UK Enacts Banking Reform Act 2013

The Financial Services (Banking Reform) Act 2013 (“Banking Reform Act”) received Royal Assent on December 18, 2013. The Banking Reform Act implements certain of the recommendations of the Independent Commission on Banking (“ICB”), chaired by Sir John Vickers, on ring-fencing requirements for the banking sector. Other reforms include the closer regulation of banking executives by means of the establishment of a new “senior management” regime and the creation of a new criminal offence for mismanagement leading to the failure of a bank. The Banking Reform Act also introduces a bail-in stabilization option that will form part of the special resolution regime, the introduction of a payment systems regulator, and empowers the Financial Conduct Authority (“FCA”) to take measures to limit the cost of payday loans to borrowers.

In parallel with the UK reforms, on January 29, 2014, the European Commission published a draft Regulation on Structural Measures Improving the Resilience of EU Banks and Transparency of the Financial Sector, which similarly aims at addressing the “too-big-to-fail” dilemma through structural measures designed to reduce the risk and complexity of large banks in the European Union (“EU”). If enacted, the Proposed Regulation would become directly applicable law in all EU member states. The draft Regulation, contemplates a possible derogation from the separation requirements for banks that are subject to a national separation law adopted by an EU member state prior to the publication of the Proposed Regulation. If enacted in its present form, and subject to a declaration by the European Commission that the Banking Reform Act is compatible with the Regulation, the UK may be able to take advantage of the derogation. The provisions of the Regulation are discussed in our Alert Memorandum, European Commission Publishes Proposed Regulation on Structural Reform of the EU Banking Sector.

1. Ring-Fencing

The underlying rationale of the ring-fencing regime is to insulate critical banking services from shocks to the financial system. Ring-fencing seeks to reduce the perception that certain banks benefit from an “implicit government guarantee”: the perception that the state will bail out a bank in the last resort.

a. Application of Regime: Ring-Fenced Banks

The ring-fencing regime separates “core” banking services which are of most importance to private individuals as well as smaller companies from the investment banking services. Core activities presently consist of accepting deposits or other payments, facilities for withdrawing money and for overdrafts. A UK incorporated institution that carries on these activities (a “Ring-Fenced Bank”) will be subject to the regime unless it is a type of entity which is exempted, such as certain categories of deposit taking institution, including building societies, credit unions, or banks that hold deposits below £25 billion. UK branches of non-UK banks will not be subject to the ring-fencing regime, although UK incorporated bank
subsidiaries of non-UK banking groups are within its scope. These provisions will come into force by January 1, 2019.

b. **Impact for Ring-Fenced Banks**

Ring-Fenced Banks are subject to a number of controls and requirements. They may not open an EEA subsidiary or branch without approval by the Prudential Regulation Authority (“PRA”). Ring-Fenced Banks are also restricted in their exposures to “relevant financial institutions”. A Ring-Fenced Bank is not permitted to carry out certain excluded activities, which include dealing in investments as principal and commodities, unless they are for risk management purposes, or comprise the sale of simple derivative products. The PRA will carry out annual reviews of the ring-fencing regime.

c. **Functional Rather Than Full Separation**

The ICB Report did not recommend that Ring-Fenced Banks be fully separated from those entities providing core activities; they were allowed to remain part of the same group. There were three main reasons cited for this: the cost in terms of extra capital, the loss of customer synergies, and concerns that full separation might not be compatible with EU law in that universal banks in other member states would remain entitled to own UK retail banking operations. However, the ICB Report did recommend three aspects of “functional” separation which were designed to ensure continued viability of the core activities in case of the Ring-Fenced Banks experiencing a catastrophic failure, and which were accepted by the U.K government (the “Government”). The recommendations were as follows:

i) **Legal separation**

Legal separation requires that a Ring-Fenced Bank be a legally separate entity from other members of its group. The same entity, and subsidiaries of that entity is not entitled to provide both core and restricted services.

ii) **Operational separation**

Operational separation entails making the wider corporate group put in place arrangements to ensure that the Ring-Fenced Bank has continuous access to group-wide services including staff and data.

iii) **Economic separation**

Economic separation requires that all intra-group transactions between a Ring-Fenced Bank entity and other group members be carried out at an arm’s length basis, such that the Ring-Fenced bank would not be dependent for its solvency on the financial health of the rest of the group. Limits were placed on intra-group exposures and funding, and the Ring-Fenced Bank is required to meet liquidity and capital requirements on an independent basis.

d. **Electrification of the Ring-Fence**

Although full separation was not required, the PRA has been empowered to require banking groups to restructure their operations if it considers that the operation of the ring-fence in a group is proving to be ineffective. The exercise of these powers may lead to
groups being required to split their retail and investment banking operations into separate corporate groups. Separation is effected by requiring a bank i) to dispose of securities, interests, property or rights of the ring-fenced body to an outside person; or ii) to apply to the court for a "ring-fencing transfer scheme", requiring transfer of whole or part of business to an outside person.

There are four situations specified in the Banking Reform Act, any one of which will allow the appropriate regulator to undertake group restructuring. These situations are: i) the carrying on of core activities by the ring-fenced body is adversely affected by the acts or omissions of other members of its group; ii) in carrying on its business the ring-fenced body is unable to take decisions independently of other members of its group, or depends on resources which are provided by a member of its group and which would cease to be available in the event of the insolvency of the other member; iii) in the event of the insolvency of one or more other members of its group the ring-fenced body would be unable to continue to carry on the core activities carried on by it; or iv) the ring-fenced body or another member of its group has engaged in conduct which is likely to have an adverse effect on the advancement by the regulator of particular objectives, including continuity.

e. **US Comparison**

In the United States, Sections 23A and 23B of the Federal Reserve Act, and Regulation W issued by the Board of Governors of the Federal Reserve System (the “Federal Reserve”), have long restricted transactions between an insured bank and its nonbank affiliates. These provisions are intended to limit risks that may arise from a bank’s transactions with nonbank affiliates, and the ability of those affiliates to benefit from the subsidy created by the bank’s access to the federal safety net (i.e., the discount window and lower cost insured deposits). Banks are subject to statutory quantitative and qualitative restrictions on “covered transactions” with affiliates, as well as to collateral requirements for certain of those transactions. Covered transactions include a bank’s purchasing assets from an affiliate, extending credit to an affiliate and issuing guarantees on behalf of an affiliate. Such transactions with a single affiliate are limited to 10% of the bank’s capital stock and surplus, and those with all affiliates are limited to 20%.

In addition, most transactions by a bank with its affiliates are required to be on arm’s-length, market terms. Prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), Section 23A created several obstacles to the efficient interaction between affiliated securities firms and banks. Such obstacles have been exacerbated after the enactment of the Dodd-Frank Act, as derivative transactions, repos/reverse repos and securities loan/borrow transactions with an affiliate, to the extent that the transactions result in “credit exposure” to the affiliate, are now subject to Section 23A’s restrictions.

Furthermore, the Volcker Rule contains so-called “Super 23A” rule, which prohibits “banking entities” and any of their affiliates that advise, manage, or sponsor “covered funds” from entering into a transaction with the fund that would be regulated under Section 23A of the Federal Reserve Act if the banking entity were a “bank” and the covered fund were a “nonbank affiliate”.

2. **Bail-In**

a. **Special Resolution Regime**

Part 1 of the Banking Act 2009 creates certain pre-insolvency stabilization powers known as the special resolution regime (the “SRR”), which allow the Bank of England to intervene in the administration or ownership of a bank, prior to any collapse. The Bail-in
mechanism will constitute an additional tool under the general auspices of the SRR. The three previous stabilization options were: i) transfer to a private sector purchaser; ii) transfer to a bridge bank; and iii) transfer to temporary public sector ownership. If the Bank of England does not consider a stabilization option appropriate, then it can instigate the Bank Insolvency Procedure. The purpose of the bail-in mechanism is to recapitalize the entity as a going concern and to preserve the continuity of all transactional and service arrangements. It should be noted that the US has no comparable bail-in arrangements.

The Bail-in mechanism allows for recapitalization of an affected institution which is effected by imposing losses on banks’ shareholders and creditors, rather than meeting this cost out of Government funds. The bail-in provisions were designed in light of the advanced negotiations around the Recovery and Resolution Directive (“RRD”). Although the ICB Report proposed expanding the SRR to include bail-in, the initial Government response from December 2011 indicated that the Government would await broader European agreement on the bail-in power, because it was anxious to avoid creating a conflict with the proposed EU regime. The bail-in provisions were added relatively late in the legislative process, by which time the Government had taken the view that negotiations relating to the RRD had advanced to the stage where there was minimal risk that the final RRD bail-in provisions would necessitate radical changes to the domestic bail-in tool it has now enacted.

b. Trigger

The conditions that must be met for the use of the bail-in power are the same as for the other stabilization powers. The conditions require the following determinations: i) by the PRA that a) the bank is failing or is likely to fail and b) that, in the circumstances, it is not reasonably likely that any other action can be taken to avert the failure; and ii) by the Bank of England that it is in the public interest to use the bail-in tool.

c. Application of Regime

The bail-in power will apply to banks and building societies, systemically important UK investment firms and certain UK banking group companies. The measures may be imposed on the shareholders and unsecured creditors by a process of either writing down their claims or by converting them to equity broadly in a manner that respects the hierarchy of claims in liquidation.

When the Bank of England determines that bail-in should be used, it is empowered to make “resolution instruments”. Resolution instruments are a form of order issued by the Bank of England, which has been delegated this power directly by Parliament in the Banking Reform Act. The Banking Reform Act makes clear that resolution instruments will take effect notwithstanding any contractual or legislative provisions to the contrary. Such instruments are referred to as “Special Bail-in Provision” and can: i) cancel, reduce or defer liabilities owed by the bank; ii) provide that a contract under which the bank has a liability is to have effect as if a specified right had been exercised under it (such as a close-out right being deemed to have been exercised); or iii) convert the form of a liability (for example, it can convert debt into equity securities). These are similar to the powers of the Bank of England under the SRR, mentioned above, to make share transfer instruments and property transfer instruments pursuant to the existing pre-insolvency stabilization options.

The Banking Reform Act provides that examples of special bail-in provision include i) provision that transactions or events of any specified kind have or do not have (directly or indirectly) specified consequences or are to be treated in a specified manner for specified purposes; or ii) provision discharging persons from further performance of obligations under a contract and dealing with the consequences of persons being so discharged. This
indicates that such Special Bail-in Provisions may have the effect of precluding the ability of both the direct counterparties to the bailed-in entity and counterparties to affiliates of the bailed-in entity from exercising rights that they might otherwise have in a default of the bailed-in institution.

d. Creditor protection

There are a number of limits on the exercise of the bail-in power. First, Special Bail-in Provision cannot be made in relation to certain “excluded liabilities”. Broadly, the excluded liabilities are deposits covered by the Financial Services Compensation Scheme (“FSCS”) or a third country equivalent. The FSCS is a Government scheme to protect certain claims against financial services firms, in the last resort. For example, the first £85,000 of deposits are guaranteed under this scheme. Other excluded liabilities include “secured” liabilities (where the debt is supported by a contingent right against an asset), client assets, liabilities owed to other banks or investment firms with an original maturity of fewer than 7 days, and certain other liabilities related to employees, trade creditors, and CCP/settlement services. These exceptions generally reflect the list of excluded liabilities contained in the General Approach text of the RRD, agreed in June 2013. If the list contained in the RRD changes, the Treasury can make use of a power contained in the Banking Reform Act to amend the list of excluded liabilities accordingly.

Second, the exercise of the bail-in tool must, in general, respect “insolvency law principles”. Such principles require that: i) a bail-in should respect the general hierarchy of creditors (so, for example, subordinated creditors should not be exposed to loss until shareholders have had their equity interests fully removed and, in turn, senior creditors should not be exposed to loss until subordinated creditors have had their debt claims fully cancelled); and ii) that all creditors who would rank pari passu in an insolvency should bear losses effected by the bail-in tool equally. However, the respect for insolvency principles is not absolute; the Banking Reform Act allows the Bank of England to exercise its powers in a manner that is inconsistent with these underlying principles. The Banking Reform Act does not specify any limits on such departures from ordinary insolvency principles, although any such measures may be open to subsequent challenge under other instruments including but not limited to the UK Human Rights Act, the European Convention of Human Rights and any applicable Bilateral Investment Treaties. In addition, if the Treasury departs from the ordinary insolvency principles, it must then report the reasons for this departure to the Chancellor of the Exchequer and Parliament.

Third, the Treasury must set up compensation arrangements following any exercise of the bail-in tool. Such measures would aim to compensate the shareholders and creditors of the institution subject to the bail-in measures who have seen their assets removed or written-down. The regulations may require a resolution fund order, a compensation scheme order, a third party compensation order or a specialized bail-in compensation order, meaning that the funding of such compensation might come from private parties as well as the Government. The Banking Reform Act and Banking Act 2009 provide that the sources of compensation may include the Treasury, the FSCS, or any other person specified by order or regulation. No further guidance has yet been issued as to the identity of the persons who are likely to be specified. By comparison, the Federal Deposit Insurance Corporation (“FDIC”) as resolution authority for a financial company under the Orderly Liquidation Authority provisions of the Dodd-Frank Act may call on an industry-backed liquidity facility during a resolution. If the assets of the resolved company are insufficient to repay the facility, the FDIC is required to make assessments on large financial companies in order to fully repay the facility.
The Banking Reform Act requires that where the Treasury exercises its power to make regulations relating to compensation schemes, it must have regard to the desirability of ensuring that the pre-resolution shareholders and creditors of a bank do not receive less favorable treatment than they would have received had the bank entered insolvency proceedings rather than the SRR (the so-called “no creditor worse off” safeguard).

Fourth, the Treasury is empowered to make either general or specific regulations dealing with the safeguards that will restrict the use of the bail-in tool in relation to certain protected financial arrangements (namely security interests, title transfer collateral arrangements, and set-off and netting arrangements).

3. Primary Loss-Absorbing Capacity

The Banking Reform Act contains requirements for the Primary Loss-Absorbing Capacity (“PLAC”) of Banks, which are super-equivalent to the Basel III and CRD IV standards. The new PLAC standards will require i) UK corporate authorised persons that are members of a UK headquartered global systemically important bank (“G-SIBs”) group; ii) Ring-Fenced Banks; and iii) other UK-incorporated entities identified as domestic systemically important banks (“D-SIBs”) to hold loss-absorbing capacity in addition to capital held to satisfy their capital requirements. The purpose of the PLAC requirements is to ensure that banks maintain a sufficient amount of debt to be recapitalized through a bail in or other resolution mechanism that results in a going-concern entity (in contrast to capital requirements, which are aimed at ensuring sufficient capability to absorb losses and avoid such a recapitalization or insolvency).

The mechanism through which additional PLAC requirements will be created under the Banking Reform Act is through orders of the Treasury in a statutory instrument. This will be called the Banking Reform (Loss Absorbency Requirements) Order (“LARO”). Although the LARO has not yet been enacted, a draft version was published as part of the Government’s consultations on the Banking Reform Bill in July 2013.

In setting PLAC requirements, and subject to the specific conditions listed in the sections below for applying requirements to different classes of institution, the LARO requires that the regulator must, so far as is reasonably practicable, take into account the degree of risk the failure of a relevant body is perceived to pose to: i) the continuity of the provision in the United Kingdom of core services; or ii) the stability of the financial systems within the United Kingdom.

The Government has expressed its belief that PLAC should comprise the highest quality loss-absorbing instruments – that is capital (equity, Additional Tier 1 capital, Tier 2 capital) and long-term unsecured debt that is clearly identified as subject to the anticipated future bail-in power, in line with the ICB’s recommendation. There are no indications in the draft LARO as to distributing or maintaining the proceeds of the PLAC.

The Government has stated that it believes it would be inappropriate for the regulator to include overseas operations of UK headquartered G-SIBs in the group PLAC calculation, where these operations do not pose a risk to UK, or EEA, financial stability. Accordingly, the regulator is required to include UK and EEA members of a banking group in the calculation of the non-capital PLAC required as a general rule. It is also required to include non-EEA subsidiaries in this calculation where the ‘resolution strategy’ (to be prepared for that G-SIB by the Bank of England) recommends that they be taken into account.

It is intended that there will be a minimum PLAC requirement of 17% of risk-weighted assets for the largest banks and building societies. The PLAC standards will vary depending
on the type of institution to which they are being applied. For example, G-SIBs will be required to hold a higher buffer of risk-weighted assets than domestic Systemically Important Banks. The PLAC reforms are also aimed at fulfilling the UK's expected obligations under the RRD, which currently requires that firms to maintain a minimum amount of “eligible liabilities” (namely liabilities that can be bailed-in in using the bail-in tool).

The appropriate regulator may impose debt requirements on a qualifying parent undertaking of a Ring-fenced Bank or a D-SIB set at an amount which includes the amount of debt requirements which it considers is appropriate in relation to the subsidiary undertaking rather than imposing debt requirements of the relevant amount on the subsidiary undertaking, provided that i) the qualifying parent undertaking is required to lend the relevant amount to the subsidiary undertaking in a form approved by the regulator; and ii) the period for which the loan is made is the same as, or greater than, the period between the issue and maturity of the debt instruments issued by the parent undertaking to comply with those debt requirements.

Where the resolution strategy prepared in relation to a bank which is a member of a UK G-SIB recommends that the risk-weighted exposures of some or all of the overseas subsidiary undertakings in that group are to be taken into account in setting the appropriate level of debt requirements to be imposed on UK corporate authorised persons, the relevant undertakings in the group for the purposes of the PLAC requirements are i) companies incorporated in the UK which are members of the UK-G-SIB; ii) any other EEA companies which are members of the group; and iii) those overseas subsidiary undertakings which are specified in the resolution strategy.

**US Comparison**

In December 2013, the Board of Directors of the FDIC released a notice and request for comment entitled “The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy” (the “Notice”). In addition to providing details regarding the single point of entry (“SPOE”) strategy for the resolution of failing systemically important financial institutions, the Notice seeks public comment on certain key components of the strategy, including issues regarding loss absorbency. The FDIC noted that, for the SPOE strategy to succeed, it is necessary that the top-tier holding company have a sufficient amount of equity and unsecured debt to the losses of and recapitalize its operating subsidiaries. The FDIC specifically requested comments regarding the amount of equity and unsecured debt would be needed to permit an SPOE strategy and establish a viable successor company, as well as what types of debt and what maturity structure would be optimal to effect the strategy. The FDIC also is interested in views on whether the leverage ratio would provide a meaningful measure of capital during a financial crisis where historical models have proven to be less than accurate.

In addition, the Federal Reserve has recently indicated that it expects to propose rules establishing minimum loss-absorbing capacity requirements for certain bank holding companies during the first quarter of 2014 to ensure that such entities would be resolvable under the SPOE strategy.

4. **Regulation of Personnel**

   a. **Approved Persons Regime**

Under pre-existing legislation, particularly the Financial Services and Markets Act 2000 (as amended) (“FSMA”), the FCA and PRA have powers over certain individuals within the financial services industry (“Approved Persons”). An Approved Person is one who has
been approved by either of the regulators to carry on certain “controlled functions, namely certain roles of responsibility within financial services. Approved Persons are to be contrasted with Authorized Persons; the latter are the corporate entities which have been authorized by a regulator to carry out certain controlled financial services activities.

b. Senior Managers Regime

Under the existing Approved Persons regime, there was a specific category entitled “significant influence function”. A new “Senior Managers” regime will replace the significant influence function controls with regards to individuals in banking firms who exercise a senior managerial role. A senior management function is defined by the Banking Reform Act where, in relation to a regulated activity by an Authorized Person, the function involves managing one or more aspects of the Authorized Person’s affairs and those aspects involve a risk of serious consequences to the Authorized Person or of other businesses in the UK.

The Senior Managers regime requires that certain persons are directly responsible for a determined part of a business and that they are made aware of this via a “statement of responsibilities”. In addition, the new regime will allow the regulator to impose time limits or other conditions on the approval of Senior Managers, such as the acquisition of a certain competence before they are allowed to begin a role within a firm.

5. New Criminal Offence

A new criminal offence has been created for reckless mismanagement causing a financial institution to fail, the penalties for which can include an unlimited fine and a custodial sentence of up to 7 years. In particular, this offence was aimed at deterring a repeat of the events which lead to the Royal Bank of Scotland collapse and U.K. Government intervention in 2008. An individual can only commit the offence if they are a Senior Manager as defined by the new Senior Managers Regime. In terms of the test for liability, a December 2013 briefing paper for the House of Lords suggested that the individual’s behaviour in taking the decision must be far below that which could be expected of someone in their position (which builds on precedents in existing offences, for example corporate manslaughter). “Failure” of a bank is defined as i) insolvency; ii) entry into any of the stabilization options under the SRR; or iii) a situation where the bank is deemed for the purposes of the FSCS to be unable, or likely to be unable, to satisfy claims against it.

a. Certification Regime

An Authorized Person must take reasonable care to ensure that none of its employees carry out functions which can cause significant harm to the firm unless they have been issued a certificate by the Authorized Person to do so. In deciding whether to issue such a certificate, the Authorized Person must have regard to whether the individual: has obtained a qualification, has undergone, or is undergoing, training, possesses a level of competence, or has the personal characteristics, required by general rules made by the appropriate regulator in relation to employees performing functions of that kind (or that they are a “fit and proper person” to undertake such a role). There is continuing obligation on the Authorized Person to inform the regulator of any disciplinary action taken against the certificated person.

Persons carrying on a significant harm function will not necessarily need to be Approved Persons, although it is likely that many of the same roles will be covered by both regimes. The main difference in scope is that the certification regime looks at what adverse effects an individual might cause through their misconduct whereas the Approved Persons regime is determined primarily by the scope of activities when carried out correctly. In
practice, there appear to be few other consequences for a certified as opposed to an Approved Person, although the Authorized Persons providing the certifications will face an additional regulatory burden.

b. Banking Conduct Rules

New banking “Conduct Rules” will replace the existing “Statements of Principle for Approved Persons”. The Conduct Rules can be made by the FCA or PRA where they consider these necessary or expedient to advance their objectives. The Conduct Rules will set more stringent standards than currently exist for senior persons and licensed bank staff and their breach will enable enforcement action by the regulators.

The Conduct Rules will be wider than the Statements of Principles in two main ways. First, the Conduct Rules will apply to all employees of a bank, and not just to Approved Persons. Second, the Conduct Rules will cover conduct in relation to any business carried on by an Authorized Person and as opposed to only conduct in relation to regulated activities.

In order to enforce the Conduct Rules, the PRA may undertake an enforcement action under the pre-existing FSMA mechanism. The Banking Reform Act increases the time limit for commencing disciplinary action under FSMA from three to six years.

6. Powers over Holding Companies

Under previous legislation, the FCA and PRA has certain powers to impose requirements on non-regulated parent undertakings of regulated firms. These powers were established by the Financial Services Act 2012 and are to be applied in order to advance the PRA’s objectives, namely the safety and soundness of PRA firms. Such directions may require the parent to take or refrain from certain actions. The PRA is also entitled to make directions to shareholders, although such directions can only take the form of instructions to the parent company to facilitate such shareholder actions (such as to call of a general meeting and the proposal of a motion).

The Government’s rationale for the new powers in respect of parent undertakings is that there may be situations where the powers directly over the regulated entity are not sufficient to exercise the structural changes necessary under the resolution and bail-in regimes. This may be the case in groups where group companies which provide services to the regulated entity concerned are not owned by the regulated entity but are owned by the parent undertaking, or where the banking subsidiary is dependent on capital and debt issued by a parent undertaking. A parent undertaking which is not an Authorized Person will be covered by the new measures where it is: i) incorporated in the United Kingdom or has a place of business in the United Kingdom; and ii) it is the parent of a Ring-Fenced Bank.

The powers apply to UK incorporated parent undertakings, anywhere in the chain of control, that meet various test. Therefore the powers will not apply, e.g., to US holding companies of UK incorporated banks, but will potentially apply to intermediate UK holding companies of non-UK groups which are parents of PRA authorised entities.

The Banking Reform Act alters the current legislation in two ways: i) the appropriate regulator is allowed to impose rules on qualifying parent undertakings for the purposes of requiring arrangements to facilitate the exercise of resolution powers; and ii) the appropriate regulator is allowed to make rules for parent undertakings to support the ring-fencing objectives concerned with ensuring the independence of the ring-fenced bank from the rest of its group.
The UK regulator may also give directions that mirror third-country resolution procedures, in order to assist an overseas regulator in exercising its powers. Through use of this power, UK regulators could take local action to give effect to the exercise of US and other non-UK resolution processes. However, its application is limited by the trigger under the Banking Reform Act, which restricts its use by reference to the advancement of the PRA Objectives. The PRA Objectives are set out in the Financial Services and Markets Act, and comprise promoting the safety and soundness of PRA-authorised persons, in particular by: i) seeking to ensure that the business of PRA-authorised persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system, and ii) seeking to minimise the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system.

In a non-exhaustive list, published by the Bank of England in an April 2013 Policy Statement, of where such powers of direction over qualifying parent undertakings would be exercised, the Bank of England did not list third country resolution actions. Nevertheless, it is open to the PRA to cooperate with the resolution authorities of any non-UK jurisdiction in relation to the resolution of a global financial group.

**US Comparison**

In December 2012, the Federal Reserve issued a proposed rule to apply the heightened prudential standards and early remediation requirements of Sections 165 and 166 of the Dodd-Frank Act to foreign banks that operate in the United States. The new U.S. intermediate holding company ("IHC") requirement would apply to foreign banking organizations ("FBOs") with $50 billion or more in global assets and $10 billion or more in U.S. assets (not including assets of branches and agencies). These heightened prudential standards and early remediation requirements would apply regardless of whether an IHC owns a U.S. bank subsidiary. Currently, U.S. banks are subject to the Prompt Corrective Action ("PCA") framework, which includes a range of capital categories and, as a bank's capital position deteriorates, the bank is subject to increasingly stringent supervisory restrictions. U.S. banking regulators also may use their discretion to place banks into resolution where they are determined to be operating in an "unsafe or unsound" condition or if they have insufficient liquidity irrespective of their capitalization. The early remediation requirements applicable to IHCs, which, like the PCA framework that applies to banks, mandate that the Federal Reserve, take action when certain thresholds are met.

Early remediation, under the proposed rules, would be triggered at four stages, each of which would result in increased regulatory intervention. Under the first three stages, the Federal Reserve would subject the IHC to (i) heightened prudential review; (ii) initial remediation, including a prohibition on certain capital distributions, growth limitations, and establishing or acquiring a new branch, engaging in any new line of business in the United States and acquiring certain controlling interests; and (iii) recovery, including capital restoration plan and capital raising requirements, limits on transactions with affiliates, management changes and asset sales. Ultimately, if an IHC or the FBO as a whole were to reach risk-based capital ratios or leverage ratios below applicable minimum standards to be established by the Federal Reserve, the Federal Reserve is instructed to consider terminating or resolving the combined U.S. operations of the non-compliant FBO. While the Federal Reserve does not have the authority to initiate resolution proceedings directly, it could be required to recommend the initiation of proceedings to other U.S. regulatory authorities.

**7. Payday Loans**
In a late addition to the Banking Reform Act, introduced at least partly in response to pressure from "back-bench" MPs in the U.K. Parliament, a duty is imposed on the FCA to cap the cost of high-cost, short-term credit agreements, otherwise known as payday loans, "with a view to securing an appropriate degree of protection for borrowers against excessive charges". The FCA must consult with the Treasury prior to the publication of these rules, which will take effect no later than January 2, 2015.

8. Depositor Protection in Insolvency

The Financial Services Compensation Scheme insures up to £85,000 of an eligible person’s debts with a deposit-taking institution. The Banking Reform Act amends the Insolvency Act 1986, to make the general insolvency regime compatible with the protections of deposits under the Financial Services Compensation Scheme. Consequently, the protected debts will become “preferred” in the insolvency hierarchy, meaning that in the event of a bank’s insolvency, such creditors will rank ahead of the claims of other unsecured creditors. Debts relating to pensions liabilities, overseas deposits and deposits by charities and local authorities are excluded from such preferential treatment. These provisions will come into force by January 1, 2019.

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If you have any questions in regard to the issues addressed herein, please contact David Toube, Simon Ovenden, Amélie Champsaur, Michael H. Krimminger, Seth Grosshandler, Knox L. McIlwain or any of our partners and counsel listed under “Banking and Financial Institutions” of our website at http://www.clearygottlieb.com.
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