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Five years of bank reform

RESEARCH PAPER 15/13 17 March 2015

This Paper brings together, in an abbreviated way, the main features of reform and regulatory activity affecting (particularly) banking to have taken place under the Coalition Government. It describes legislation and provides links to reports and studies by the principal regulatory bodies.

Timothy Edmonds

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Research Paper 15/13

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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.

The 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; established new rules and responsibilities for senior managers and set up a new Regulator for payment systems.

Domestic legislation was reflected at the EU level with a mass of directives and regulations on a wide range of issues. In addition was the creation of the EU Banking Union which is 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 five 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.

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 co-operatively (at least at the start it might be argued) within an international consensus. 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 over the past five years (both by Parliament and by regulators) and the reorganisation of the regulatory system that has come about as a result. The focus is primarily on banks and banking but other changes, e.g. to consumer credit are also included.

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

A brief description of the principal features of each Act is shown in the next part of this Paper.

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.

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

2 References to legislation to do with, for example, the mutual sector or cooperatives 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.

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) and the Prudential Regulation Authority (PRA), which sit within the Bank of England, and the separate Financial Conduct Authority (FCA) which assumed most of the functions of the Financial Services Authority;
- 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

Financial Services (Banking Reform) Act 2013

For convenience this legislation will be referred to as the *Banking Reform* Bill/*Act*.

Library Papers on it can be found here and, for the committee stage here. This particular 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 before; 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:

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

- 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.

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 passed, 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 Measures in progress

Controls on bank employee remuneration

The pay of banking executives are 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 should there be a period within which bonuses (and/or salary) can be subject to clawback.

A revised code came into force for existing firms on 1 January 2011[5]. It applies to the larger banks and building societies with regulatory capital in the in excess of £1bn and FCA-

[5] The Remuneration code is part 19A of the SYSC High Level Standards part of the Handbook

authorised investment firms with regulatory capital in excess of £750m. Such firms must comply with a series of remuneration principles which are set out in the FCA Handbook as the *BIPRU Remuneration Code*. Whilst there is no 'cap' on salary, beyond the general requirement that remuneration takes into account the stability of the firm, the principles affect how bonuses are paid. A proportion of any award should be deferred for either three to five years. The deferred proportion rises with the size of the award and can be withdrawn if

> (a) there is reasonable evidence of *employee* misbehaviour or material error; or
>
> (b) the *firm* or the relevant business unit suffers a material downturn in its financial performance; or
>
> (c) the *firm* or the relevant business unit suffers a material failure of risk management.[6]

The current regulations allow for bonuses under £500,000:

- 30% immediate cash, maximum
- 30% immediate shares
- 20% deferred cash
- 20% deferred shares.

And for bonuses over £500,000:

- 20% immediate cash, maximum
- 20% immediate shares
- 30% deferred cash (held by the employer for 5 years)
- 30% deferred shares (held by the employer for 5 years and then by the employee for 6 months)

Bonuses over £500,000 are subject to a 60% deferral factor.[7] Part of the requirements of the EU directive is that bonuses should not be greater than base salary. More information on bank remuneration can be found in the Library's standard note SN/BT/6204.

Bank levy tax

Against a backdrop of massive state support for the sector the previous Labour Government introduced the concept of a bank payroll tax on discretionary bonuses above £25,000 to be paid by the bank, not the bank employee. It was applied from December to 5 April 2010 and raised £3.5 billion in gross terms.

The Coalition Government sought to impose its own bank levy, to be introduced from January 2011 to apply to the balance sheets of UK banks and building societies, and to the UK operations of banks from abroad. It was intended to raise over £2 billion annually. Since then the rates have been amended seven times, with a view to attain maintaining the yield that it had initially anticipated.

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6 FCA Handbook; BIPRU code SYSY19C.3.52

7 FCA Handbook; BIPRU code SYSY19C.3.50

The levy raised £1.6 billion in 2012/13, and it is now forecast to raise £2.3bn in 2013/14, £2.7bn in 2014/15, and £2.9 billion each year over the following four years.[8]

There is every indication from all the main political parties that some form of bank specific tax will continue after the election although only the Labour Party, in its *A Better Plan for Britain's Prosperity*, makes this explicit. They say they will introduce a "bank bonus tax to provide a paid starter job for [every] young person unemployed for over a year".

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 because the PRA has judged that a more prescriptive approach is necessary to meet the PRA's requirements under the Act.[9]

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

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 by, 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 to introduce a greater degree of personal accountability throughout banking.

Prior to this there individuals had to meet certain personal standards had been elements of personal assessment and fitness required for senior positions however "individual accountability was often unclear or confused".[10] The new rules (which come into force by March 2016[11]) differed 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 current Approved Persons Regime (APR).

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8 HC Deb 23 June 2014 c31W

9 Bank of England/PRA; *The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities*; October 2014

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

11 FCA press release/CP15/9

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'[12]

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.[13]

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

Following the consultation the Economic Secretary to the Treasury, Andrea Leadsom, announced the next statutory steps to be taken to implement the changes in a written statement in March 2015.[14]

3 Major Reports and consultations

Since the 2010 General Election there has 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.

The Treasury Select Committee published *Financial Regulation: a preliminary consideration of the Government's proposals* in February 2011. This covered both supervisory structure

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

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

14 HCWS336; 3 March 2015

and regulatory issues. One of its key concerns was that the timetable for introducing the new rules was too rushed.[15]

It recommended that the Government delay introducing firm proposals until the Vickers, 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.[16]

Independent Commission on Banking, (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.

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.[17] 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.[18] 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*.[19]

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.[20]

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.[21]

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.[22]

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

15 *Financial Regulation: a preliminary consideration of the Government's proposals,* HC 430-2010-12, Summary
16 *Joint Committee on the draft Financial Services Bill*, HC 236 2010-12
17 Parliamentary Commission on Banking Standards; *First Report*; HC 848, HL 98 2012/13
18 Parliamentary Commission on Banking Standards; changing banking for good; HL 27 vol I-VIII
19 HM Treasury; *The government's response to the Parliamentary Commission on Banking Standards;* Cm 8661
20 June 2012, Cm 8356
21 October 2012, Cm 8453
22 February 2013, Cm 8545

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 are 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.[23]

Activities and future work of the FSB can be found in its First Annual Report published in January 2015. 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.

4 Activity by the Regulators

This section lists some of the main actions undertaken by the new 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 and hence activities in connection with insurers is largely excluded.

4.1 Financial Policy Committee

> The Financial Policy Committee (FPC) was set up as a body within the Bank of England. It is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the Government.

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 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.

23 Financial Stability Board website

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.

4.2 Prudential Regulation Authority

The PRA is a part of the Bank of England and responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It sets standards and supervises financial institutions at the level of the individual firm.

It has two statutory objectives: to promote the safety and soundness of these firms and, specifically for insurers, to contribute to the securing of an appropriate degree of protection for policyholders. It makes an important contribution to the Bank's core purpose of protecting and enhancing the stability of the UK financial system. There are also statutory requirements – Threshold Conditions – that firms must meet. These include firms maintaining appropriate capital and liquidity, and having suitable management.

As one of the new organisations the first job of the PRA has been 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:

- 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 new liquidity regime which embeds the EU wide Liquidity Coverage Ratio.
- Instituted regular firm-specific and sector wide stress test exercises for deposit takers.
- Engagement with domestic and international regulators

The ongoing work is the continuous assessment of the very largest firms which the PRA believe 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.

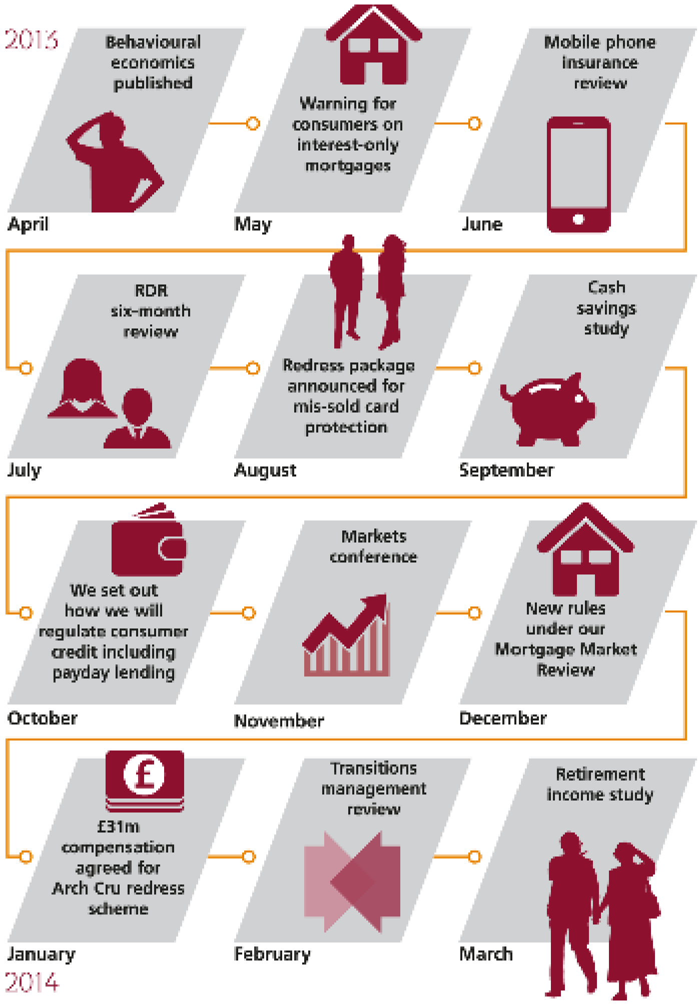
4.3 Financial Conduct Authority (FCA)

The 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, how they carry out their business. They regulate 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:[24]

- 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:

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



FCA Annual Report 2013/14

Notable retail-consumer related work includes the Mortgage Market Review, the Retail Distribution Review; redress for PPI mis-selling and the new rules surrounding pay day loans.