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Banking Services: reform and issues

By Timothy Edmonds

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Summary

Ever since the financial crisis of 2008 there has been a seemingly endless stream of new laws, directives, recommendations, Boards, Councils and bodies established to either change the previous system of regulation or to implement it and take it forward. This note brings together the main legislation, bodies and documents to emerge from the five years of the Coalition Government as it affects (mainly) the banking industry. It is not in any way inclusive and has a bias towards the consumer or retail side of bank activity rather than investment banking.

Three new Acts have established the broad framework of a new regulatory system which directs the banks' structure, conduct, or in the event of their failure, how they are dealt with.

Financial Services Act 2010: gave the predecessor body to the Financial Conduct Authority (the Financial Services Authority) a new objective of financial stability. It paved the way for later regulations on the disclosure of the remuneration of higher paid executives in banks and for the so called 'living wills' which banks have had to draw up.

Financial Services Act 2012: created the three new regulatory bodies: the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA), which sit within the Bank of England, and the Financial Conduct Authority (FCA), which assumed most of the functions of the Financial Services Authority. It also clarified the role of the Chancellor during a financial crisis.

Financial Services (Banking Reform) Act 2013: established the framework of the ring-fencing system – the separation of investment banking from retail banking. It also established new rules and responsibilities for senior managers and set up a new Regulator for payment systems.

To these has recently been added the

Bank of England and Financial Services Act 2016: which **although it** was more concerned with reorganisation of the Bank and oversight of it, than the system it was responsible for, it did make changes to the regulation of financial services. In particular it extended the Senior Managers and Certification Regime to all financial service providers.

Domestic legislation has been reflected at the EU level with a mass of directives and regulations on a wide range of issues. In addition there was the creation of the EU Banking Union, designed to support the financial institutions of the euro zone, of which the two large building blocks are a common supervision system and resolution mechanism.

Work within the financial community continues across a broad spread of initiatives, including controls on bank employee remuneration; the taxation of banks; the design of ring-fenced activities and the extension of personal responsibility to senior post holders. At the international level, the Financial Stability Board amongst others is looking hard at subjects such as the regulation of shadow banking.

A recurring theme of the last seven years has been the sheer volume of material – consultations, discussion documents, proposals and legislation, produced across the broad landscape of financial services. Readers may like to look at the House of Lords European Union Committee Report *The post-crisis EU financial regulatory framework: do the pieces fit?*, for answers to the biggest question of all.

This Paper outlines the main legislation and the roles of the new regulators.

1. Introduction

When the Conservative – Liberal Democrat Coalition Government took office in May 2010 the main challenge facing the new Government was to tackle the public finances. Not far behind was the need to continue the programme of reform of financial regulation begun by the last Labour Government. Chapter 1 of the Coalition's *Programme for Government* was headed 'Banking' and included the following general proposal:

> In recent years, we have seen a massive financial meltdown due to over-lending, over-borrowing and poor regulation. The Government believes that the current system of financial regulation is fundamentally flawed and needs to be replaced with a framework that promotes responsible and sustainable banking, where regulators have greater powers to curb unsustainable lending practices and we take action to promote more competition in the banking sector. In addition, we recognise that much more needs to be done to protect taxpayers from financial malpractice and to help the public manage their own debts.[1]

This has been a multi-level task. The UK could not operate in a vacuum but had to co-operate within an international framework. Where it took unilateral action it kept one eye on the rear view mirror, watching EU proposals develop in the wake of UK decisions on the same topics. Not everything done was sourced from government; it was often reliant on the work of non-governmental bodies, of which the Parliamentary Commission on Banking Standards was the most obvious.

This note outlines:

- the main pieces of legislation passed or over the past five years (both by Parliament and by regulators);
- the reorganisation of the regulatory system that has come about as a result; and
- current, ongoing or new issues.

The focus is primarily on banks and banking but other changes, e.g. to consumer credit, are also included.

1 *The Coalition: our programme for government*, May 2010

2. Legislation

2.1 UK legislation

Primary financial services legislation[2] passed since 2010 includes;

Financial Services Act 2010[3]

Financial Services Act 2012

Financial Services (Banking Reform) Act 2013

Bank of England and Financial Services Act 2016

Financial Services Act 2010

Library Papers on the Bill can be found here and, for the committee stage here. Note, the Bill was passed in truncated form in order to meet the deadline of the dissolution of Parliament for the 2010 General Election, hence the Papers also include descriptions of parts of the Bill which were not passed.

The main features of the Act are shown below:

- The Act gave the predecessor body to the Financial Conduct Authority (the Financial Services Authority) a new objective of financial stability.[4] This has carried over to the FCA.
- It paved the way for later regulations on the disclosure of the remuneration of higher paid executives in banks.
- It paved the way for the Regulator to draw up recovery and resolution plans by banks – the so called 'living wills'.
- It paved the way for the Regulator to make rules about 'short selling'.
- It gave the Regulator more flexible and extensive disciplinary powers.

Financial Services Act 2012

Library Papers on the Bill can be found here and, for the committee stage here.

The main features of the Act are shown below:

- It created the three new regulatory bodies: the Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA), which sits within the Bank of England, and the separate Financial Conduct Authority (FCA), which assumed most of the functions of the Financial Services Authority;

[2] References to legislation to do with, for example, the mutual sector or co-operatives is excluded from this list but does include banks and consumer credit legislation

[3] This Act was passed by the previous Labour administration just before the 2010 General Election and is shown here for completeness only. Those parts of the original Bill that were dropped to meet the Election timetable found their way into subsequent legislation.

[4] Unless otherwise stated this Paper will refer to the two bodies interchangeably as the Regulator.

- The FPC is responsible for monitoring and responding to emerging systemic risks, while the PRA will oversee micro-prudential regulation of systemically important firms. The FCA will regulate conduct of financial services firms;
- The Act gave clearer pre-eminence to the Chancellor during a financial crisis;
- Responsibility for regulation of consumer credit was transferred from the Office of Fair Trading to the FCA;
- The Bill changed the term of the Governor of the Bank of England from two five-year terms to a single eight-year term
- It brought 'benchmark activities' within the scope of regulation by the FCA.

Financial Services (Banking Reform) Act 2013

For convenience this legislation is normally referred to as the *Banking Reform Act*.

Library Papers on it can be found here and, for the committee stage here.

This Act had a 'collective' parentage. It started life as the recommendations of the Independent Commission on Banking (the Vickers Report - see below), which was considered and largely accepted by government. A draft Bill based on Vickers was then consulted on in more depth than perhaps any Bill has been before; the consultation was followed by the deliberations and recommendations of the Parliamentary Commission on Banking Standards. Its recommendations were also largely accepted by government before they appeared in a revised Bill and thus became incorporated into the 2013 Act.

The main features of the Act are shown below:

- Established the framework of the ring-fencing system – the separation of investment banking from retail banking.
- Established new rules and responsibilities for senior managers.
- Set up a new Regulator for payment systems.
- Set up new insolvency procedures for companies involved in the provision of banking infrastructure services.
- Gave the Prudential Regulatory Authority new competition responsibilities and objectives.

Bank of England and Financial Services Act 2016

Although a large part of this legislation was more concerned with reorganisation of aspects of the Bank and oversight of it, it did make changes to the regulation of financial services and to the regulators too. Particularly:

- The Senior Managers and Certification Regime is extended to all financial service providers.

- The 'reverse burden of proof' which applied to the more restricted Senior Managers Regime is itself to be reversed. Hence, now the regulator will be required to prove the misconduct.
- Future appointments of the FCA Chief Executive will be required to attend a pre-commencement hearing by the Treasury Committee.

The Library Paper on the Bill can be found here. The pre-commencement measure was introduced as a late amendment to the Bill on Report here.

2.2 EU directives

EU directives on financial services (most of which have been updates on previous directives) which either began or were completed within the 2010 – 2015 period include:

Capital Requirements Directive IV and Capital Requirements Regulation

Markets in Financial Instruments Directive (MiFID2)

Market Abuse Directive

Bank Recovery and Resolution of Banks Directive

Also relevant is the creation of the EU Banking Union designed to support the financial institutions of the euro zone, of which the two large building blocks are the Single Supervision Mechanism and the Single Resolution Mechanism.

Regulations on Short Selling & Credit Default Swaps

Supervision of financial conglomerates directive

There are many more directives and measures, especially in the insurance sector, and more in progress. Still to come are directives on:

Shadow banking

Structural Reform of Banks

Regulation of Financial Benchmarks

2.3 Major Reports and consultations

Since the 2010 General Election there have been a large number of Reports and consultations, many of which, one way or another, fed into the legislation cited above. A selection is shown below, broadly in chronological order.

Pre Vickers

The Treasury Select Committee published *Financial Regulation: a preliminary consideration of the Government's proposals* in February 2011. This covered both supervisory structure and regulatory issues. One of its key concerns was that the timetable for introducing the new rules was too rushed.[5]

5 *Financial Regulation: a preliminary consideration of the Government's proposals*, HC 430-2010-12, Summary

It recommended that the Government delay introducing firm proposals until the Vickers Commission, or Independent Commission on Banking, had reported in the summer 2011. The Government ignored this recommendation and published its White Paper *A new approach to financial regulation: blueprint for reform* in June 2011. The draft (of the 2012 Act) Bill which the Government produced was considered in a Joint Committee. Oral and written evidence to the Joint Committee can be found here. Its final report can be found here.[6]

Independent Commission on Banking

Also known as the (Vickers Commission.) *Final Report: recommendations*, was published in September 2011. The most fundamental finding was the recommendation to ring-fence banks' activities. The Commission's conclusions are summarised in the Overview of this long Report here.

Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards (PCBS) was set up initially in response to the discovery of the manipulation of the LIBOR interest rate benchmark and other rates. The PCBS's first report was published on 21 December 2012.[7] Although it has a wide remit, the Report focused almost entirely on the issue of the structural separation of the activities of banks as proposed by the Vickers Commission. In particular, it looked at the proposals as contained in the draft 2013 Banking Reform Bill.

The full final Report of the Commission is *Changing Banking for Good* which was published in June 2013. The summary volume (vol I) published at the same time can be found here.[8] References to the other Reports published by the Commission can be found here.

The Government's response to the Commission's final report was published in July 2013: *The government's response to the Parliamentary Commission on Banking Standards*.[9]

The Government produced a number of documents prior to the publication of the draft 2013 *Banking Reform Bill*. In date order they are:

Banking reform: delivering stability & supporting a sustainable economy.[10]

This set out the broad platform for the Coalition Government's plans to implement the Vickers Commission recommendations under three main headings, ring fencing, loss absorbency and competition Sound banking: delivering reform.[11]

6 *Joint Committee on the draft Financial Services Bill*, HC 236 2010-12
7 Parliamentary Commission on Banking Standards; *First Report*, HC 848, HL 98 2012/13
8 Parliamentary Commission on Banking Standards; changing banking for good; HL 27 vol I-VIII
9 HM Treasury; *The government's response to the Parliamentary Commission on Banking Standards*; Cm 8661
10 June 2012, Cm 8356
11 October 2012, Cm 8453

This was both a response to the Consultation paper above and a further consultation in its own right, as it included a draft (*Banking Reform*) Bill [Banking reform: a new structure for stability and growth](). [12]

This included the Government's response to the first report of the PCBS and consequent changes to the draft Bill.

Fair and Effective Markets Review

The Fair and Effective Markets Review was a major review into how financial markets worked. This Report was published by the Bank of England in June 2015 in response to scandals involving various benchmark and trading activities in the London markets. It recommended further tightening of the rules surrounding personal accountability; better mechanisms for agreeing, promulgating and adhering to common standards of market practice; extensions to the coverage of regulation; and work to raise standards in other global markets to avoid regulatory arbitrage, e.g. in the spot foreign exchange market.

Specific recommendations are shown below.

Personal accountability

A common set of standards for trading practices in trading markets – potentially applied globally. New minimum standards of training and professionalism. The Review recommends consideration of an extension of the Senior Managers regime to FICC (wholesale) markets.

Enforcement

Criminal sanctions exist for market abuse. This framework should be extended to include a wider range of markets and activities. The maximum sentence for market abuse should be extended from seven to 10 years imprisonment, aligning it with the offences of fraud and bribery.

Market standards

Firms would be required to develop market standards to deal with the practical aspects of market trading such as how to deal with conflicts of interest and issues over the timing of transactions. The Review calls for the creation of a Financial Market Standards Board.

Specifically the Review suggested:

- setting minimum professional standards and a requirement for continuing professional development;
- that existing criminal sanctions for market abuse be extended to a wider range of financial instruments;
- that the maximum sentence for criminal market abuse be increased from seven to 10 years. [13]

12 February 2013, Cm 8545
13 Bank of England; *Fair and Effective Markets Review*, June 2015

3. Activity by the Regulators

This section lists some of the initial actions undertaken by the newly created regulators, most of whom officially took over some years after the 2010 Election, and references to key documents. The focus is once more on banks, hence activities in connection with insurers are largely excluded.

Financial Stability Board

The ultimate source of much of the past and future regulatory initiatives is the body at the top of the financial regulatory 'tree', namely the **Financial Stability Board** (FSB). The FSB is an international body, set up in 2009 of the G20 Summit. The Chairman is the Governor of the Bank of England Mark Carney. The work of identifying risks and framing policy initiatives which are then effected by subsidiary bodies or governments is taken on by a series of subsidiary committees:

- The Standing Committee on Assessment of Vulnerabilities (SCAV), which is the FSB's main mechanism for identifying and assessing risks
- The Standing Committee on Supervisory and Regulatory Cooperation (SRC), which is charged with undertaking further supervisory analysis or framing a regulatory or supervisory policy response to a material vulnerability identified by SCAV.
- The Standing Committee on Standards Implementation (SCSI), which is responsible for monitoring the implementation of agreed FSB policy initiatives and international standards.[14]

Activity and future work of the FSB can be found in its Annual Report. The latest, published in July 2016, can be found here. The FSB is not a regulator as such, because it can only make recommendations, however, its proposals form the starting point for much of the regulatory work carried out since 2009.

Financial Policy Committee

The focus of much of the FPC's work has been:

Generalised institutional capital and institutional leverage ratio requirements.

In addition to the general capital reserve requirements (see below), the FPC has the power to direct other regulators to adjust capital reserve

[14] Financial Stability Board website

requirements if it sees a macroeconomic danger to stability. It also has responsibility for setting the 'countercyclical capital buffer'. These powers form the mainstay of the 'macro-prudential controls' that have been given to the Bank of England bodies post financial crisis. Information on these can be found in: *The Financial Policy Committee's powers to supplement capital* requirements published in January 2014

The leverage ratio is a simple measure of a firm's solvency. It is a firm's capital divided by its exposure (lending) which avoids the complexities inherent in risk-weighted calculations. The broad aspects of the leverage regime can be found in: *The Financial Policy Committee's powers over leverage ratio tools* published in February 2015.

Housing market controls

Housing market controls such as directions on loan-to-value ratios and debt-to-income ratios for buy to let lending. The broad outlines of policy can be found in a draft policy statement: *The Financial Policy Committee's powers over housing tools,* published in February 2015.

Prudential Regulation Authority (PRA)

The first job of the PRA, as one of the new organisations, was to start work and establish itself within the Bank of England. A good guide to its early work can be found in its 2013/14 Annual Report.

The work of the PRA is to meet its statutory objectives, two primary and one secondary:

- a general objective to promote the safety and soundness of the firms it regulates;
- an objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders; and
- a secondary competition objective.

As well as the enforcement of the threshold conditions for authorisation which apply to all of its 1,700 firms and groups, specific work streams include:

- setting capital adequacy targets and implementing CRD IV which is the EU Directive which sets common minimum capital standards;
- establishment of a new liquidity regime which embeds the EU-wide Liquidity Coverage Ratio;
- instituting regular firm-specific and sector-wide stress test exercises for deposit takers; and
- engagement with domestic and international regulators

The ongoing work is the continuous assessment of the very largest firms which the PRA believes pose the greatest risk to the stability of the financial system. Each firm has its own dedicated team of supervisors which presents an annual 'stock take' (Periodic Summary Meeting) to the firm's Board. A publication in June 2014 sets out its general approach: *The PRA's approach to banking supervision.*

Part of the CRD IV work of public interest has been its rules regarding bank remuneration, which have been significantly different from UK rules. A joint PRA and Financial Conduct Authority publication was published in July 2014: *Strengthening the alignment of risk and reward: new remuneration rules* sets out the main issues.

Current policy work streams include the implementation of the new Senior Manager and Certification Regimes (introduced by the 2016 Banking Act) which are designed to increase personal directorial and managerial accountability for the actions of financial institutions and the structural reforms to banking known as 'ring fencing'.

Senior Manager and Certification Regimes

From 7 March 2016, the Senior Insurance managers Regime and Senior Insurance Managers Regime introduced:

- A new 'Senior Managers Regime' (SMR) and 'Senior Insurance Managers Regime' (SIMR) for individuals who are subject to regulatory approval, which will require firms to allocate a range of responsibilities to these individuals and to regularly assess their fitness and propriety.
- A 'Certification Regime' (CR) for banking firms which will require relevant firms to assess the fitness and propriety of certain employees who could pose a risk of significant harm to the firm or any of its customers.
- A new set of 'Conduct Rules' applying to banking and Solvency II firms that includes the responsibility of senior managers for oversight of any delegated activities.

More information about the ongoing development of policy in this area can be found on the PRA website here, including a speech by the then head of the PRA, Andrew Bailey, on 'culture in financial Services'.

By virtue of the *Bank of England Act 2016* (see above) the constitution of the PRA changed. It is no longer a subsidiary of the Bank, it is now, formally, a committee of the Bank.

Ring Fencing

One response to the financial crisis has been to force banks to split their normal retail (core) activities from more investment banking activity. In the UK, the PRA is required to make rules to implement the ring-fencing of core UK financial services and facilities.

The changes are intended to ensure that ring-fenced bodies (RFBs) are protected from shocks that originate in the rest of their banking group or the financial system in order to minimise disruption to the continuity of the provision of core services. They are also intended to ensure that RFBs, and groups containing RFBs, can be resolved in an orderly manner with minimal disruption to the provision of core services. *The Financial Services (Banking Reform) Act 2013* Act defines three 'core services':

i. facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits;

ii. facilities for withdrawing money or making payments from such an account; and

iii. overdraft facilities in connection with such an account.

The Government has stated its intention for ring-fencing to be implemented from 1 January 2019. The PRA is currently consulting and developing outline plans for the implementation. It published near-final plans on 7 July 2016. More information about the implementation of ring fencing (updated regularly) can be found on the PRA website here.

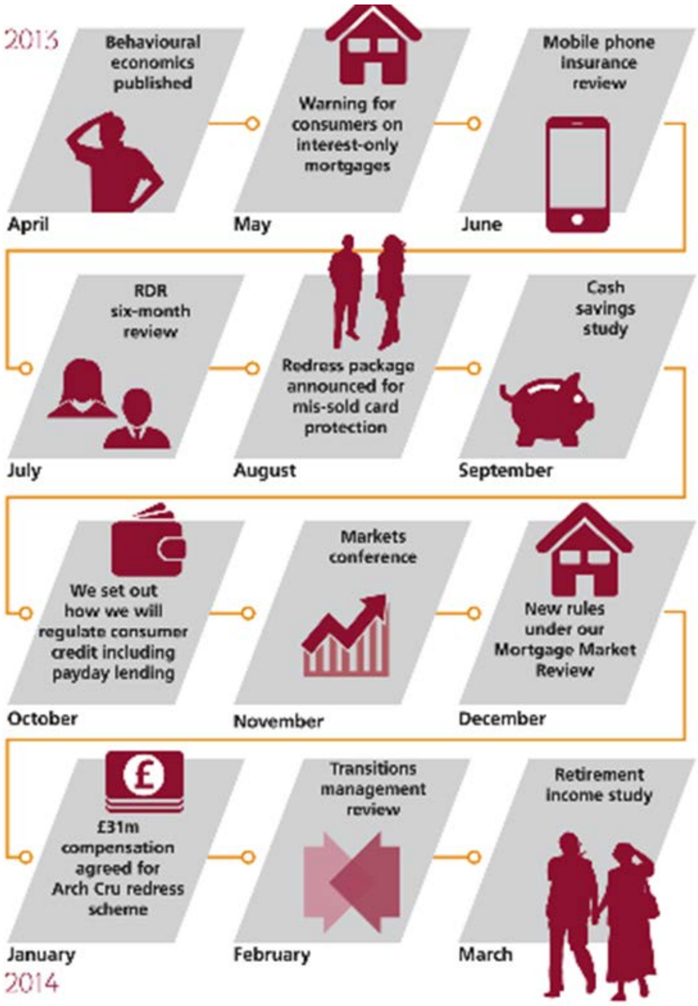
Financial Conduct Authority

The Financial Conduct Authority (FCA) took over from the Financial Services Authority, which was heavily criticised for its supervisory failings pre-crisis. The FCA is responsible for what firms do, and how they carry out their business. It regulates both the very largest and the smallest financial service firms. Large firms may therefore be regulated by the PRA for their soundness and by the FCA for their conduct. Many smaller firms are regulated for both conduct and soundness by the FCA. Its statutory objectives are:[15]

- Securing an appropriate degree of protection for consumers
- Promoting effective competition in the interests of consumers
- Protecting and enhancing the UK financial system

The FCA produced the following diagram of its main activity in the 2013/14 period below:

[15] See Section 6 *Financial Services Act 2012*



Notable retail-consumer related work has included the Mortgage Market Review, the Retail Distribution Review; redress for PPI mis-selling and the rules surrounding pay day loans. The FCA announced in December 2016 that it was engaged in another review of many aspects of high cost credit including how the price cap was working and the cost of overdrafts.

The FCA published its 2017/18 Business Plan in April 2017. Along with stand alone work – such as preparations for Brexit - it described its cross sector priorities as being:

- Firms' culture and governance
- Financial crime and anti-money laundering (AML)
- Promoting competition and innovation
- Technological change and resilience
- Treatment of existing customers
- Consumer vulnerability and access to financial services[16]

16 Financial Conduct Authority Business Plan 2017/18

As part of its broader 'Mission' (see below) the FCA decided that it "would focus particularly on vulnerable consumers" across all aspects of its work.

In October 2016 the FCA announced its 'Mission' consultation as a wide ranging review of what the FCA should do to balance its:

> large and complex remit, and finite resources with which to fulfil it. It has clear objectives set by Parliament, principally to ensure that relevant markets function well..[17]

The resulting Mission Document was published in April 2017, its contents page outlines its scope:

- 2 Public value
- 3 How we make regulatory decisions
- 4 Our remit: Interpreting our objectives
- 5 Assessing our impact and measuring our performance
- 6 Considering user needs
- 7 What consumers can expect
- 8 What firms can expect

It promises to "publish a number of documents that will give a clearer explanation of the way we carry out our main activities" in the coming year.

The Payment Systems Regulator

Two issues guided the creation and subsequent work of the Payment Systems Regulator (PSR).

Although, by and large, retail payment systems remained stable throughout the financial crisis, the potential consequences of a breakdown in the 'plumbing' of the system, on top of all the other problems at the time, alerted authorities worldwide to a possible gap in their regulatory powers.

The existing payments and settlement systems are owned by the existing large banks. Other institutions (e.g. credit unions) who wish to access it are generally charged for doing so, and may not have access to all its features. This was seen as a disincentive for new 'challenger' banks. Also, it was perceived that with the system restricted to one body there were disincentives to innovation and development.

The upshot in the UK of concerns about the system was Part 5 of the *Financial Services (Banking Reform) Act 2013* which established the PSR.

The PSR has three objectives:

- The **competition objective** is a long list of considerations which the PSR must take into account, including the needs of different users; the ease of systems' use; the ease with which users can change their service provider; and the ease with which new infrastructure providers can enter the market.[18]

[17] FCA Press Release; 31 October 2016
[18] Section 50

- The **innovation objective** is simply to encourage new developments in both service delivery and infrastructure development.[19]
- The **service user objective** is "to ensure that payment systems are operated and developed in a way that takes account of, and promotes, the interests of those who use, or are likely to use, services provided by payment systems".[20]

The PSR is a subsidiary of the FCA and became fully operational in April 2015.

The PSR published its framework document in March 2015 which included its three 'pillars' of work:

1. A new and inclusive strategy setting process that really involves users of these systems for the first time. This will be done by setting up a Payments Strategy Forum to develop a long term vision for how payment systems should develop and identify priority areas for the industry to work together where appropriate to deliver this vision;
2. Increasing transparency around how decisions are made and who is making them. We will shine a light on the control and governance of payment systems, challenge payment system operators to explain how they have listened to people and organisations that use payment systems, and check that operators are really taking payment systems in a direction that meets people's needs; and
3. Improving the way people and businesses gain access to a payment system - whether directly or indirectly – to be clearer and fairer and in a way that fosters innovative and competitive solutions for customers using payment systems.[21]

The formal Policy Statement: *A new regulatory framework for payment systems in the UK*, and other material, can be found on the PSR website here.

Current work

As well as establishing the broad framework of regulation the PSR has initiated two market reviews. Both are aimed squarely at one of the big stumbling blocks (it is alleged) to a more competitive banking system. The two reviews are:

- ownership and competitiveness of infrastructure provision
- the supply of indirect access

Ownership and competitiveness of infrastructure provision

As a result of history and 'natural' economic advantage, the main banks have developed the payments infrastructure system – the 'plumbing' –

[19] Section 51
[20] Section 52
[21] PSR Press release 25 March 2015

amongst themselves. The body running this, Vocalink, is owned by the banks. It is argued that the current set up does not encourage competition or innovation in the payments system.

Whether these accusations had merit was one of the first work-streams of the PSR.

The PSR published the interim findings of its review in February 2016.[22]

The final Report into access was published in September. It concluded "We have found that there is no effective competition for the provision of UK payments infrastructure for the three interbank payment systems".

The final report included a factsheet which summarises the findings and proposed remedies contained within it. The remedies are shown below:

- **Competitive procurement exercises are undertaken for the provision of infrastructure services.** This will enable other infrastructure providers to offer these services, which will create the potential for more efficient and innovative services.
- **Divestment by the four largest VocaLink shareholder PSPs of their interest in VocaLink.** This will address the operators' lack of incentive to consider alternative infrastructure providers, as the operators and the infrastructure provider are currently owned and controlled by the same PSPs. MasterCard has recently announced its acquisition of VocaLink, subject to regulatory approval and other customary closing conditions. It will be for the relevant merger authority to consider the effects of this merger under merger control law. However, we note that the transaction would change VocaLink's ownership arrangements in a way which could address the issues we've identified as restricting competition.
- **A common international messaging standard for Bacs and FPS.** This will help facilitate a wider choice of infrastructure providers.

The supply of indirect access.

Any institution which wants to use the payments system has to pay for it. It is argued (by the non-members) that the costs are high and the service is not as good as for members, e.g. it might be slower and prevent real time settlements. This was the focus of a second review by the PSR.

The main outcome so far of this work has been an industry code of conduct overseen by Payments UK the UK's trade body for groups involved in payment transactions. The new code (a revised version was published in September 2016) can be found here.

Phishing

Of popular interest is the fact that the PSR is engaged in the problem of bank fraud – in particular when individuals are tricked into making payments online through their banks. This followed a 'super-

[22] Payment Systems Regulator; MR15/2.2; 25 February 2016

complaint' by the consumer group Which?. The PSR response, published December 2016 can be found here.

More information can be found in a Library Paper: Payment Systems Regulator.

4. Significant regulatory changes

4.1 Introduction

As the preceding pages show there has been an enormous amount of new regulation for financial firms to absorb. For readers who need a convenient compilation of the requirements of the Resolution Regime – the rules which govern how failing institutions are dealt with – the Bank of England's 'Purple Book' can be found here.

Separately, in December 2017 the European Commission has produced a Report that looks at all the measures taken between 2008 and 2015 across the EU in response to the financial crisis: *Coping With the International Financial Crisis at the National Level in a European Context*.

Beyond these there have been a few initiatives which are of more systemic application and are worth highlighting separately.

Controls on bank employee remuneration

The pay of banking executives is now constrained by an amalgam of FCA remuneration codes and the EU CRD IV directive. The aim of the rules is to prevent poor incentives from influencing behaviour. At issue is how big profit-related bonuses as compared to base salaries should be; how should such bonuses be paid (cash or in shares); and whether there should be a period within which bonuses (and/or salary) can be subject to clawback.

There are five Codes which apply to different types of firm – banks, investment finds, collective investment schemes and dual regulated firms etc. these are to be found in the relevant parts of the FCA Handbook:

- SYSC 19A – IFPRU Remuneration Code
- SYSC 19B – AIFM Remuneration Code
- SYSC 19C – BIPRU Remuneration Code
- SYSC 19D – Dual-regulated firms Remuneration Code
- SYSC 19E – UCITS Remuneration Code

The main principles are that

> all applicable firms must make sure their remuneration policies and practices are consistent with and promote sound and effective risk management.
>
> This includes the following:
>
> - At least 40% of a bonus must be deferred over a period of at least three years. At least 60% must be deferred for the most senior management (for SYSC 19A and SYSC 19D only) or when an individual's bonus is a particularly high amount.

- At least 50% of a bonus must be made in shares, share-linked instruments or other equivalent non-cash instruments (or units of shares of the alternative investment fund for firms subject to SYSC 19B or units or shares of the UCITS, equivalent ownership interests in the UCITS, share-linked instruments relating to the UCITS concerned, or equivalent non-cash instruments with equally effective incentives). These shares or instruments should be subject to an appropriate retention period.
- Ensure guarantees are only given in exceptional circumstances to new hires for the first year of service.
- Ensure senior management adopts and periodically reviews the general principles of the remuneration policy and ensures its implementation as well as disclosure of details of their firm's remuneration policies at least annually.
- Variable remuneration is risk-adjusted and ensures performance is assessed with respect to financial and non-financial factors and is based on the performance of the individual, business unit concerned and the overall results of the firm.
- Ensure that any variable remuneration, including a deferred portion, is paid or vests only if it is sustainable according to the financial situation of the firm as a whole, and justified on the basis of the performance of the firm, the business unit and the individual concerned.[23]

Details of the FCA code(s) can be found on its website here.

More information on bank remuneration can be found in a Library standard note (no. 6204): Banking executives' remuneration in the UK.

Ring-fencing

This refers to the separation of the functions of retail from investment banking. Large multi-national banks are immensely complex business entities and the job of separating them out sufficiently is equally complex and one that is occupying the banks now. Information on this process and the guidelines and rules surrounding it can be found in a Bank of England document: *The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities*. The lead on this is being taken by the PRA. The broad outline of activity is set out in the opening pages of the document:

The Consultation Paper articulates the outcomes the PRA expects, but the way that firms achieve these outcomes is, in general, a matter for them. There are some areas, however, where a more prescriptive approach is necessary. This may be because the Act requires the PRA to make rules in specific areas, or

23 FCA website

because the PRA has judged that a more prescriptive approach is necessary to meet the PRA's requirements under the Act.[24]

The full set of documents relating to the process can be found on the PRA's website.

The framework for the new rules was set by the *Financial Services (Banking Reform) Act 2013* and endorsed by the Parliamentary Commission on Banking Standards.

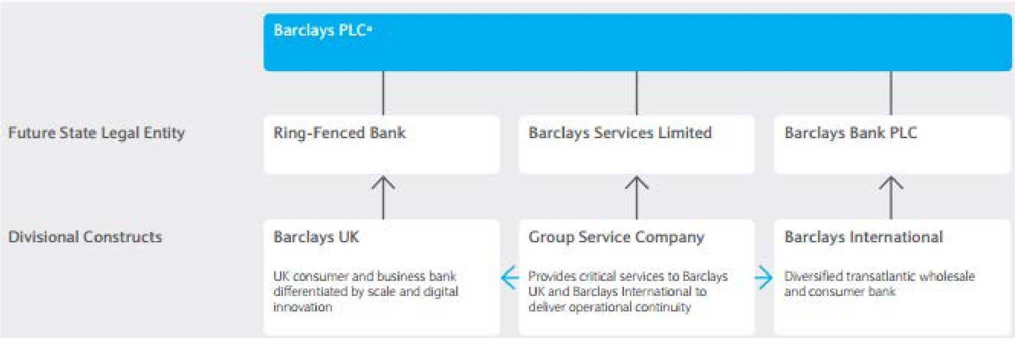
The 2013 Act defines 'core activities' as the regulated activity of accepting deposits and requires that banking groups which undertake core activities place these activities into ring-fenced bodies (RFBs).
The Act extends 'core' to include three 'core services':

- (i) facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits;
- (ii) facilities for withdrawing money or making payments from such an account; and
- (iii) overdraft facilities in connection with such an account.

Implementation

Broadly, the affected institutions have worked to produce ring fenced plans and these have been looked at by the FCA and the PRA. An iterative process of communication and amendment between the banks and regulators is ongoing.

An outline of what preparations the banks have made appears in their Annual Reports. The new Barclays outline looks like this:[25]



Senior managers' regime

One aspect of the financial crisis that confused and surprised the public was that no one was apparently to blame (personally) or had (personally) been found guilty of any offence. Through dint of public and no little parliamentary pressure from, amongst others, the Treasury Committee, most of those in charge of banks at the time of the crash have been forced to resign. However, one aim of the new system was

24 Bank of England/PRA; *The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities*, October 2014
25 Barclays Bank Annual Report 2016

to introduce a greater degree of personal accountability throughout banking.

Prior to this, individuals had to meet certain personal standards and there had been elements of personal assessment and fitness required for senior positions, however "individual accountability was often unclear or confused".[26] The new rules (which come into force by March 2016[27]) differ from the existing rules in the following ways:

> A new 'Senior Managers Regime' (SMR) for individuals who are subject to regulatory approval, which will require firms to allocate a range of responsibilities to these individuals and to regularly vet their fitness and propriety. This will focus accountability on a narrower number of senior individuals in a firm than the Approved Persons Regime (APR) which it replaced.
>
> A 'Certification Regime' which will require relevant firms to assess the fitness and propriety of certain employees who could pose a risk of significant harm to the firm or any of its customers.

A new set of 'Conduct Rules'[28]

Under the Act, the PRA and FCA can specify a function as a Senior Management Function (SMF). Individuals in such posts will require pre-approval either by the PRA or FCA, depending on the specification of the post. As part of the pre-approval process, firms will be required to include a Statement of Responsibilities concerning the individual. The expectation is that executive committee members (or equivalent), i.e. the layer below the board, would also be within the scope of its regime. As well as board members, a number of other individuals will require approval as Senior Managers. These include:

> heads of key business areas meeting certain quantitative criteria
>
> individuals in group or parent companies exercising significant influence on the firms' decision-making, and
>
> where appropriate, individuals not otherwise approved as Senior Managers but ultimately responsible for important business, control or conduct-focused functions within the firm.[29]

Below this level of responsibility will come a Certification Regime for jobs that pose a "risk of significant harm to the firm or its customers". It will be the responsibility of the firm to certify its staff. There is potentially a wide pool of people this applies to due to the 'harm of customers' criterion:

> customer-facing roles that are subject to qualification requirements (e.g. financial advisors)
>
> any individuals who supervise or manage another Certified Person, and

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[26] FCA/PRA; *Strengthening accountability in banking: a new regulatory framework for individuals*, CP 14/13; July 2014

[27] FCA press release/CP15/9

[28] FCA/PRA; *Strengthening accountability in banking: a new regulatory framework for individuals*, CP 14/13; July 2014

[29] FCA/PRA; *Strengthening accountability in banking: a new regulatory framework for individuals*, CP 14/13; July 2014

any other SIF roles under the current Approved Persons Regime not otherwise covered by the SMR, for example benchmark submitters.

Following the consultation, the then Economic Secretary to the Treasury, Andrea Leadsom, announced the statutory steps to be taken to implement the changes in a written statement in March 2015.[30]

The regime was changed by the *Bank of England and Financial Services Act 2016.* The Act extended the Regime to all financial service providers. As a consequence – because it now applied to relatively small firms, the 'reverse burden of proof' which applied to the more restricted Senior Managers Regime was itself to be reversed. Hence, the regulator will now be required to prove misconduct rather than managers prove their innocence.

Benchmarks regulation

The relevant benchmarks include

- **LIBOR** (London Inter-Bank Offered Rate) - a key interest rate benchmark
- **SONIA** (Sterling Overnight Index Average) and **RONIA** (Repurchase Overnight Index Average), which both serve as reference rates for overnight index swaps
- **WM/Reuters London 4pm Closing Spot Rate**, which is the dominant global foreign exchange benchmark
- **ISDAFIX**, which is the principal global benchmark for swap rates and spreads for interest rate swap transactions
- **London Gold Fixing** and the **LMBA Silver Price**, which determine the price of gold and silver in the London market
- **ICE Brent Index**, traded on the ICE Futures Europe (IFEU) exchange, which acts as the crude oil futures market's principal financial benchmark.

After successive scandals afflicting benchmark setting operations, the regulatory community is undertaking a review of how to bring these often long-established, club-like activities within the normal parameters of regulated activity. Benchmarks first became a regulated activity under the *Financial Services Act 2012* following publication of the Wheatley Review of LIBOR in September 2012.[31]

Since then, the FCA has worked with a variety of international regulatory organisations to draw up a coherent international regime. These included the International Organisation of Securities Commissions (IOSCO,) the Financial Stability Board and work by the European Securities and Markets Authority (ESME) and European Banking Authority (EBA), published in June 2013.

30 HCWS336; 3 March 2015

31 *Financial Services Act* 2012 s7

In 2014 the Government accepted the recommendations of the **Fair and Effective Markets Review** that seven benchmarks should be regulated.

- **LIBOR** (London Interbank Offered Rate) a key interest rate benchmark
- **SONIA** (Sterling Overnight Index Average) and **RONIA** (Repurchase Overnight Index Average), which both serve as reference rates for overnight index swaps
- **WM/Reuters 4pm London Closing Spot Rate**, which is the dominant global foreign exchange benchmark
- **ICE Swap Rate** (formerly known as ISDAFIX), which is the principal global benchmark for swap rates and spreads for interest rate swap transactions
- **LBMA Gold Price** and the **LBMA Silver Price,** which determine the price of gold and silver in the London market
- **ICE Brent Index**, traded on the ICE Futures Europe (IFEU) exchange, which acts as a benchmark for the crude oil futures market.

This was done by *The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2015* (SI 2015/369).

Work is currently being taken forward on detailed rules under the EU Regulation approved in June 2016. Information on this can be found on the FCA website here.