratios (ICRs, see paragraph 27) and to fine regulated companies. It has adopted a risk-based approach to regulation. The FSMA does not give the FSA any specific powers concerning competition issues or any responsibilities regarding the fees and prices charged by financial institutions.

18. The FSA sets out the rules that financial institutions must follow in its Handbook and in guidelines. The Handbook sets out rules relating to:
 - high level standards, covering principles for businesses (see paragraph 20), senior management arrangements, the responsibilities of senior management and statutory minimum threshold standards;
 - prudential standards, covering capital adequacy, liquidity risk and notification requirements;
 - business standards, covering the conduct of business, the handling of customer assets, market conduct, training and competence, and money laundering;
 - regulatory processes, covering authorizations, supervision, enforcement and decision-making; and
 - redress, covering complaints, dispute resolution and compensation.

19. These rules include conduct of business requirements for most financial activities, although such requirements have limited application to deposit taking, which is covered by voluntary regulation under the Code and supervised by the Banking Code Standards Board (see Appendix 2.2). The FSA is not, therefore, involved in the detailed regulation of the quality of service provided by banks' PCAs.

20. The Handbook's principles for businesses set out the fundamental obligations of regulated businesses, provide a basic yardstick for firms to order their behaviour by and provide a basis for supervisory and enforcement activity by the FSA itself. They provide that a firm must:

- conduct its business with integrity, due skill, care and diligence;
- take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems;
- maintain adequate financial resources;
- observe proper standards of market conduct;
- pay due regard to the interests of its customers and treat them fairly;
- pay due regard to the information needs of its customers, and communicate information to them in a way which is clear, fair and not misleading;
- manage conflicts of interest fairly, both between itself and its customers and between one customer and another;
- take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment;
- arrange adequate protection for customers' assets when it is responsible for them; and
- deal with its regulators in an open and co-operative way, and disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

21. All financial institutions authorized by the FSA must always meet its 'threshold conditions', which include FSA approval of the adequacy of financial resources, management⁸ and systems and controls.

22. The provision of Personal Current Accounts (PCAs) or savings accounts is a regulated activity.⁹ UK subsidiaries of UK banks are authorized by the FSA to carry out this activity; they must comply with all relevant FSA rules and obligations under

⁸Senior management arrangements, including individual senior management appointments must be approved by the FSA, which applies a 'fit and proper person' test.

⁹Banking in a wider sense is not a regulated activity but some of the businesses carried out by banks (such as accepting deposits) are regulated activities as detailed in The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

the FSMA and general laws. The FSA undertakes their prudential supervision. In relation to inward passported branches of an EEA bank providing PCAs, the EEA state in which the EEA bank's head office is located will generally be responsible for the authorization and prudential regulation of the branches, although certain of the FSA's rules, eg those applying to conduct of business matters and money laundering, will still apply to them.

23. The FSA has a 'treating customers fairly' initiative. This aims to deliver six improved outcomes for customers, namely that firms should: (a) make the fair treatment of customers a key part of their corporate culture; (b) market and sell products designed to meet customers' needs and target them appropriately; (c) give customers clear information and keep them suitably informed both before and after selling a product; (d) give suitable advice that takes account of customers' circumstances; (e) provide the product performance and acceptable service quality that customers have been led to expect; and (f) not impose unreasonable post-sale barriers to customers changing product, switching provider, submitting a claim or making a complaint.

Prudential requirements

24. The FSA sets the prudential requirements for UK banks. The purpose of the prudential standards applying to banks is to ensure that they maintain capital and other financial resources commensurate with their risks and appropriate systems and controls to enable them to manage those risks. The FSA requires in particular that banks maintain adequate capital against their risks.¹⁰

¹⁰FSA's *Interim Prudential Sourcebook: Banks*, January 2005, GN: Section 2 Page 1.

25. To determine the required level of capital the FSA uses a basic capital adequacy framework as set out in the Basel Capital Accord 1998 (Basel 1, see paragraph 44) and refined through subsequent developments, including EU initiatives.
26. The capital adequacy framework is a quantitative framework consisting of three main elements:
- (a) A definition of what characteristics an instrument should have to qualify as capital. Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument.¹¹
 - (i) Tier 1: the bank's core capital, consisting of ordinary shares, other permanent share capital and reserves.
 - (ii) Tier 2: supplementary long-term capital, such as subordinated long-term debt and cumulative preference shares.
 - (iii) Tier 3: short-term debt with a minimum maturity of two years.
 - (b) A risk-weighting framework that produces risk-weighted measures of the relevant risks captured by it. Using this framework, a bank may hold less capital backing for assets with lower risk weights than for assets with higher risk weights.
 - (c) A capital ratio. This is a ratio of total capital to risk-weighted assets; applying it to a bank's risk-weighted assets generates the level of capital that the bank should maintain, given its activities.¹²
27. The ICR is the minimum percentage of total risk-weighted assets that the firm must fund using tier 1 capital. Basel 1 requires that it is always set at not less than 8 per cent. In practice, the FSA tends to set higher ratios, depending on the risk profile of the bank concerned. The ICRs set for particular firms reflect operational risks in

¹¹Ibid, CO: Section 2 Page 1.

¹²Ibid CO: Section 2 Page 1.

addition to the nature, size and riskiness of the business conducted; they usually lie in a range from 8 to 12 per cent. In practice, banks normally choose to maintain levels of capital in excess of the minimum level set by the FSA as regulatory capital requirements are only one of several constraints on a bank's capital base. The level of capital held by a bank is also linked to the rating given to it by credit rating agencies. If a bank were to reduce its level of capital to the regulatory level, its credit rating might be downgraded. This would increase the cost of the bank's debt and put it at a competitive disadvantage. Reducing a bank's capital base to the regulatory level could also increase the level of risk measured in terms of its equity beta,¹³ which would in turn increase the bank's cost of capital and its required rate of return. Finally, a bank may wish to hold more than a minimum level of capital to ensure that strategic and business development objectives can be met.

28. All banks pay a levy to the Financial Services Compensation Scheme, which provides deposit protection for personal customers and small businesses. It covers 100 per cent of the first £2,000 and 90 per cent of the next £33,000 of a bank's total liability to a depositor, and nothing thereafter.

The Bank of England

29. The BoE's role in maintaining the overall stability of the financial system involves keeping a broad overview of the system as a whole; upholding the stability of the monetary system; promoting the efficiency and effectiveness of the financial sector; and undertaking official financial operations to limit the risk of particular institutions' problems affecting other parts of the system. It includes acting as the bankers' bank, developing and strengthening the infrastructure of the financial system and overseeing the operation of payments systems.

¹³The equity beta of a company's shares is a measure of their level of non-diversifiable risk relative to the risk of equities in general.

Oversight of payment systems

30. The BoE's main objective in overseeing payment systems (see Appendix 2.3) in the UK is to assess and, where necessary, mitigate systemic risks to the wider economy. The BoE also seeks to promote an efficient payment and settlement infrastructure when this does not conflict with its primary responsibility for systemic risk mitigation. It recognizes that payment systems which minimize systemic risks would be counterproductive if they were so expensive or impractical that payment traffic migrated to other, less safe, systems or jurisdictions.¹⁴
31. Payments system oversight focuses on any weaknesses in risk management that would have the greatest potential impact on the overall financial system. The BoE analyses the credit, liquidity, operational and legal risks inherent in the systems and assesses the system operators' management of those risks against international benchmarks set by the Bank for International Settlements.¹⁵
32. Most attention is given to the UK-wide wholesale payment systems,¹⁶ that is CHAPS¹⁷ Sterling and CHAPS Euro (the high-value real-time interbank payment systems) and the settlement systems for the securities and commodity markets. Of the UK retail banking payment systems, the BoE concentrates on BACS¹⁸ (which processes Direct Debits, Direct Credits and standing orders), the Cheque and Credit Clearing Co Ltd (which processes cheques and paper credits in Great Britain), LINK Interchange Network Ltd (the ATM network operator), and the debit and credit card payment systems. The BoE does not currently consider other UK payment systems to have sufficient impact on the economy to warrant formal oversight.

¹⁴For more detail see the Payment Systems Oversight Report at <http://www.bankofengland.co.uk/publications/psor/psor2005.pdf>.

¹⁵See *Core Principles for Systemically Important Payment Systems*, Bank for International Settlements.

¹⁶All these systems, other than the Cheque and Credit Clearing Co Ltd, process payments in both Northern Ireland and Great Britain, see Appendix 2.3.

¹⁷Clearing House Automated Payment System, see Appendix 2.3.

¹⁸Bankers Automated Clearing System, see Appendix 2.3.

33. In addition, the BoE oversees a number of core infrastructure suppliers to the payment systems. These include SWIFT¹⁹ and Voca Ltd, which provide support to CHAPS and BACS respectively, as well as the BoE's own banking services area, which operates the real-time settlement infrastructure at the heart of the CHAPS interbank arrangements.

The Cruickshank Report recommendations

34. In 2000, the Cruickshank Report (Cruickshank, see Appendix 2.3) made recommendations, among other things, for action concerning payment systems. The report found that they had 'profound competition problems and inefficiencies' and called for the establishment of a new payment systems regulator. Cruickshank thought that payment systems had failed to deliver price transparency, good governance, non-discriminatory access, efficient wholesale pricing, and innovation.

The OFT payments systems task force

35. The Chancellor of the Exchequer responded to the Cruickshank recommendations in his 2003 Pre-Budget Report. He asked the OFT to take an enhanced role on payment systems for a period of four years. In 2004 it established a payments systems task force (the Task Force) to identify, consider and resolve competition, efficiency and incentive issues relating to payment systems and particularly the network effects of the existing systems (see Appendix 2.3). The Task Force includes representatives from consumer and business associations, as well as representatives of the UK payment systems and an observer from the BoE. The Task Force is examining a range of issues, including the governance of payment systems, the level of innovation and the criteria for access to these systems. It is also examining possible improvements to the payment systems that might both reduce

¹⁹Society for Worldwide Interbank Financial Telecommunications SCRL, see Appendix 2.3.

risks and bring efficiency benefits for consumers and the financial sector (see Appendix 2.3).

36. The first major initiative resulting from the work of the Task Force was an agreement to speed up clearing times for electronic payments made through BACS (see Appendix 2.3). In November 2005, the Task Force announced the establishment of a working group to examine issues relating to cheque clearance (see Appendix 2.3).

Consumer credit

37. The Consumer Credit Act 1974²⁰ (the 1974 CCA) requires most businesses that offer goods or services on credit or lend money to consumers to be licensed by the OFT. It applies to overdraft lending, personal loans, credit cards and mortgages secured by a second charge but not to mortgages secured by a first charge, which are subject to regulation by the FSA. The 1974 CCA only covers loans not exceeding £25,000. Licensees must satisfy the OFT that they are fit to carry out the type of business in question. The 1974 CCA sets out detailed rules covering (among other things) the form and content of agreements; the advertising of credit; the method of calculating the annual percentage rate (APR) of interest charged; procedures to be adopted in the event of default, termination or early settlement; extortionate credit agreements; and individuals' rights of access to credit reference files. The 1974 CCA is augmented by numerous regulations, orders and notices.
38. Consumer rights granted by the 1974 CCA include a 'cooling-off' period within which a consumer can cancel a credit agreement and the right to ask a court to examine whether a credit agreement is 'extortionate'.²¹ If it concludes that the agreement is extortionate, the court may alter its terms or require the creditor to repay sums

²⁰Although the 1974 CCA and the 2006 CCA apply to the whole UK, certain special provisions apply in Northern Ireland. These do not affect the substance of the statutory regime.

already paid by the debtor. The 1974 CCA has been criticized for providing insufficient protection to consumers and failing to provide sufficient powers for regulators to tackle unfair conduct by lenders.

39. The Government also introduced secondary legislation to make the APR the prime comparator in advertising consumer credit and requiring lenders to provide clear pre-contractual information about costs and key terms of loans.

40. In 2004, the DTI made regulations under the 1974 CCA that introduced major changes in consumer credit law. They provide for rules on: (a) advertising consumer credit products; (b) requirements for pre-contract disclosure to consumers; (c) the form and content of agreements; and (d) early settlement. The first set of regulations covers the information an advertisement must contain and how that information is presented. The aim is to ensure that consumers are given sufficient, fair information about the nature and cost of credit to enable them to compare different products and choose the ones that are best for them. The second set of regulations specifies that information provided to customers should be: easily legible; not interspersed with other information; presented with equal prominence; contained in a separate document from the contract concerned, headed 'pre-contract information'; and capable of being taken away by the consumer to read. The third set of regulations provides that contracts have to be divided into three main sections: key financial information; other financial information; and key information. Specified information has to be included in each section including certain warnings to consumers. The fourth set of regulations entitles the debtor making an early repayment to a rebate and incorporates an actuarial formula to be used in calculating the minimum rebate.

²¹Under the 1974 CCA, a credit agreement is extortionate if it grossly contravenes ordinary principles of fair trading or requires the debtor to make grossly exorbitant payments.

41. Following a three-year review of consumer credit laws, the Consumer Credit Act 2006 (the 2006 CCA) was enacted in March 2006. The 2006 CCA amends and updates the 1974 CCA to enhance consumer rights. It enables consumers to challenge unfair credit agreements in court and replaces the 'extortionate credit' provisions of the 1974 CCA with a new and more extensive 'unfair credit relationship' test, concerned not only with the cost of credit but with anything relating to the agreement itself, the way it is sold and any other aspects that a court considers to be unfair. The 2006 CCA entitles consumers to receive more information about the state of their accounts to help them identify problems earlier. It also entitles consumers to take complaints about lenders to a dispute resolution scheme run by the Financial Ombudsman Service and seeks to strengthen the credit licensing system with enhanced and new powers to address problem traders and practices. The £25,000 limit on the agreements covered is removed (see paragraph 37) but wealthy individuals meeting certain criteria are able to opt out of the provisions of the 2006 CCA. A more robust and flexible licensing system for lenders has been introduced; this provides for indefinite licences that do not need to be renewed and are targeted at particular areas of business. In addition, it gives the OFT more effective powers to tackle issues with lenders quickly and in proportion to the scale of the problem. The 2006 CCA has also introduced a reformed appeals system whereby lenders may challenge decisions of the OFT. The main provisions of the 2006 CCA are expected to be brought into force in two phases in April 2007 and April 2008.

Unfair contract terms

42. Under the Unfair Terms in Consumer Contracts Regulations 1999 (the UTCCRs), the FSA and the OFT have powers to challenge firms that are using unfair terms in standardised consumer contracts. A concordat between the two regulators provides that the OFT will consider the fairness within the meaning of the UTCCRs of standard terms in financial services contracts for activities that are governed by the Consumer

Credit Acts, including personal loans. In September 2006, the OFT announced that it was to going to examine whether the level of PCA overdraft default charges throughout the UK was fair.

International regulation

43. The activities of national banking regulators are coordinated by the Basel Committee on Banking Supervision (the Basel Committee) which includes representatives from central banks and financial regulators in the 13 major banking countries and has a secretariat provided by the Bank for International Settlements. The Basel Committee does not have any formal supranational supervisory authority; rather it formulates broad standards and guidelines (set out in 25 core principles for effective banking supervision²²) for the convergence of regulatory approaches in the expectation that national authorities will implement them.

The Basel Accord

44. The Basel Committee established international standards for capital adequacy in the Basel Accord of 1988 (Basel 1). This had the aim of promoting the soundness of international banking system by providing a common framework of capital standards for banks conducting international business. This framework was translated into EU law through a series of EC Directives.
45. Basel 1 provided for a single, clear capital standard based on a simple credit risk measurement system with a minimum capital standard of 8 per cent (see paragraph 27). All assets exposing a bank to credit risk are assigned a broad-brush risk weight according to the overall level of risk of the asset type. The risk-weighting approach

²²See: <http://www.bis.org/publ/bcbs123.htm>.

was intended to ensure that, within very broad parameters, capital requirements are matched to risk.

Basel 2

46. The introduction of the Basel 1 was followed by a period of strong growth in international banking. This was accompanied by product innovation in areas such as derivatives, which increased the complexity of financial markets, creating new types of risk. Increasing scale and complexity exposed weaknesses in the simple approach to risk assessment in Basel 1. As a result national financial regulators responded by adding their own national rules to the basic framework. It was generally recognized that the Basel 1 risk weights only provided a crude measure of economic risk, that banks had subsequently developed improved methods of risk measurement and that there was a need to modernize the accord.

47. Negotiations to produce a revised Basel Accord took several years and led to a new framework for the international convergence of capital measurement and capital adequacy standards (Basel 2) which was issued in June 2004. This is in the process of being adopted by the EU and national regulatory authorities and will come into operation in the UK from 1 January 2007. The overall effect of the changes is expected to be that banks (a) will need to hold less capital to support good-quality corporate lending, residential mortgages and retail lending to personal customers and small and medium-sized enterprises but (b) will need to hold more capital in support of certain types of specialized and poorer-quality corporate lending.

48. The scale of the work required to implement the Basel 2 rules, both from banks and regulators, is very substantial. There are three complementary elements to Basel 2, referred to as its 'three pillars'.

Pillar 1

49. Pillar 1 refines the rule-based minimum capital requirements set out in Basel 1. The objectives are to establish requirements that are more sensitive to the risk levels of particular exposures and to add an explicit charge to cover operational risks. It is intended that the new framework should broadly maintain the existing overall level of capital in the banking system but reallocate it to relate more closely to a bank's own measures of its exposure to credit and operational risks. The Basel 2 framework encourages banks to upgrade their measures of credit and operational risks by providing incentives in the form of lower capital requirements for banks that adopt more comprehensive and accurate measures of risks.²³ Two types of approach are allowed.

Standardized approach

50. The standardized approach to credit risk is a development of the Basel 1 methodology (based on risk weightings for broad categories of counterparties), but adopts more granular risk weightings for different categories. These risk weights are either set by regulators or, for corporate exposures, set with reference to the published credit rating of a counterparty.

Internal ratings based approach

51. Alternatively, financial institutions with well-developed risk management systems are encouraged by their supervisors to select an 'internal ratings based' (IRB) approach to credit risk. Under an IRB approach, banks rely partly on their own measures of each borrower's credit risk to determine their capital requirements; this is subject to strict data, validation and operations requirements. The FSA told us that most major banking groups intended to adopt an IRB approach.

²³See Bank for International Settlements: <http://www.bis.org/press/p040626.htm>.

Pillar 2

52. Under Pillar 2 banks are required to make their own assessment of the credit risks they face and assess whether the capital they hold is adequate to cover these risks. This would include considering the extent to which capital should be held for risks that are not fully captured, or not captured at all, under Pillar 1. Pillar 2 then requires supervisors to review the each bank's assessment and to identify whether any remedial action is required.

Pillar 3

53. Pillar 3 sets out increased disclosure requirements to help investors understand the banks' risk management techniques and thus enhance market discipline on banks as a complement to regulatory supervision.

European Union

54. The EU has adopted a number of directives to harmonize the regulation of the banking industry. These incorporated the Basel 1 (and subsequently Basel 2) into EU law, applying them to all credit institutions (rather than just those involved in international banking business, see paragraph 44) and govern other aspects of banking.
55. The main principles underlying movement towards an EU single market in banking are:
- the harmonization of member states' laws and practices governing: access to banking activity; the capital required to cover credit and market risks; the limitation of large exposures to a single borrower or a single group of associated clients; and the form and content of, and valuation rules used in, the annual and consolidated accounts published by banks;

- home-country control of banking groups, reinforced through cooperation between national supervisory authorities to enable a bank operating in other member states to be licensed and supervised by the authorities in the country in which its registered office is located; and
- mutual recognition by the national supervisory authorities of the rules and regulations in the countries of origin of the EEA banks operating on their territory.

56. The Second Banking Co-ordination Directive (SBCD), which came into force in 1993, established the principle that a single licence should allow banks and other credit institutions to set up branches and offer services throughout the EU. It contained a list of banking services that can be provided in all the member states on the basis of such a licence. The SBCD required banks to have a minimum level of capital in line with Basel 1, and it laid down rules covering, for example, qualifying holdings, sound administrative and accounting procedures, and adequate internal controls. The SBCD was superseded by the 2000 Banking Consolidation Directive which brought together all the relevant Directives, including the Capital Adequacy Directive.

57. The regulation of a banking group's activities in other countries partly depends on the bank's structure. Where a bank operates branches in another country without establishing a separate trading subsidiary in that country, prudential regulation of its activities there is entirely the responsibility of the home state banking supervisor.²⁴ If, on the other hand, the bank sets up a subsidiary in another country, the home state banking supervisor remains the overall supervisor of the group (referred to as the consolidated supervisor) but the local national banking supervisor will also have a role in the regulation of the subsidiary in such areas as liquidity, money laundering measures and conduct of business rules.

²⁴The necessary regulatory authorizations are said to be passported.

58. The granting of licences for subsidiaries of banks with registered offices outside the EU is, in principle, governed by the same rules, subject to any international agreements entered into by the EU. Once authorized, a subsidiary of a bank with its registered office in a third country enjoys the same rights as EU-based banks.

59. The EU regulatory framework for financial services is being overhauled to provide further harmonization of regulation in member states. A framework of measures was set out in the EU Financial Services Action Plan (FSAP), which was endorsed in March 2000. These measures were intended to fill gaps in regulation and remove the barriers to the integration of EU financial markets by 2005.

60. The FSAP consisted of 42 measures intended to establish a single market in wholesale financial services; make retail markets open and secure; and strengthen the rules on prudential supervision. The legislative phase of the FSAP is now almost complete. Some FSAP measures take the form of EC regulations, which apply directly in all member states, whilst others take the form of EC directives, which have to be transposed into the law of each member state. A key objective was to strengthen the ability of financial institutions to offer their services throughout the EU. Nonetheless a number of administrative and legal obstacles still hamper the provision of retail banking services on a cross-border basis. These include the absence of EU-wide (or even eurozone-wide) banking clearing systems (see Appendix 2.3).

61. The EC Capital Requirements Directive, which was adopted in June 2006, will implement Basel 2 into EU law and is expected to be implemented in the UK at the beginning of 2007.²⁵

62. The European Commission is currently carrying out a sector inquiry into the markets for payment cards and for core retail banking services. In July 2006, it published an interim report on core retail banking, including PCAs, that identified areas where the European Commission considered that markets were not working as well as they should. The report contained evidence of markets fragmented on national lines, fragmented clearing systems, low customer mobility and widely varying charges and profitability across the EU. The European Commission is consulting on its preliminary findings and intends to publish its final report by the end of 2006.

63. The EU has also adopted rules concerning such matters as the monitoring of market risks, money laundering and deposit-guarantee schemes. The Third Money Laundering Directive (the TMLD) was adopted in October 2005 and is expected to be implemented into UK law by December 2007. It updates European legislation in line with international recommendations on money laundering and counter terrorist financing measures. In doing this the TMLD takes account of new risks including terrorist financing and sectors vulnerable to money laundering or corruption.

Regulation in other EU countries

64. As banking regulation in all EU countries is based on the same EC directives, the national requirements in each country are broadly similar to those in the UK. In addition, all EU national regulators follow the 25 Basel Core Principles (see paragraph 43) in the supervision of banking organizations within their jurisdiction.

²⁵See: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#directive.

The ability to passport an authorization into the UK means that regulatory barriers to entry are low for banks already authorized in another EU country.

65. In the Republic of Ireland, for example, banks are regulated by the Irish Financial Regulator, which derives its supervisory and regulatory powers from the Central Bank and Financial Services Authority of Ireland Act 2003 and the Central Bank and Financial Services Authority of Ireland Act 2004. Prudential requirements are broadly similar to those in the UK. Conduct of business is, however, subject to the Irish Financial Regulator's codes of conduct and practice in contrast to the UK system of voluntary regulation under the Code and the Banking Code Standards Board. The Irish Financial Regulator's Consumer Director is responsible for monitoring the provision of financial services to consumers and protecting the interests of consumers of those services. There is a statutory Financial Services Ombudsman to deal with complaints against financial institutions. Although the institutional arrangements differ from those in the UK, most of the significant powers applied have a broadly similar effect. There are, however, some aspects of Irish regulation that differ from UK requirements. The most significant of these is the regulation of banking fees and charges.²⁶

Authorization of banks from outside the EEA

66. Where a bank operating elsewhere in the world (but not yet established in the EEA) wants to establish a branch business in the UK, the FSA has to consider whether the branch should be authorized. The FSA will then seek to apply its threshold conditions (see paragraph 18) to the bank's operations as a whole. In doing so, it will take account of supervisory work done by overseas regulators. However, the FSA only

²⁶The regulation of fees and charges may, however, be removed in line with the recommendations of a recent market investigation by the Irish Competition Authority (see: <http://82.195.149.137/templates/index.aspx?pageid=936>).

relies on the work of other regulators where it is satisfied that it has reasonable grounds to do so.

Other areas of government intervention

67. The UK Government requires cooperation from banks in a number of other areas. The most important of these concern money laundering, recovering the proceeds of crime, suspicious activity reporting, anti-terrorism measures and business continuity planning. Measures to help detect money laundering are coordinated by the Treasury Money Laundering Advisory Committee and the Joint Money Laundering Steering Group, both of which include representatives from the FSA and the banks. Work on business continuity planning has led to joint action by the Treasury, the BoE and the FSA to increase the resilience of the banking sector in response to major disruptions.

Banking Code

68. The Code (which is discussed in detail in Appendix 2.2) provides voluntary regulation of the conduct of business by deposit takers. Although the FSA has powers under the FSMA to write conduct of business rules for deposit taking, it does not use these as it considers that the present arrangements are working well.