Banking Regulation

Contributing editor
Richard K Kim

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GETTING THE DEAL THROUGH

GETTING THE
DEAL THROUGH

Banking Regulation 2018

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Banking Regulation 2018
Eleventh edition

Getting the Deal Through is delighted to publish the eleventh edition of *Banking Regulation*, which is available in print, as an e-book, and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Ghana and Monaco.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Richard K Kim of Wachtell, Lipton, Rosen & Katz, for his continued assistance with this volume.

GETTING THE
DEAL THROUGH

London
March 2018

Andorra

Miguel Cases and Marc Ambrós
Cases & Lacambra

Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The main focus of the Andorran banking regulations is centred on the stability and efficiency of banks and other Andorran financial entities that operate in the financial system, to enhance the confidence of international financial markets in the Andorran banking sector and to protect the interests of its clients and investors.

Andorran banking regulations are based on the cornerstone principle of reserve of activity. According to this principle, only the banks that have been duly authorised by the local regulator, the Andorran National Finance Institute (INAF), may carry out typical banking activities, such as receiving deposits and other funds from clients and granting any kind of credits by its own account. Andorran banks can also render investment and ancillary services.

Andorran banking regulation is being increasingly influenced by international standards in financial regulation (ie, EU and international financial standards), which are taken as a reference by the Andorran legislature in order to adapt its internal banking regulation. Andorra signed the European Union Monetary Agreement in 2011 (the Monetary Agreement), which obliged the Andorran government to implement several banking and anti-money laundering European directives and regulations before 2020.

2 Summarise the primary statutes and regulations that govern the banking industry.

Overall, the primary statutes governing the banking sector are Law No. 7/2013, of 9 May 2013, on the regime for the operating entities in the Andorran financial system and other provisions that govern financial services in Andorra, and Law No. 8/2013, of 9 May 2013, which covers the organisational requirements and operating conditions of entities operating in the Andorran financial system, investor protection, market abuse and financial securities agreements. The first of these Laws establishes the substantive regime for banking and financial activity within Andorra, while the second determines the formal aspects (ie, organisational requirements and operating conditions) for Andorran financial entities, jointly with the market abuse regulation and the regime of financial securities agreements in line with the corresponding EU regulations.

Specifically, certain areas of the banking sector are governed by concrete rules, including:

- Law No. 35/2010 on the legal regime for authorising the creation of new operating entities within the Andorran financial system;
- Law No. 10/2008 regulating Andorran collective investment schemes' undertakings;
- Law No. 8/2015 on urgent measures to introduce mechanisms for the recovery and resolution of banking entities;
- Law No. 10/2013 of the INAF;
- the financial system disciplinary Law, dated 27 November 1997;
- the capital adequacy and liquidity criteria of financial institutions Law, dated 29 February 1996;
- the insurance companies' Law; and
- Law No. 14/2017 on prevention and fight against the money or securities laundering and the terrorism financing.

Additionally, the INAF is empowered to issue technical communications and recommendations to develop the Andorran banking regulations applying international standards on the banking industry.

It should be noted that the Accounting Plan of the Andorran Financial System was abolished with legal force from 1 January 2017 by means of the Decree dated 22 December 2016, which transposed the International Financial Reporting Standards (IFRS) rules into the Andorran legal framework. Andorran financial institutions shall apply the IFRS rules to their 2017 financial statements.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The INAF is the national banking authority, responsible for supervision of Andorran banks. The INAF has been a member of the International Organization of Securities Commissions (IOSCO) since 2013. It is envisaged that in 2018, this entity will also assume supervision over the insurance and reinsurance of Andorran entities, due to the coming into force of the draft legislation on the organisation and supervision of insurance and reinsurance within Andorra. See question 9.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

By means of Law No. 1/2011, of 2 February 2011, related to the creation of a banking entities deposit guarantee system, the Andorran government created a banking deposits' guarantee system that does not have legal personality and is managed by a management committee, which is in turn directed by the INAF. The banking deposits' guarantee system is participated in by all banks authorised to operate within Andorra.

In essence, the Andorran banking deposits' guarantee system is aligned with EU standards. Law No. 1/2011 establishes the maximum amount of coverage at €100,000 per depositor and €100,000 per investor. The initial overall limit was €94.1 million, which will be increased as the system of annual contributions to the fund assets reaches 1.5 per cent of the calculation basis of contributions, with a maximum limit of €200 million (as the absolute value). The scope of the protection provided by the banking deposits' guarantee system encompasses all cash and securities deposits of natural and legal persons, irrespective of their nationality or domicile, held in the Andorran banks.

The banking deposits' guarantee system is excluded from contribution to bail-in in the event of bank resolution. (See question 13.) All in all, this deposit guarantee system is configured as an ex post mechanism by paying the corresponding amounts secured in case of intervention or resolution of an Andorran bank.

So far, the deposits' guarantee system has never been applied to the financial assistance of Andorran banks. Moreover, the Andorran State Agency for the Resolution of Banking Institutions (AREB) and the Andorran Fund for the Resolution of Banking Institutions, as the financing mechanism for the banking resolution processes, were incorporated in 2015.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

The legal regime on transactions that banks may carry out with their affiliates is principally made up of the capital adequacy and liquidity criteria of the Financial Institutions' Law, dated 29 February 1996, since the Andorran banks acting as a group have to comply with solvency and liquidity ratios and risk concentration limits stated in the Financial Institutions' Law under a consolidated basis.

Under Andorran law, an 'affiliate' relationship applies when there are dominant and dependent entities, and the dominant entity directly or indirectly:
- holds the majority of the voting rights of the dependent entity;
- has the power to appoint or to remove the majority of the board of directors of the dependent entity;
- has appointed exclusively with its votes, at least the majority of the board of directors of the dependent entity; or
- exercises control of the board of directors of the dependent entity where at least the majority of its members are directly or indirectly directors of the dominant entity.

The type of entity and its specific regulatory status are the criteria that determine the activities that Andorran financial entities may carry out. Banks may perform the widest spectrum of activities, since these are the only entities authorised to take deposits or other repayable funds from the public. Additionally, banks are also authorised to render investment services and investment ancillary services, yet they can neither directly manage collective investment schemes nor perform the activities reserved to life insurance companies, unless they acquire either a majority or a minority stake in these companies.

In relation to the other Andorran financial entities that act in the Andorran financial system, the essential note is that they have a limited range of activities and services:
- investment financial entities may render both investment and ancillary services, including complementary activities, as long as their principal activity continues to be performed efficiently. On the other hand, they cannot carry out typical banking activities;
- non-banking financial entities of specialised credit (specialised credit institutions) may only grant financing under any form (eg, mortgage loans); and
- management entities of collective investment schemes.

All the aforementioned financial institutions have an exclusive corporate purpose; therefore, they may only render the relevant financial services established by law with express exclusion of other activities, except for complementary activities that are reasonably linked to their financial business.

6 What are the principal regulatory challenges facing the banking industry?

The Andorran legislator has made significant efforts in recent years to adapt and modernise the Andorran banking industry to international standards.

To this end, the areas that have been set up and strengthened include:
- investor protection;
- market abuse regulation;
- the general regulatory regime for Andorran financial entities;
- regulation of financial guarantees; and
- regulation of banking resolution and restructuring

Nevertheless, there are several upcoming challenges that must be carefully monitored for their impact.

Insurance and reinsurance regulation

Recently approved Law No. 12/2017 on the regulation and supervision of insurances and reinsurances in Andorra will serve as a cornerstone for the Andorran insurance market. In particular, the main challenges in this respect are the adaptation of Andorran insurance entities to the capital requirements imposed by that Law, which are aligned with the provisions of Directive 2009/138/EC (Solvency II), as well as the exercise of effective and efficient supervision by the future regulator, the Andorran National Finance and Insurance Institute (INAF). A draft bill is currently being considered by the Andorran Parliament in order to provide the INAF with all the necessary authority, powers and instruments to exercise as the sole supervisor of financial and insurance industries in Andorra.

Banking industry framework

One of the main challenges for the banking industry is to continue to open up to foreign investment while, simultaneously, maintaining its independence and remaining a competitive financial hub by implementing the commitments agreed in the Monetary Agreement. Furthermore, the Andorran government signed an agreement with the European Union in February 2016 that involved incorporating Andorran law to the Common Reporting Standard of the Organisation for Economic Co-operation and Development. This commitment came into force following the enactment of Law No. 19/2016, of 30 November 2016, on the automatic exchange of tax information.

Bank resolution and restructuring regulation

The main challenges refer both to the modernisation of the Insolvency Decree, dated 4 October 1969, which governs the general bankruptcy regime and its alignment with Law No. 8/2015, which provides for the specific banking insolvency regime, and the level of effectiveness and certainty that their combination has to provide.

Association agreement

Currently, the Andorran government is working on the future framework of relations between Andorra and the European Union in order to allow progressive and structured access to the European Union internal market, taking into account the particularities of Andorra by means of a specific association agreement.

7 Are banks subject to consumer protection rules?

Andorran banks are subject to general and specific consumer protection rules.

The general consumer protection rules are established by Law No. 13/2013, of 13 June 2013, on effective competition and consumer protection. Its key points may be summarised as follows:

General principles on consumer protection

The good faith principle, the fair equilibrium between consumer protection and competitiveness of companies as well as the irrevocable status character of consumer protection regulation.

Basic rights of consumers

In addition to any applicable provisions established by sectoral rules and civil regulation, the basic rights of consumers protected are:
- health and safety;
- economic and social interests; and
- the right to information.

Requirements common to all consumer relations

In the framework of any consumer relation the following requirements must be met at all times:
- consumer relations may not cause a risk to health, insurance or environment, unless expressly permitted by law;
- publicity, information and offers made by any means may be subject to the principles of veracity and objectivity, and must not lead to confusion or error;
- availability of information to consumers by businesses;
- information regarding beneficial conditions for consumers;
- requirements and configuration of the right of withdrawal;
- requirements and configuration of the guarantee over products and post-sale service;
- customer satisfaction and product suitability;
- seller's responsibility;
- civil liability for damage caused to consumers;
- abusive clauses;
- special procedures for sale; and
- information and dissemination on consumption through mass media.

Unfair terms
This law provides a general definition of unfair terms and a catalogue of possible contractual clauses with consumers that may be considered unfair, and therefore, void. Unfair terms are defined as all those that derive from an agreement that have not been individually negotiated, and those practices not expressly permitted that, against the good faith principle obligation, cause prejudice to a consumer and a material imbalance between the rights and obligations of each party to a contract.

Specific protection rules apply to Andorran banks in respect of investment services by means of Law No. 8/2013, which is in line with the provisions of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004, on Markets in Financial Instruments (MiFID I). This regulation aims to maintain and enhance certain ethical and behavioural principles as well as regulate specific practices that are actively combatted internationally.

According to Law No. 8/2013, a retail investor or client is any individual or legal person other than a professional investor or client. In turn, a professional investor is a client that possesses the experience, knowledge and expertise to make its own investment decisions and to properly assess the risk that it incurs.

The Commerce and Consumer Unit is the administrative body responsible for the development, promotion and implementation of policies with the aim of improving the Andorran commercial sector, as well as for protecting consumers' rights.

In addition, according to the Monetary Agreement implementation of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments (MiFID II) and Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No. 648/2012 (MiFIR) is planned for 31 December 2020.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

The main trends regarding legal and regulatory policy will be in accordance with the commitments contained in the Monetary Agreement (eg, capital requirements, payment services, electronic money and financial instruments' market regulations). The Andorran government is working to enact a gradual framework of securities law. Moreover, Andorra is currently negotiating jointly with Monaco and San Marino an association agreement with the European Union whose main objective is the participation of Andorra, Monaco, San Marino and their citizens in the European Single Market, and also to give the possibility to European investors and banking entities to accede to these jurisdictions. However, in order to operate in a level playing field, Andorran economic and financial needs would accelerate the implementation of international standards.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The INAF is the regulatory authority for Andorran banking entities, which performs a supervisory role over Andorran financial entities, in accordance with Law No. 10/2013. Since Andorra is not a member of the European Union, the INAF is not integrated within the framework of the Single Supervisory Mechanism.

In brief, the main objectives of the INAF are:

- to promote and ensure the proper functioning of the Andorran financial system;
- to ensure the stability and reputation of the Andorran financial system and contribute to reducing systemic risk deriving from credit events affecting the Andorran financial entities or their counterparties;
- to provide adequate protection to clients and investors;
- to enhance the competitiveness of Andorra as an international financial hub;
- to reduce the systemic risk deriving from the financial markets; and
- to perform all activities that may be deemed necessary for the exercise of its functions.

INAF-performed supervision aims to protect the public interest rather than to guarantee the individual interests of the supervised entities or the interest of their clients and third parties. It performs supervision on a consolidated basis over:

- entities operating in the Andorran financial system;
- Andorran undertakings of collective investment schemes;
- financial markets located or operating in Andorra or requiring INAF authorisation to operate; and
- those natural or legal persons over whom the INAF may exercise supervisory powers.

The most relevant functions and competences of the INAF that Law No. 10/2013 does not expressly foresee, among others, are:

- to issue technical communications, communications and recommendations in order to develop the regulation and instrumental technical regulations in accordance with Andorran law and also with international standards;
- to supervise, on a consolidated basis, groups of entities operating in the financial system;
- to exercise disciplinary and sanctioning power;
- to examine and manage the claims brought against Andorran banks before it and, possibly, carrying out specific controls if the problem advertised through the claim regards prudential supervision;
- to undertake treasury services for the state and manage the issuance of public debt; and
- to assess the Andorran government on economic and financial policy.

The INAF has discretionary powers to conduct investigations and on-site inspections over Andorran banks and request information from supervised entities, as well as imposing administrative penalties for cases breaching Andorran financial legislation. Such INAF on-site inspections are frequent and are thorough.

In spite of not being a member state of the European Union, article 20 of Law No. 10/2013 foresees the international cooperation with other regulators in addition to INAF IOSCO membership. To this end, there is a memorandum of understanding (MoU) in force between Andorra and Spain, signed on 4 April 2011. The MoU's terms:

- constitute an agreement for consolidated cooperation in the supervisory framework between the INAF and the Bank of Spain;
- establish the terms of the protocol for the relationship and collaboration between both authorities; and
- enable the supervisory authority of the country of origin to request information of consolidated risks of banking groups from the relevant authority of the country where the entity has subsidiaries.

In addition to this MoU, the INAF signed the Multilateral Memorandum of Understanding on Cooperation and Exchange of Information on 17 September 2013, becoming a member of the IOSCO framework.

10 How do the regulatory authorities enforce banking laws and regulations?

As stated in question 9, banking regulation is enforced by the INAF, a body that is entitled to exercise the widest enforcement powers.

INAF enforcement powers facilitate, among others:

- restricting or limiting a bank's business and operations;
- requesting divestment of activities posing excessive risks;
- requiring institutions to limit variable remuneration;
- requesting the use of net profits to strengthen own funds;
- imposing specific liquidity requirements; and
- requesting judicial assistance to undertake its powers.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

In recent years, the principal enforcement issues with relevant implications for the banking sector have been:

- the increase in the default ratio (NPL ratio) of Andorran banks;
- compliance with the anti-money laundering law; and
- the judicial proceedings issued against unfair terms incorporated in consumer contracts.

Nevertheless, the volume and intensity of the three aforementioned enforcement issues in comparison with other jurisdictions has been significantly lower (eg, promotion of preferred shares to retail investors).

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Law No. 8/2015 comprises a set of rules specifically applicable to the restructuring and resolution of banks, in line with the provisions stated in Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD).

Under this law banks may be taken over by the regulatory authorities (INAF or AREB) when they infringe or it is expected that they will infringe in the near future insolvency, organisational or disciplinary regulations.

Once a bank is under one of such situations the INAF can adopt several measures to rectify them. If the situation cannot be rectified, the INAF will have to determine whether the bank is unviable.

If the INAF determines the unviability of the bank, it must communicate that situation to the AREB, which will decide what resolution measures to implement.

Bank intervention and processes of resolution and restructuring are governed by the following principles:
- shareholders will necessarily bear losses in the first place;
- after the shareholders, creditors will bear losses pursuant to the seniority of their credits;
- there will be an equivalent treatment for creditors with the same seniority;
- shareholders and creditors will not bear higher losses than those that would have arisen under an insolvency proceeding;
- the directors may be replaced and shall be responsible for any damage caused to the bank; and
- full protection to guaranteed deposits is provided (see question 4).

The AREB may intervene in a credit institution's business, in order to start its restructuring and, possibly, its resolution process if:
- there is evidence that the bank's situation may damage its stability, liquidity and solvency;
- in a restructuring, the AREB may order the removal or replacement of one or several members of the bank's board of directors, as well as senior management members, if it determines that such members are not eligible to fulfil their obligations in accordance with the mandatory aptitude requirements; or
- right after the opening of a resolution process, the AREB shall dictate the substitution of the whole board of directors. This measure has a limited temporal extent of one year, although it may be extended by the AREB to the extent necessary for the smooth development of the resolution process.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

The role of the bank's management and directors in the framework of a bank failure can be explained by distinguishing the following plans: the action plan (living will), the debt restructuring plan and the reorganisation of activities' plan.

Under Law No. 8/2015, the bank's management must draft an action plan in the case where a bank is already or is foreseeably going to enter an insolvency situation. The plan's objective is to provide measures to restore the bank's position and must be accompanied by a specific implementation schedule.

In addition to this plan, the board of directors must draft a plan in order to negotiate the debt restructuring with part or all of the creditors.

Furthermore, in the event of internal recapitalisation being used as resolution instrument, the AREB will ask the board of directors to draft a plan for the reorganisation of activities. This plan shall contain measures that, in accordance with the economic situation of the bank and the markets in which it operates, are geared towards re-establishing the long-term economic viability of the entity, either all of its activity or a part of it, within a reasonable period of time. This plan must be approved by the AREB, prior to a non-binding consultation with the INAF. The AREB shall also adopt all necessary measures to ensure the fulfilment of the reorganisation plan.

14 Are managers or directors personally liable in the case of a bank failure?

Managers or directors may incur personal liability in the event of a bank failure. Such liability may be civil, criminal or administrative or a combination of all three.

Civil liability implies that the directors may be liable for any damages caused if a causal link between the bank failure and their acting with gross negligence or wilful misconduct is verified.

Criminal liability exists in several cases (eg, false accounting, negligent management of the business and fraudulent transactions prior to commencement of the restructuring process).

From an administrative perspective, infringements are classified in different grades: very serious, serious and minor. The sanctions that may be imposed on the managers or directors in the case of a bank failure and depending on the gravity of the sanction are:
- pecuniary sanctions (from €36,000 to €200,000), which may be imposed on directors in the event of, among other things, obstructing AREB and INAF functions with respect to analysis of the bank's situation;
- removal from the position of director and disqualification from exercising management or directorship activities in the failed entity for five years;
- disqualification from exercising management or directorship activities in any financial or banking entity, and removal, as the case may be, from his or her position as director, for a period of less than 10 years;
- an order for the directors to cease and desist from the prejudicial activity performed against the entity;
- a public reprimand in the Andorran official journal or the website of the sanctioning organisation; or
- a private reprimand.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

Under Law No. 8/2015, the bank's management must draft an action plan in cases where a bank is already or is foreseeably going to enter an insolvency situation. The plan's objective is to provide measures to restore the bank's position and must be accompanied by a specific implementation schedule. Such a plan would include the different foreseen actions with the necessary information needed to conduct such actions, for example:
- detailed information on the strategy required to address the circumstances;
- a description of the arrangements to ensure business operational continuity;
- a description of the financing requirements; and
- the necessary financing sources for implementing the plan's strategy.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Andorran banks are subject to the law regulating the minimum capital adequacy and liquidity ratios, which establishes the general framework for prudential requirements. The minimum percentage of own resources that banking entities have to maintain at all times is the level of own funds necessary to reach a solvency ratio of 10 per cent.

Additionally, without prejudice to the obligations derived from the solvency and liquidity ratio, Andorran banks should have solid, effective and exhaustive strategies and procedures to evaluate and permanently maintain the amount, type and distribution of share capital adequate to cover the nature and the level of risk to which a bank may be exposed. These strategies and procedures must be periodically subject to evaluation. Moreover, Andorran banks must have a minimum share capital of €30 million.

Own resources of banking entities cannot be below 10 per cent, except for the two first exercises of operation, in which only in the case of accumulated losses, can own resources be under 20 per cent, as long as the reduction in capital resources is guaranteed by the entity's shareholders. The INAF has competence to adopt all necessary measures if a bank has insufficient own funds.

Furthermore, the Monetary Agreement established the implementation of the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV) and the Capital Requirements Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (CRR) by 30 September 2017. However, even if these regulations are not yet formally implemented into Andorran law, the INAF is empowered to require their compliance with Andorran banking entities since it views them as international standards.

17 How are the capital adequacy guidelines enforced?

Banks are required to report information quarterly to the INAF in relation to solvency and liquidity ratios. The communication will be made during the first 15 days following the submission date of the quarterly balances. Additionally, the INAF is entitled to demand banks declare their ratio situation at any moment it deems it necessary.

On the basis of such information, the INAF will be able to determine whether a bank is undercapitalised, in which case it will proceed as stated in question 17.

18 What happens in the event that a bank becomes undercapitalised?

Banks that do not comply with the solvency and liquidity ratios are normally required by the INAF to draft a restructuring plan. This plan has to be drafted by the board of directors, determining all the measures that must be taken in order to overcome the problems detected in the framework of an implementation schedule. In addition to this, the drafting of a debt restructuring plan may also be ordered at the INAF's initiative.

If a bank is financially struggling, yet is still in a position to reverse this situation and avoid entering into a resolution process, the INAF may adopt certain preventive measures, among others:

- to require the board of directors to call a general meeting or call on its constitution directly, in order to adopt the corporate resolutions that may be considered necessary;
- to order the cessation or dismiss members of the board of directors or senior managers; or
- to appoint a representative in the bank to monitor the process and assess its effectiveness.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

The AREB may initiate the resolution process if, in spite of the measures mentioned in question 18:

- a bank is not able to fulfil solvency and liquidity ratios, and falls into insolvency or will foreseeably do so;
- there is no likelihood that private-sector measures will be able to prevent the insolvency within a reasonable period of time; and
- for reasons of public interest, it is necessary or convenient to wind up the entity, hence the dissolution or liquidation of a bank by means of bankruptcy proceedings will not reasonably allow the resolution objectives to be fulfilled.

There are several instruments for the resolution of a bank under Law No. 8/2015, which can be individually or jointly applied by the AREB:

- sale of the bank's business;
- transfer of the assets and liabilities to a bridge entity;
- transfer of the assets and liabilities to a management company; or
- the internal recapitalisation of the bank.

However, it is also possible that banks will be subject to ordinary, court-driven insolvency proceedings (ie, under the general framework of the Insolvency Decree, dated 4 October 1969), if after the valuation process the AREB reaches the conclusion that the objectives stated in question 12 will not be fulfilled by the banking resolution process.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

Capital adequacy guidelines are expected to be amended in the near future, in order to align their provisions with bank capital and liquidity provisions stated by CRD IV and CRR, by implementing them into Andorran legislation. However, although the INAF has been anticipating provisions of Basel III framework by means of personalised direct recommendations and communications (note that the regulator has the ability to set as applicable what he or she deems to be an international standard) the provisions of Basel III and the corresponding EU Capital Requirements Regulations (EU) No. 575/2013 have not been homogeneously imposed by the INAF when performing its supervisory activity.

As Basel III provisions have been already phased in by the regulator and IFRS rules were also applicable to 2017 financial statement, the impact on the regulatory Andorran framework should not be particularly relevant.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

The creation or acquisition of entities, with a long-term project and acquiring a 'qualified stake', is subject to the INAF's prior consent and subsequent registration.

A participation is considered as 'qualified' when it reaches, either directly or indirectly, 10 per cent of the capital or voting rights in the participated entity, or regardless of its amount, it enables the holder to exercise 'significant influence'. In turn, 'significant influence' is defined as the power to intervene in the financial and business activity decisions of the entity, without having an absolute or joint control over it (eg, the capacity to appoint or dismiss a director is normally deemed as 'significant influence').

The INAF will deny the consent to the authorisation or the registration if, from the analysis of the documentation, it reaches the conclusion that the act does not adjust to legislation in force or may negatively affect in a significant way the elements that are technical, economical or professional guarantees of the entity or its group. Additionally, prior to granting authorisation for the transaction, the INAF will request a report from the anti-money laundering (AML) authority (UIFAND), which will also examine the transaction and the acquirer.

22 Are there any restrictions on foreign ownership of banks?

There are no general restrictions on foreign ownership of banks. Thus, foreign natural or legal persons may own banks without having to fulfil additional requirements, except for the prior obtention of a foreign investment authorisation granted by the Andorran government.

The request form to the foreign investment authorisation has to identify the investor and explain the details of the business plan to undertake as well as the investment amount.

The Andorran government has up to 45 days to decide whether to grant authorisation. However, if authorisation is not resolved in that period, it is deemed granted.

Moreover, the Andorran government has a safeguarding clause to deny such authorisations to protect the sovereignty, public and economic order, national security, public health or general interest of Andorra.

23 What are the legal and regulatory implications for entities that control banks?

Entities that control banks fall under the supervision of the INAF for prudential purposes; in particular, these entities must comply with the requirements set down in question 24.

Controlling entities and holders of significant stakes are liable to administrative sanctions if they exercise a negative influence over, or otherwise destabilise, the bank in question.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

The entity or individual controlling a bank as a parent company is subject to the suitability requirements that apply to directors of banking entities (ie, business reputation, suitable knowledge and professional experience). Hence, the parent company's proposal for appointing directors must be submitted to, and analysed by, the INAF prior to the appointment of these directors.

Additionally, according to Law No. 10/2013, if the home state regulator of the entity or individual controlling a bank incorporated in Andorra has signed a cooperation agreement for supervision on a consolidated basis with the INAF, the entity or individual shall comply with the following provisions in accordance with the terms of the specific cooperation agreement:

- transmitting all the information required by its home state regulator and, as the case may be, all the information regarding risk management to its parent company; and
- demanding the home state regulator to perform on-site inspections in relation to entities supervised by the INAF and vice versa.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

Law No. 8/2015 expressly establishes that shareholders will be the first to bear the entity's losses, although they will not bear any losses to a higher extent than those accumulated if the entity had been subject to a general insolvency proceeding. Consequently, the loss that may be suffered by a shareholder is limited to its stake in the share capital.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The acquisition of a 'qualified stake' in the capital of an Andorran bank is subject to prior INAF approval and registration. Furthermore, the considerations of the UIFAND, in respect of AML control, will have to be taken into consideration.

'Qualified stake' is defined as the reaching, either directly or indirectly, of 10 per cent of the capital or voting rights in the participated entity or regardless of its amount, a percentage of the share capital that enables the holder to exercise 'significant influence'. In turn, 'significant influence' is defined as the power to intervene in the financial and business activity decisions of the entity, without having an absolute or jointly control over it (eg, the capacity to appoint or dismiss a director is always deemed 'significant influence').

In turn, definition of 'control' includes the following situations:

- a person or entity has the majority of the voting rights;
- a person or entity has the right to appoint or revoke the majority of members of the board of directors, direction or control and at the same time, while being a shareholder or partner of that company;
- a natural or legal person is a shareholder or associated party and has exclusive control, by means of an agreement concluded with other shareholders or associated parties of this bank, over the majority of voting rights of the shareholders or the associated parties; or
- a natural or legal person may exercise or actually exercises a dominant influence or an influence of control.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The INAF is receptive to foreign acquirers. The regulatory process does not differ substantially for a foreign acquirer, except for the requirement for a foreign investment authorisation.

The INAF has accepted the purchase of stakes in Andorran banks by foreign banks, as well as the incorporation of subsidiaries of foreign banks in Andorra. Therefore, the jurisdiction of a foreign acquirer is not an obstacle in itself, as long as the INAF can continuously perform its supervisory and regulatory activity.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The key factors analysed by the INAF in the context of an acquisition of control of an Andorran bank are principally:

- the business reputation of the acquirer and the persons controlling it;
- the capacity of a bank to comply with the applicable regulatory and disciplinary rules stated in Andorran legislation;
- the directors and senior officers of a bank who may be appointed as consequence of taking control, who will have to comply with the suitability requirements of business reputation, experience, knowledge and independence;
- the absence of a significant negative effect on the elements that form the technical, economic and professional guarantees of the entity whose control is acquired;
- absence of a breach of Andorran laws by the acquisition of control of an Andorran bank; and
- the existence of signs that may reasonably lead to suspicion that the transaction is related to money laundering or terrorism financing.

29 Describe the required filings for an acquisition of control of a bank.

The INAF will demand the following information to authorise the acquisition of control of a bank:

- information about the transaction:
  - purpose, price and payment terms;
  - identification of the entity;
  - impact on the distribution of voting rights;
  - transaction financing and the existence of agreements with third parties or other shareholders in relation to the transaction;
  - documentation stating that the technical, economic and professional guarantees of the Andorran bank will not be affected;
  - whether qualified stakes are not in breach of Andorran legislation; and
- information about the acquirer and its controlling persons:
  - a certificate of the general meeting of the foreign entity according the acquisition;
  - the identity of the acquirer and its controlling persons, group structure, structure and members of the management bodies as well as their reputation and experience,

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  - their economic and financial situation;
  - verification or previous links with the acquired bank;
  - evaluations performed by AML bodies; and
- the impact on the bank's economic activity and impact on the Andorran economy:
  - business and strategic plans;
  - changes and structure of the corporate governance structure;
  - internal controls; and
  - AML compliance procedures.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

For both domestic and foreign acquirers, the framework for regulatory approval is the same. Therefore, the INAF should make a decision on the acquisition, accepting or opposing the transaction within 30 business days of submission of the application or, if applicable, from the date of submission of additional information.

The INAF may always choose to oppose an application. The foreign entity may file an administrative appeal against this decision before the competent Andorran courts.

Austria

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

Austrian governmental and regulatory policies for the banking sector primarily aim at maintaining a stable and robust financial system. Transparency and trust in the stability of the banking and financial system are indispensable for the smooth and efficient supply of funds to the corporate, private and public sectors and must be consistently upheld. To this end, the entire financial market must observe a strict rule-based framework.

The main goals of the regulatory framework for the banking sector are:

- increasing transparency, the financial stability and the financial institutions' loss-bearing capacity;
- ensuring the efficient supply of credit to businesses and individuals;
- strengthened harmonisation of bank supervision, securities, insurance and financial conglomerates; and
- requiring better and more effective institutional internal control by the management board.

2 Summarise the primary statutes and regulations that govern the banking industry.

As a member state of the European Union, the development of Austria's banking regulations are extensively connected with EU measures. The key Austrian legislation applicable to credit institutions includes:

- the Banking Act (BWG), including additional regulations (eg, relating to capital requirements, liquidity, ownership, notification duties, etc), provides for the fundamental framework applicable to credit institutions and financial institutions in Austria, including, inter alia, the licensing regime, supervision, capital and liquidity requirements, as well as receivership proceedings and penalties;
- the Payment Service Act (ZaDiG) and the E-Money Act 2010 (E-GeldG) implement the Payment Service Directive (Directive 2007/64/EC) (PSD I) and the Electronic Money Directive (Directive 2009/110/EC). PSD I and the E-Money Act 2010 provide for the licensing and capital requirements for payment and e-money institutions. The revised Payment Service Directive (Directive 2015/2366 (PSD II) entered into force on 12 January 2016 and had to be implemented in national laws by 13 January 2018. In addition, the Interchange Fee Regulation (Regulation (EU) No. 2015/751), which provides for requirements for card-based payment transactions, applies since 9 June 2015;
- the Bank Recovery and Resolution Act (BaSAG) implements the Bank Recovery and Resolution Directive (Directive 2014/59/EU (BRRD) and provides for the obligation of credit institutions to draw up recovery and resolution plans. The implementation of the Single Resolution Mechanism (SRM) at EU-level required a revision of the BASAG in 2015. Most of the amendments entered into force in January 2016 and strengthens the rights and duties of the Austrian Financial Markets Authority (FMA) as the national resolution authority;
- the Securities Supervision Act 2007 (WAG 2007), including additional regulations, provides for licensing of investment service providers, customer protection provisions, disclosure and notification requirements, etc. The Securities Supervision Act 2018 (WAG 2018), which entered into force on 3 January 2018, implements a substantial part of the Markets in Financial Instruments Directive (Directive 2014/65/EU (MiFID II). Further, the amended law ensures that Austrian law is in line with the provisions of the Markets in Financial Instruments Regulation (Regulation (EU) No. 600/2014) (MiFIR), which has applied since 3 January 2018. The Securities Supervision Act 2018 implements organisational and product requirements and increases transparency and information requirements and supervising provisions;
- the Capital Markets Act (KMG), which primarily implements the Prospectus Directive (Directive 2003/71/EC (PD), provides in particular for the prospectus framework relevant to securities offerings and offerings of investments in Austria;
- the Investment Fund Act (InvFG 2011), together with selected provisions of the BWG, is the main legal source governing activities of investment fund management companies;
- the Real Estate Investment Fund Act (ImmoInvFG) regulates the issuance of open-end real estate funds and the activities of investment fund management companies for real estate;
- the Alternative Investment Fund Manager Act (AIFMG) implements the AIFM Directive (Directive 2011/61/EU) and governs the activities of alternative investment fund managers;
- the Stock Exchange Act (BörseG) and the Takeover Act (ÜbG) provide the legal framework relating to listing and trading of securities as well as public takeover offerings. The amended Stock Exchange Act 2018 (BörseG 2018) came into force on 3 January 2018, implements certain MiFID II provisions and introduces the possibility for a legal delisting of publicly traded stock companies from the Official Market, which is now the only regulated market in Austria;
- the Securities Deposit Act (DepotG) regulates the depositing and acquisition of securities;
- the Act on Deposit Guarantee Schemes and Investor Compensation (ESAEG) implements the Directive on Deposit Guarantee Schemes (Directive 2014/49/EU) and regulates the protection of all deposits and credit balances including interest on accounts and savings;
- the Act on the Financial Market Authority (FMABG), including additional regulations, governs the organisation of the FMA, the cooperation with other regulatory authorities and the applicable cost framework;
- the Mortgage Bond Act (PfandbriefG) applies to the issuance of mortgage bonds by credit institutions;
- the Financial Conglomerate Act (FinanzkonglomerateG) contains provisions regarding the additional supervision of financial conglomerates by regulatory authorities;
- specific other laws, inter alia, apply to Sparkassen, Bausparkassen and Hypothekenbanken;
- the Financial Markets Anti-Money Laundering Act (FM-GwG; Finanzmarkt-Geldwäschegesetz), in force since 1 January 2017, implements the revised Anti-Money Laundering Directive (2015/849/EU). Prior to that, anti-money laundering rules were provided in the Banking Act (BankwesenG); and
- the Ultimate Beneficial Owners Register Act (WiEReG) entered into force on 16 September 2017 and 15 January 2018, respectively, and implements the regulatory framework for a register of the ultimate beneficial owners of Austrian corporate and other legal entities.

In addition to Austrian law, certain EU regulations are directly applicable to Austrian credit institutions, including the Capital Requirements Regulation (Regulation No. 575/2013/EU (CRR), which, to a large extent, is based on the Basel III standards issued by the Basel Committee on Banking Supervision. The CRR includes most of the technical provisions governing the prudential supervision of Austrian credit institutions. The EU Funds Transfer Regulation (EU) No. 2015/847 became effective on 26 June 2017 and repealed Regulation (EC) No. 1781/2006. The Money Market Funds Regulation (EU) No. 2017/1131, implemented to strengthen the liquidity and diversity of money market funds, became effective on 14 June 2017.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The European Central Bank (ECB), as the prudential supervisor of banks in the eurozone, the FMA and the Austrian National Bank (OeNB; and together with the FMA, the Austrian regulatory authorities) are the regulatory authorities primarily responsible for overseeing Austrian banks. Since November 2014, banking supervision is shaped by the Single Supervisory Mechanism (SSM) based on the SSM Regulation (Regulation (EU) No. 1024/2013) and the SSM Framework Regulation (Regulation (EU) No. 17/2014). Since then, banking supervision is performed by the ECB having extensive micro- and macroprudential powers. All credit eurozone credit institutions are under the SSM's remit; however, the ECB does not directly supervise all of them. Supervisory tasks and responsibilities are divided between the ECB and the national competent authorities and are allocated on the basis of the significance of the supervised credit institutions. Credit institutions are classified as 'significant' or 'less significant', based on criteria set forth in the SSM Regulation and the SSM Framework Regulation. The ECB directly supervises only the first category comprising approximately 120 credit institutions.

The following Austrian banks (including their subsidiaries or affiliates) are directly supervised by the ECB: Promontoria Sacher Holding NV, Erste Group Bank AG, Volksbank Wien AG, Raiffeisenbankengruppe OÖ Verbund eGen, Raiffeisen Bank International AG, Sberbank Europe AG and VTB Bank (Austria) AG. UniCredit Bank Austria AG and Schoellerbank Aktiengesellschaft, as subsidiaries of UniCredit SpA, Deutsche Bank Österreich AG, as subsidiary of Deutsche Bank AG, Santander Consumer Holding Austria GmbH and Santander Consumer Bank GmbH, as subsidiaries of Banco Santander, SA, Hellobank BNP Paribas Austria AG, as subsidiary of BNP Paribas SA and FCA Bank GmbH, as subsidiary of Crédit Agricole SA, are also supervised by the ECB directly. The day-to-day supervision is conducted by joint supervisory teams (JSTs), comprising staff from both the ECB and the Austrian regulatory authorities.

Less significant banks remain under the supervision of the Austrian regulatory authorities, subject to the oversight of the ECB. The ECB may take on the direct supervision of less significant institutions if required to ensure the consistent application of the high supervisory standards. Austrian regulatory authorities have to report to the ECB on a regular basis about their supervisory activities. Banking supervision in Austria itself has been divided between the FMA and the OeNB since 1 January 2008.

The FMA is responsible for licensing, authorisation, notification and supervisory procedures, supervising intra-bank models, commissioning the OeNB to carry out on-site inspections, monitoring actions taken by credit institutions to remedy shortcomings, collecting and analysing qualitative information, evaluating analysis results with respect to official measures and legislation related to banking supervision, sending departmental representatives to international bodies, supervising branches and representative offices of foreign credit institutions in Austria, as well as cross-border supervision. Furthermore, the FMA is the competent authority with respect to securities supervision.

The OeNB is responsible for the ongoing prudential supervision of credit institutions, including regular inspections as well as ad hoc inspections of credit institutions. Moreover, the OeNB obtains data on other financial intermediaries from the FMA to analyse financial conglomerates and also draws up off-site banking analyses. The OeNB notifies the FMA if the risk situation of a credit institution has changed significantly or if a violation of supervisory provisions by a credit institution is suspected. The OeNB provides the FMA with the findings of its inspections and analyses, which are the basis for official actions by the FMA.

Pursuant to the BWG, the Federal Minister of Finance has to appoint a state commissioner and a deputy state commissioner for each Austrian bank with total assets of more than €1billion to assist in the supervision of such bank. State commissioners ensure that no decisions are taken by the credit institution's shareholder meetings and supervisory board meetings, which, in their view, violate federal laws, regulations or orders by authorities. If the state commissioner objects to any resolution proposed at a credit institution's shareholder meeting or supervisory board meeting, he must notify the FMA immediately. The effectiveness of such resolution is suspended until the FMA has determined the validity of the shareholders' or supervisory board's resolution.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Deposit guarantee schemes are harmonised on a European level. In 1994, the Deposit Guarantee Schemes Directive (Directive 94/19/EC) introduced the obligation to implement deposit guarantee schemes. However, in their national implementations of the Directive, the EU member states introduced significantly different schemes in view of the level of coverage, the scope of covered depositors and products and the pay-out delay.

Under current legislation, any credit institution accepting deposits or providing specific investment services must belong to an investor compensation scheme. Otherwise, the FMA would render a decree declaring the credit institution's licence to be expired. The investor compensation schemes are established within the framework of the respective trade associations. By regulation of the Federal Minister for Economy governing the establishment of these trade associations and specialised groups, credit institutions accepting deposits or providing investment are assigned to one of the five trade associations:

- the Austrian Bankers' Association;
- the Regional Mortgage Banks Association;
- the Rural Credit Cooperatives Association;
- the Savings Banks Association; or
- the Credit Cooperatives' Association according to the Schulze-Delitzsch system.

Each trade association is obliged to maintain an investor compensation scheme that all member institutions accepting deposits or providing investment services may join.

Based on the BWG (section 93 of the BWG):

- deposits and building saving deposits;
- credit balances that result from funds left in an account or from temporary positions in the course of banking transactions, the provision of payment services or the issuance of e-money that the credit institution must repay according to the applicable legal and contractual provisions; and
- any debt evidenced by a certificate issued by a credit institution, with the exception of mortgage bonds, municipal bonds and funded bank bonds of private persons and undertakings are guaranteed in full up to an amount of €100,000.

Additionally, liabilities of a credit institution arising from custody business, trading for one's own account or on behalf of others in certain instruments, third-party securities underwriting or severance and retirement fund business are covered by the investor compensation scheme and guaranteed in full up to €100,000; regarding undertakings, such claims have to be deducted by a deductible of 10 per cent.

In addition to deposit guarantee schemes, several sectors (eg, Sparkassen, Raiffeisen, Volksbanken) established a liability network providing for reciprocal liability of all members of the network for the liabilities of a single member. This liability is in excess of the statutory guaranteed amount of €100,000 and, therefore, offers additional security.

The revised Directive on Deposit Guarantee Schemes (Directive 2014/49/EU) amends the legal framework for the protection of deposits and harmonises the legal situation in Europe. The Deposit Guarantee Schemes and Investor Compensation Act transposed the Directive into national law in August 2015. It provides a single protection scheme instead of five schemes from different trade associations, as is currently the case. On 1 January 2019, a single fund will be established at the Austrian Economic Chambers for deposit protection purposes. Credit institutions will be obliged to pay into the funds in advance, rather than retrospectively, as under current legislation. Payment in advance should guarantee the fund's ability to protect depositors against the consequences of the insolvency of a credit institution.

During the global financial crisis of 2008 and its aftermath, various Austrian banks had to be rescued, or at least supported, by the Austrian government. Kommunalkredit Austria AG, which later demerged into Kommunalkredit Austria AG and KA Finanz AG, and Hypo Alpe Adria International AG were fully taken over by the government. KA Finanz AG and Hypo Alpe Adria International AG (whose wind-down unit is now operating under the name Heta Asset Resolution AG) are bad banks and will be fully liquidated. Kommunalkredit Austria AG was recently privatised. Österreichische Volksbanken AG was restructured in 2015 and split into the bank Volksbank Wien AG and immigon portfolioabbau ag (Immigon). The Austrian government holds a 43.3 per cent stake of Immigon, which is a wind-down unit pursuant to section 162 of the BaSAG.

On 24 May 2016, the European Banking Authority (EBA) published its final guidelines on stress tests of deposit guarantee schemes (DGSs) under Directive 2014/49/EU. The guidelines were published in all official EU languages on 19 October 2016. Competent authorities had to notify the EBA as to whether they comply or intended to comply with these guidelines, or otherwise had to give a well-founded explanation for non-compliance, by 19 December 2016. The guidelines apply since 19 December 2016. They provide the methodological principles to assess whether the operational and funding capabilities of DGSs are sufficient to ensure deposit protection in the event of a bank failure.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Pursuant to section 70a, paragraph 5 of the BWG, the FMA is entitled to supervise the transactions between the credit institutions, superordinate holding companies and its subsidiary undertakings when the parent undertaking of a credit institution is a mixed financial holding company, parent mixed financial holding company or a mixed activity holding company. For this purpose, a mixed financial holding company is a parent undertaking, other than a regulated entity, which together with its subsidiaries, at least one of which is a regulated entity whose head office in the EU, and other entities, constitutes a financial conglomerate. This term is defined in article 4 (21) of the CRR in conjunction with article 2(15) of Directive 2002/87/EC.

Credit institutions must have adequate risk management processes and internal control mechanisms in place, including sound reporting and accounting procedures, so that the credit institution's transactions with the parent undertaking and its subsidiaries can be identified, measured, monitored and controlled appropriately. Intra-group transactions trigger particular reporting obligations towards the FMA. Credit institutions must report all material intra-group transactions, especially loans, guarantees, off-balance sheet transactions, cost-sharing agreements, reinsurance transactions, capital investment transactions and transactions concerning own funds, on at least a quarterly basis. These reporting obligations go beyond the mandatory reports to the Central Credit Register pursuant to section 75 of the BWG. Where intra-group transactions impose a threat to a credit institution's financial position, the FMA can take appropriate measures.

The affiliation of credit institutions requires the conclusion of a contract between the central body and the affiliated credit institutions, the approval of the shareholders' or general meeting of each participating credit institution and amendments of the articles of association. The formation of an affiliation of credit institutions is subject to an application to and an approval by the FMA. The application must be accompanied by documents reflecting in particular the control, monitoring and risk management processes, the ability of the affiliation to permanently comply with the prudential requirements, and other significant information. An affiliation of credit institutions is not a group of credit institutions, which is formed by a superordinate institution and its subsidiaries.

Various provisions of the BWG, for example, relating to licences, freedoms of establishment and to provide services, capital requirements and liquidity, or supervision, are not applicable to affiliated credit institutions. The affiliated credit institutions are subsequently exempt from those notification and reporting duties that are intended exclusively for the monitoring of these provisions.

Under the BWG, financial institutions are authorised to conduct one or more of the following activities for commercial purposes if they are conducted as the institution's main activities:

- conclusion of lease agreements (leasing business);
- provision of advice to undertakings on capital structure, industrial strategy and related questions, as well as advice and services related to mergers and the purchase of undertakings;
- provision of credit reporting services;
- provision of safe deposit services;
- provision of payment services pursuant to section 1, paragraph 2 of the ZaDiG; and
- issuance of e-money pursuant to section 1, paragraph 1 of the E-GeldG.

6 What are the principal regulatory challenges facing the banking industry?

Contributions to the resolution financing arrangements (eg, national resolution funds and the Single Resolution Fund) are a great challenge for the Austria banking industry. The relatively high, and therefore heavily criticised, bank levy of €640 million was reduced in January 2017 to €100 million in exchange for a lump sum of €1 billion. The main goal is to avoid competitive disadvantages.

Other burdens include the rapid development of banking regulations and the resulting necessity for banks to react quickly. Provisions regarding the professional qualifications and necessary experience for operating the credit institution for both the executive and supervisory board of credit institutions have been tightened in recent years (eg, the fit and proper test). The EBA and the European Securities and Markets Authority (ESMA) have published joint guidelines to assess the suitability of members of management bodies and key function holders, which apply as of 30 June 2018. Such enhanced rules strengthen the overall confidence in the financial markets but are also likely to hinder effective governance, especially in smaller banks that cannot find appropriate board members easily. Further, the high number of credit institutions on the small Austrian market and the low margins in Austria may lead to a restructuring of the credit institutions' business strategy, particularly driven by acts of risk minimisation.

In general, credit institutions will face challenges in banking supervision to different extents, based on whether they are designated a significant or a less significant credit institution. Nevertheless, all banks within the eurozone must comply with ECB-issued guidelines and use standardised templates for data collection and information requests, and this may temporarily cause multi-track processes in credit institutions and require organisational changes in a medium to long term perspective.

7 Are banks subject to consumer protection rules?

Banking activities rendered towards consumers are subject to consumer protection rules, most of which are provided for in the Consumer Protection Act (KSchG), the Consumer Credit Act (VKrG) and the Remote Financial Services Act (Fern-FinanzdienstleistungsG). The BWG also provides for consumer protection rules (eg, section 33 of the BWG imposing special provisions for mortgage and real-estate credit contracts like the requirement that employees concerned with offering and concluding such contracts possess an adequate level of knowledge and skill, section 34 of the BWG relating to consumer current account agreements and stipulating that such account agreements must at least contain the annual interest rate applicable to credit balances, apart from the information required under the ZaDiG, and section 37 of the BWG, which provides for specific value dates for money transactions with consumers in connection with savings deposits, credit accounts or current accounts).

In relation to credit agreements and credit transactions and when dealing with consumers as defined in the KSchG, banks must comply with the Consumer Credit Act. In addition, WAG 2018 obliges banks to apply the necessary expertise and diligence for the best interest of their clients when providing investment services (section 47 of WAG 2018).

The Consumer Payment Accounts Act (VZKG), which implements the rules of the Payment Account Directive (2014/92/EU) (PAD), has been applicable since September 2016. The VZKG provides for comparability of fees related to payment accounts, changing of consumer payment accounts and access to consumer payment accounts with basic functions. Apart from regulatory authorities, other organisations (eg, Organisation for Consumer Protection, Chamber of Labour) monitor the conduct of banks towards consumers and make infringements of consumer protections rules public or bring them to court. Recent practices that have drawn intense scrutiny particularly relate to wrong or misleading investment advisory services (eg, shipping funds).

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

We expect that comprehensive legislative changes on a European level will continue and, therefore, will significantly influence the Austrian banking industry in the coming years.

On 30 September 2015, the European Commission published its Capital Markets Union Action Plan (CMU Action Plan), which provides for the establishment of a true single market for capital across all member states. The European Commission intends to support access to finance, to remove barriers to cross-border investments and to lower the costs of funding. The upcoming implementation of various EU Directives will tie up considerable resources in the banking sector. On 30 November 2015, the European Commission (COM (2015) 583 final) proposed to revise prospectus rules to improve access to finance for companies and to simplify information for investors (eg, a prospectus for smaller companies (SMEs), simplifying secondary issuing for listed companies). In June 2017, the European Commission published a mid-term review of the capital markets union action plan, reporting on the progress in implementing the 2015 CMU Action Plan and setting the timeframe for the next round of outstanding measures. The mid-term review updates and complements the original CMU agenda, with some selected new priority measures to respond to evolving challenges. The revised MiFID II with its accompanying MiFIR provides a new legal framework for securities trading, investor protection (including rules on advice and the sale of investment products) and reporting requirements; and strengthens supervisory powers for regulators. In Austria, MiFID II and the implementation measures for MiFIR were implemented in WAG 2018 and, to some extent, BörseG 2018, entering into force on 3 January 2018. In conjunction with MiFID II and MiFIR, delegated acts, guidelines, question and answers and further interpretation guides are published regularly.

PSD II replaced PSD I and had to be transposed into national law by EU member states by 13 January 2018. PSD II extends the scope of application for providers of payment services (eg, new business models known as 'third-party payment service providers') and introduces new rules for liability allocation and transparency requirements. ZaDiG 2018 implementing the revised PSD II is currently going through the legislative procedure. ZaDiG 2018 will implement a broader scope (including account information services and payment initiation services), changes in the exceptions (eg, payment transactions by a provider of electronic communications networks are excluded), high- level clear information, a strong consumer authentication and save communication.

Since 1 January 2016, the application of the SRM has provided for the establishment of a single resolution fund (SRF). The SRM aims to ensure the orderly resolution of failing banks without recourse to taxpayers' money. The SRF will be built up over a period of eight years with ex ante contributions from the banking industry and a target level of at least 1 per cent of the covered deposits of all the credit institutions authorised within EU member states (Austrian's credit institutions contributed €188 million in 2017. The amount of deposits covered by the SRF should be about €50 billion by the end of 2024).

In addition, we expect that Europe-wide cooperation with regard to the supervision of banks will still intensify, particularly between the ECB and the national competent authorities but also closer cooperation among other European institutions and bodies such as the European Systemic Risk Board and the European Banking Authority.

A new provision in the BWG (section 22b) in force since 1 July 2018 provides the FMA with the power to implement additional supervisory measures to control systemic risks in the real estate sector (eg, loan-to-value ratio, debt ratio, debt service ratio).

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Four institutions supervise the financial markets in Austria:

- the ECB supervises banks under the SSM;
- the OeNB monitors the stability of the financial market at a macro level. It is responsible for the supervision of payment systems and is involved in the supervision of banks;
- the FMA monitors and checks the individual financial institutions and participants in the markets (micro level); and
- the Federal Ministry of Finance develops the legislative framework, which is then adopted by the Austrian parliament (legislative process).

The ECB is responsible for banking supervision in the eurozone under the SSM. The ECB cooperates with the FMA and OeNB in performing supervisory tasks. The division of supervisory tasks depends on whether the supervised bank is deemed 'significant' or 'less significant.' This differentiation is based on the size, economic relevance, and scope of cross-border activities of the supervised bank.

The ECB directly supervises significant banks. JSTs, whose size and organisation depends on the nature, complexity, scale, business model and risk profile of the supervised credit institution, carry out the ongoing supervision of these banks. Moreover, JSTs carry out on-site inspections (eg, in-depth risk investigations, risk controls and governance with a pre-defined scope and time frame at the premises of a credit institution). These inspections are risk-based and proportionate. The need for an on-site inspection is determined by the JST in the context of the Supervisory Examination Programmes (SEPs). The scope and frequency of on-site inspections are proposed by the JST, taking into account the overall supervisory strategy, the SEP and the characteristics of the credit institution (eg, size, nature of activities, risk culture). In addition to these planned inspections, ad hoc inspections may be conducted in response to an event or incident that has emerged at a credit institution warranting immediate supervisory action.

The FMA and OeNB directly supervise less significant banks. The FMA remains the authority in charge of taking supervisory decisions concerning less significant banks. The OeNB continues to be responsible for the overall risk assessment.

The Austrian regulatory authorities supervise credit institutions by means of:

- on-site inspections (yearly and ad hoc);
- mandatory information to be submitted on a regular basis (annual reports, regular notification requirements, etc); and
- requests for other information and documents that seem necessary at any time.

The FMA monitors the adequacy of the capital and liquidity available for the quantitative and qualitative coverage of all significant risks arising from banking transactions and banking operations, the systemic risk emanating from a credit institution for the stability of the financial system and the risks as determined on the basis of stress tests. Moreover, the FMA supervises the exposure of credit institutions to the interest rate risk arising from non-trading activities and takes measures when the economic value of a credit institution declines by more than 20 per cent of its own funds as a result of a sudden and unexpected change in interest rates.

The FMA and OeNB jointly define an inspection plan for each calendar year, taking into account inspections of systemically important credit institutions, an appropriate frequency of inspections of institutions that are not systemically important, resources for ad hoc inspections, thematic focuses of inspections, and review of measures taken to remedy the defects identified. The Austrian regulatory authorities regularly publish and update directives and guidelines regarding supervision and how they will approach certain issues. See question 3.

10 How do the regulatory authorities enforce banking laws and regulations?

The FMA is authorised to exclusively enforce banking laws and regulations, including:

- requesting certain kinds of information or documents pursuant to section 70, paragraph 1 of the BWG;
- implementing certain measures pursuant to section 70, paragraphs 2, 4 and 4a of the BWG (eg, prohibition of profit distributions, complete or partial prohibition of the continuation of business operations, imposing additional capital requirements or fines and withdrawal of the banking licence);
- requesting reorganisation measures (receivership or insolvency proceedings) pursuant to section 81 et seq of the BWG;
- collecting penalty interest for violating capital requirements pursuant to section 97 of the BWG; and
- imposing fines owing to administrative offences stipulated in section 98 and 99 of the BWG.

The ECB may impose sanctions on significant banks if regulatory requirements have been breached. The ECB may impose administrative pecuniary penalties on these banks of up to twice the amount of the profits gained, or losses avoided, because of the breach where those can be determined, or up to 10 per cent of the total annual turnover in the preceding business year (article 18 of the SSM regulations).

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

According to the FMA's annual report for 2016, the FMA conducted 68 management talks (the purposes of the meetings is to maintain contact with the management of credit institutions and to examine in greater detail their risk assessment and strategy), and 23 bank audit and early recognition meetings with bank auditors of the auditing associations of the decentralised sectors, issued 26 audit engagements to the OeNB. If there is a risk of a credit institution being unable to fulfil its obligations to creditors and customers, pursuant to section 70, paragraph 2 of the BWG, the FMA may prohibit distributions of capital or profits, appoint a government commissioner, relieve directors of their duties or prohibit the further pursuit of business activities. The FMA was not obliged to order such measures in 2016. But, the FMA ordered 16 credit institutions, under threat of a coercive penalty, to establish compliance with statutory provisions within an appropriate period of time. Furthermore, the FMA once imposed a minimum capital requirement that is higher than the statutory minimum, once enforced an obligation to risk reduction and charged interest pursuant to section 97 of the BWG on four occasions.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

The Financial Market Stability Act entitles the Federal Minister of Finance to take measures for the recapitalisation of credit institutions and insurance undertakings (relevant entities) in order to remedy a considerable disruption within Austria's economy, in order to ensure the macroeconomic balance, and for the protection of Austria's national economy. Apart from monetary measures (eg, assumption of liabilities or provision of facilities and own funds), the Minister of Finance is entitled to acquire shares in a relevant entity and, if performance of a relevant entity's obligations as regards its creditors is jeopardised, may, as a final remedy, take over the relevant entity for reasonable consideration. The shares acquired in accordance with the provisions of the Financial Market Stability Act have to be privatised upon the achievement of the intended purpose, taking into consideration the prevailing market conditions. The Federal Minister of Finance is entitled to set forth further conditions and requirements for the measures specified in the Financial Market Stability Act. In this context, additional conditions and requirements were imposed, in particular, with regard to the following aspects:
- the business focus (the pursuance of sustainable business policies);
- the application of the funds received;
- the remuneration of managers;
- the Tier 1 requirements;
- the dividend policy (payment of dividends only to the extent reasonable in consideration of the profit situation);
- measures for safeguarding jobs;
- measures for the prevention of distortion of competition; and
- the legal consequences of non-compliance with the aforementioned conditions and requirements.

The Austrian government has taken over, or has supported several banks, pursuant to the Financial Market Stability Act (see question 4).

Since 1 January 2015, the BaSAG provides the regulatory authorities with a wide range of powers (eg, the FMA may appoint a temporary administrator in case the replacement of managing directors, members of the supervisory board or members of the senior management (see question 13) is not sufficient to remedy the need for early intervention). This temporary administrator either replaces or acts jointly with the managing directors. Further, the FMA, as resolution authority, is entitled to take over a credit institution when applying the resolution tools or when arranging their application.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

Managing directors of a credit institution are responsible for defining and supervising the internal principles of a proper management to ensure due diligence in managing the credit institution, and for providing for an organisational segregation of duties and the prevention of conflicts of interest. The effectiveness of these principles has to be regularly verified and appropriate steps to correct any deficiencies have to be taken. Managing directors and members of the supervisory board have to observe statutory, regulatory, organisational and capital requirements, as well as specific rules of conduct.

If a credit institution's management and directors consider that their credit institution is failing or likely to fail, they are obliged to notify the FMA pursuant to section 114 of the BaSAG. A credit institution is deemed to be failing or likely to fail in one or more of the following circumstances:
- the credit institution infringes or will infringe the law or the requirements for continuing authorisation in a way that would justify the withdrawal of the banking license;
- the assets are or will be less than the liabilities;
- the credit institution is or will be unable to pay its debts or other liabilities as they fall due; or
- extraordinary public financial support is required.

Further, pursuant to the BaSAG, the FMA (either as regulatory authority or as resolution authority):
- is entitled to demand that a specific or all managing directors, members of the supervisory board or members of the senior management resign or are being replaced in the stage of early intervention; and
- is obliged to do so when applying the resolution tools and exercising the resolution powers.

Pursuant to the BaSAG, every credit institution (in the case of a group, only the superordinate institution, central organisation or central institution) is obliged to draw up a recovery plan and has to provide information for a resolution plan drawn up by the FMA. The FMA reviews the recovery plan and the resolution plan as to mandatory content and compliance with all requirements set by law. In this regard, the FMA also requests an expert opinion from the OeNB. In case of financial problems, the supervisory authorities are entitled to intervene at an early stage and have related additional powers to intervene (see question 18).

14 Are managers or directors personally liable in the case of a bank failure?

Managing directors and members of the supervisory board are subject to the liability scheme of general civil and corporate law. Subsequently, a managing director or a member of the supervisory board can be held liable for the failure of a credit institution, when acting deliberately or without the required diligence (see question 13). If managing directors do not comply with their obligation to notify, pursuant to section 114 of the BaSAG (see question 13), they can be punished with an administrative fine of up to €5 million or up to twice the amount of the benefit derived from the infringement where that benefit can be determined. The BaSAG also threatens this administrative penalty for other violations (eg, information obligations). The company itself can also be held liable for violations of the BaSAG by their managing directors, with an administrative fine of up to 10 per cent of the total annual net turnover in the preceding business year.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

Banks are obliged to produce recovery plans in which they explain what measures they would take if their financial situation were to deteriorate. Planning using the possible financial support of public funds is not allowed. The competent authorities review and assess these recovery plans. If they detect any deficiencies, the credit institution is required to change the recovery plan accordingly. The resolution authorities (FMA) draw up resolution plans in which they describe how an institution can be resolved or restructured in an orderly way. Banks have to provide the resolution authorities with information for the production of resolution plans. If the resolution plans reveal potential obstacles to successful resolution, the institution concerned will be requested to take measures to remove them (eg, by changing its legal or operational structure, selling off certain assets, limiting certain activities). The recovery plan and the resolution plan must be updated at least once a year or, immediately, if a material change to the credit institution's legal or organisational structure, its business activity or its financial position could have an impact on the recovery plan or the resolution plan.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Directive 2013/36/EU (CRD-IV) and the CRR implement the Basel III guidelines and harmonise EU banking supervision.

As to capital requirements, the CRD IV and CRR provide for a change in the structure and quality of own funds. Tier I capital was divided into common equity Tier I capital (CET I capital) and additional Tier I capital. While Tier II capital is still eligible, Tier III capital has been eliminated. Banks must satisfy the requirement of 8 per cent of own funds in relation to the total risk exposure amount, consisting of at least 4.5 per cent CET I capital and 6 per cent Tier I capital. Further, the CRD IV and CRR implemented various capital buffers, such as:

- a capital conservation buffer of 2.5 per cent of CET I capital;
- a countercyclical capital buffer, which is calculated for each bank individually and amounts to up to 2.5 per cent of CET I capital; or
- a systemic risk buffer of up to 2.5 per cent CET I capital.

Also, higher capital requirements for counterparty credit risk exposures arising from derivatives, repos and specific securities financing activities were implemented.

On liquidity requirements, the CRD IV and CRR provides for a harmonised system with regard to quantitative liquidity standards. Regarding liquidity measures, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) are applicable. The LCR is a short-term liquidity measure equal to the ratio of high-quality liquid assets to net cash outflows during a 30-day stress period. The NSFR is based on a long-term horizon, during which available stable funding must exceed required stable funding. Finally, a leverage ratio, calculated as the ratio between Tier I capital and the sum of the exposure values of all assets and off-balance sheet items, was also implemented to improve the system stability.

17 How are the capital adequacy guidelines enforced?

The capital adequacy guidelines are enforced through the ongoing supervision by the Austrian regulatory authorities, in particular through the FMA's authority to enforce banking laws and regulations (see questions 10, 18 and 19). Additionally, credit institutions are obliged to submit certain monthly, quarterly, half-yearly and yearly reports to the Austrian regulatory authorities, especially stating qualitative and quantitative information on their own funds, capital adequacy and the risks they have incurred and their risk-management procedures. Such reports are analysed by the OeNB and the results are provided to the FMA.

18 What happens in the event that a bank becomes undercapitalised?

Credit institutions should have robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of liquidity risk over an appropriate set of time horizons to ensure that credit institutions maintain adequate levels of liquidity buffers. If a credit institution does not comply with the capital and liquidity requirements or appears likely to violate these requirements, the FMA shall intervene.

The specific measures for early intervention by the FMA include:

- the implementation of one or more recovery measures contained in the recovery plan;
- specific improvements of the risk management;
- the convening of a general meeting, particularly to introduce capital measures, or inclusion of certain items on the general meeting's agenda or the proposal to adopt certain decisions; the FMA may also call the general meeting itself, if necessary;
- the preparation of a negotiation plan that provides for a voluntary restructuring of the credit institution's obligations towards its creditors; and
- an on-site inspection by the OeNB to assess the assets and liabilities of the institution.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

Austria implemented the BRRD by adopting the BaSAG. The BaSAG aims to ensure an orderly market exit of banks without causing substantial negative repercussions for financial stability while protecting depositors and other customers. If prevention measures and early intervention prove ineffective, institutions can be resolved instead of undergoing normal insolvency proceedings. These specific resolution tools are available for the resolution authority: sale of businesses, bridge institutions, asset separation and bail-in.

Pursuant to section 49 of the BaSAG, a resolution is only possible under the following circumstances:

- the credit institution is failing or likely to fail;
- no private sector solution is planned;
- the resolution is in the public interest.

If these conditions are not met, the credit institution must be wound up under normal insolvency proceedings.

Either the credit institution that is over-indebted or insolvent itself, or the FMA may request receivership from the competent court if it appears likely that the credit institution's over-indebtedness or insolvency can be remedied. Receivership can only be granted for one year and has various specific consequences determined in section 83 et seq of the BWG. During the receivership, with regard to liabilities established prior to the arrangement of receivership and being subject to statutory deferment of payment, neither insolvency proceedings over the assets of the credit institution can be initiated nor can a court-ordered lien or right to satisfaction be obtained. The receivership ends by order of the court or opening of insolvency proceedings.

In general, only the FMA may file for the opening of insolvency proceedings. During receivership, only the receiver may file such a request. The substantive insolvency requirements are determined according to section 66 et seq of the Insolvency Act (IO). The court must consult the FMA before appointing or dismissing a receiver or a liquidator. The insolvency proceedings follow the IO, with the exception that recapitalisation proceedings cannot be initiated.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

The most recent changes of capital adequacy guidelines relate to the CRD IV and CRR and its implementation in the BWG. CRD IV and CRR provide for the adoption of a large number of delegated and implementing acts in order to give full effect to the single banking rule book. These acts will specify the detail of how competent authorities and institutions should comply with the obligations laid down in CRD IV and CRR.

At the end of 2016, the European Commission published the 'CRR Review Package' with changes of CRD IV, CRR and BRRD. The changes concern:

- equity requirements (eg, a binding 3 per cent leverage ratio, binding detailed net stable funding ratio, requirement to have more

Update and trends

EMIR: Clearing Obligation for Interest Rate Swaps Set

The European Markets Infrastructure Regulation (Regulation (EU) No. 648/2012 (EMIR) introduced a mechanism for a legal obligation to clear certain classes of over-the-counter derivatives (OTC) through clearing houses, also referred to as central counterparties (CCPs). The ESMA has determined that certain interest rate swaps classes fulfil the criteria of standardisation, having sufficient volume, liquidity and pricing information, and so should be subject to mandatory clearing. The obligation for central clearing of OTC derivatives under EMIR applied since June 2016. The clearing obligation covers the following class of OTC interest rate derivatives denominated in the following currencies:

- fixed-to-float interest rate swaps (also known as plain vanilla) for the euro, pound sterling, Japanese yen and US dollar;
- float-to-float swaps (also known as basis swaps) for the euro, pound sterling, Japanese yen and US dollar;
- forward rate agreements for the euro, pound sterling, Japanese yen and US dollar; and
- overnight index swaps for the euro, pound sterling and US dollar.

The central clearing of interest rate swaps became obligatory for firms in Category 1 on 21 June 2016. The firms deemed as falling in Category 2 followed on 21 December 2016, while those falling in Category 3 had to follow the rules since 21 June 2017. Finally, Category 4 firms, which are non-financial counterparties whose OTC portfolios exceed an asset-specific threshold, will have to clear their trades from 21 December 2018.

In May 2017 the European Commission proposed a first set of amendments to EMIR. These amendments will introduce simpler and more proportionate rules on OTC derivatives that will reduce costs and burdens for market participants, without compromising financial stability. In June 2017, the Commission proposed a second set of amendments to EMIR to enhance the supervision of third-country CCPs and make the supervision of EU CCPs more coherent.

Analytical credit datasets (AnaCredit)

On 18 May 2016, the Governing Council of the ECB adopted the Regulation on the collection of granular credit and credit risk data (Regulation (EU) No. 2016/867/EU of the ECB, 'AnaCredit'). AnaCredit is a project to set up a dataset containing detailed information on individual bank loans in the euro area, harmonised across all EU member states. The Regulation sets out the reporting requirements and defines the reporting population. The reporting is mandatory beginning from September 2018.

European Deposit Insurance System (EDIS)

In October 2017, the European Commission published a communication for completing the Banking Union by 2018, in particular with regard to an EDIS. In November 2015, the European Commission put forward a legislative proposal to establish an EDIS that would complement existing national deposit guarantee schemes. In October 2017, the European Commission suggested discussions to introduce EDIS more gradually compared with the original proposal of November 2015. There would be only two phases: in the more limited reinsurance phase, EDIS would provide liquidity to national DGS's in case of a bank failure, which would have to be paid back by the national DGS. And then in the coinsurance phase, EDIS would also cover losses, without recouping them from the national DGS (through a single fund).

risk-sensitive own funds for institutions that trade in securities and derivatives, following Basel's work on the 'fundamental review of the trading book', Tier II add-ons, liquidity and capital waivers);

- recovery (eg, implementation of new standards on the total loss-absorbing capacity of global systemically important institutions, Minimum Requirement for own funds and Eligible Liabilities); and
- proportionality.

Currently, the proposals are being discussed within the European Council and the European Parliament.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

There is no limit to the type of entities and individuals that may own a controlling interest in a credit institution or a financial institution. The FMA, however, may prohibit an acquisition of a qualifying holding in case specific criteria are not met (see question 26).

The BWG, in connection with the CRR, distinguishes between:

- participation means the ownership, direct or indirect, of 20 per cent or more of the voting rights or capital;
- qualifying holding means a direct or indirect holding, which represents 10 per cent or more of the capital or voting rights or entitling to exercise a significant influence;
- control means the relationship between a parent undertaking and a subsidiary or a similar relationship between any natural or legal person and undertaking; and
- close links means a situation in which two or more natural or legal persons are linked (eg, by participation of ownership or via a third party).

A qualifying holding is already sufficient to trigger notification requirements (see question 26).

22 Are there any restrictions on foreign ownership of banks?

Foreign ownership of an Austrian bank is neither prohibited nor restricted under Austrian law. Nevertheless, the FMA may prohibit the acquisition or increase of a qualifying holding after examination of the necessary criteria (see questions 26, 27 and 29).

23 What are the legal and regulatory implications for entities that control banks?

In case the influence exercised by the entity having a qualifying holding imposes a risk for the sound and prudent management of the credit institution, the FMA must take required measures, including:

- prohibition of profit distributions, appointment of a government commissioner, completely or partly prohibition of the continuation of business operations, etc;
- sanctions completely or partly prohibiting the directors to manage the credit institution; or
- submission of a motion with the competent court to suspend the voting rights controlled by entity in question during the risk prevails or until the shares are purchased by a third party (see question 26).

Depending on its legal form, an entity having a qualified holding in a credit institution may become subject to consolidated group supervision, including group financial statement requirements.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

Any person controlling a credit institution shall, in particular:

- notify the FMA of any intention to increase, sell or reduce the holding in a way that it exceeds, reaches or falls below certain thresholds (see question 26);
- make available information and documents that the FMA needs to fulfil its duties; and
- not prevent effective and efficient supervision by the Austrian regulatory authorities.

Transactions between a credit institution and its shareholder or other entities controlled by the shareholder have to be at arm's length in order to avoid breaches of Austrian capital maintenance rules. Transactions between the credit institution and certain individuals or entities (eg, managing directors, members of the supervisory board and board members of controlling or controlled entities) require unanimous resolution by all managing directors and are subject to the consent of the supervisory board or any other supervisory body competent according to applicable law or the articles of association.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

Under Austrian law, a credit institution may only be established in the legal form of a corporation, a cooperative society or a savings bank. In general, only cooperation members of a credit institution organised as cooperative society may be held liable for the liabilities of the institution in case of insolvency.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The current intention to directly or indirectly hold a qualifying holding (ie, 10 per cent of the voting rights or capital) in a credit institution, or to increase such a qualifying holding in order to reach or exceed the thresholds of 20 per cent, 30 per cent or 50 per cent of the voting rights or capital, or in such a way that the credit institution becomes a subsidiary of that party, must be pre-notified to the FMA (see question 29). To ensure the sound and prudent management of the credit institution in which an acquisition is proposed, and having regard to the likely influence of the potential acquirer on the credit institution, the FMA shall appraise the suitability of the proposed acquirer and the financial soundness of the proposed acquisition based on the following criteria:

- the reliability of the potential acquirer;
- the reliability, professional qualification and experience of any person who will direct the business of the credit institution as a result of the proposed acquisition;
- the financial soundness of the potential acquirer, in particular in relation to the type of business pursued and envisaged by the credit institution;
- whether the credit institution will be able to comply and continue to comply with regulatory requirements, in particular, whether the group it will become a part of has a structure that may jeopardise effective supervision; and
- whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing within the meaning of article 1 of Directive 2015/849/EU is being or has been committed or attempted, or that the potential acquisition could increase such risk.

Based on this appraisement, the FMA prepares a draft decision for the ECB to oppose or not to oppose the acquisition. The ECB decides on the basis of the appraisement and the FMA's draft decision. If the ECB does not prohibit the intended acquisition within 60 days after the FMA received the notification, the acquisition shall be deemed approved. If an application is to be rejected or additional conditions need to be imposed, it will become subject to a hearing procedure.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

In principle, there is no difference in the regulatory process for a foreign acquirer. If the FMA requests additional documents from a non-European Economic Area proposed acquirer or a proposed acquirer not subject to supervision under Directives 2013/36/EU, 2009/65/EC, 2009/138/EC or 2014/65/EU, the 60-day period can be suspended for up to 30 days (see questions 26, 29 and 30).

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The FMA will review and assess all information provided by the proposed acquirer in connection with the notification, focusing on the criteria set by law (see questions 26 and 29).

29 Describe the required filings for an acquisition of control of a bank.

Specific information to be filed is provided for in the Ownership Control Regulation, including information about:

- the identity of the proposed acquirer, bylaws, management board, economic beneficiaries, etc;
- the reliability of the acquirer with regard to criminal or administrative offences, insolvency proceedings, etc;
- the participations with a group of companies as well as other possible ways to exercise influence;
- the relevant business relationships, family ties or other relevant relationships, as well as acquisition interests;
- the financial situation and credit standing of the acquirer;
- the funding of the intended acquisition, including disclosure of all relevant agreements; and
- the business plan, including a description of strategic objectives and plans, if the acquirer gains control.

If the bank is an Austrian stock exchange listed entity, an acquirer must also comply with the provisions of the BörseG and the Takeover Act (eg, filing and notification obligations, mandatory takeover bid, etc).

Similar requirements must be fulfilled if the proposed acquirer intends to acquire a qualified holding in an insurance company pursuant, an investment firm, an investment service provider or a payment institution.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

In order to acquire a qualifying holding, the FMA has to confirm the receipt of the notification within two working days. Within five working days after the acknowledgement of the receipt, the FMA notifies the ECB of the intended acquisition. The FMA verifies the completeness of the application and prepares its draft decision for the ECB at least 15 working days before the expiry of the assessment period of 60 days (see question 26). The authorities have 60 days to examine the intended acquisition and to prohibit it. With regard to the FMA requesting additional documents, the 60-day period is extended for up to 20 days (in some cases up to 30 days). If the ECB does not prohibit the acquisition within 60 days (or 80 or 90 days), the acquisition shall be deemed approved.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

Canada has a centrally regulated banking system with a focus on macroprudential regulation and stability of the financial system. The Bank Act, the principal federal statute governing all aspects of banking, indicates its main purposes as:

- fostering a strong and efficient banking sector comprising competitive and resilient institutions;
- protecting the interests of depositors and consumers; and
- maintaining stability and public confidence in the financial system.

The Bank of Canada (the central bank) exercises a monetary policy focusing on an inflation-control target of around 2 per cent and a policy of non-intervention in a flexible foreign exchange rate.

Canada is a strong supporter of the Financial Stability Board (FSB) and has been a leading jurisdiction in the adoption of the Basel III international regulatory framework. The Office of the Superintendent of Financial Institutions (OSFI), Canada's primary bank regulator, introduced revised capital adequacy requirements in 2011, which came into effect in 2013. More recently, further revisions to the Capital Adequacy Requirements Guideline came into effect for banking institution's as of their 2018 fiscal year. The revised guideline accommodates for the changes in the capital treatment of allowances under the new International Financial Standard Reporting 9 (IFRS 9). The thrust of Canadian banking regulation is guided by principles-based regulation as opposed to bright-line rule making. The OSFI has issued guidelines on:

- capital adequacy;
- prudential limits;
- accounting and disclosure; and
- sound business and financial practices that are considered 'best' or 'prudent' practices for banks and set industry standards for the financial services sector as a whole.

To ensure the safety and protection of the Canadian banking system, Canada also imposes a public ownership requirement on banks, requiring large domestic banks to be 'widely held' by the public and listed on a prominent Canadian stock exchange and medium-sized domestic banks to be at least 35 per cent publicly owned and listed. Similarly, Canadian banks are prohibited from engaging in any business other than the 'business of banking' through various ownership restrictions resulting in a separation between banking, insurance, auto leasing and securities dealing sectors of the economy. The 'business of banking' includes:

- providing financial services;
- acting as a financial agent;
- providing investment counselling services and portfolio management services; and
- issuing and operating payment, credit or charge cards.

As of November 2017, there were 32 domestic banks, 21 foreign banks and 32 foreign bank branches operating in Canada. There were also 20 foreign bank representative offices established, giving presence to the banking companies of their home nations. Additionally, OSFI has designated Canada's six largest banks: Royal Bank of Canada, Toronto-Dominion Bank, Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce and National Bank of Canada, as domestic systemically important banks (D-SIBs). In November 2017, the FSB further designated Royal Bank of Canada as a global systemically important bank (G-SIB).

2 Summarise the primary statutes and regulations that govern the banking industry.

Regulation of the banking industry falls under the exclusive jurisdiction of the federal government. Although provincial governments have jurisdiction to incorporate and regulate certain deposit-taking institutions, such as credit unions, only a financial institution incorporated under the Bank Act can conduct business as a 'bank' in Canada.

The Bank Act regulates domestic banks (listed on Schedule I of the Bank Act), foreign subsidiary banks that are controlled by eligible foreign institutions (Schedule II) and bank branches of foreign institutions (Schedule III). The Bank Act regulates, inter alia, the ownership, capital and corporate governance structures of banks, prohibits certain business undertakings and associations, prescribes capital and liquidity adequacy requirements, and regulates consumer disclosure, transparency and record-keeping.

The Bank Act also contains a sunset clause that provides for a statutory review and update of the Bank Act every five years. New legislation tabling the Bank Act together with any proposed amendments was originally scheduled to be brought into force by March 2017. However, the Canadian government has extended the statutory sunset date by two years, until 29 March 2019. In August 2017, the Department of Finance published a consultation paper setting out four central themes in relation to its review:

- supporting a competitive and innovative sector;
- improving the protection of bank consumers
- modernising the framework; and
- safeguarding a stable and resilient sector.

The Bank Act is also supplemented by numerous regulations that set out various banking requirements, regarding, for example, the disclosure of charges and interest on banking services, the cost of borrowing for loans under a credit agreement and notice of uninsured deposits. OSFI publishes guidelines and advisories to provide more guidance and clarity for participants.

The Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA) also forms an important part of the Canadian regulatory landscape for banks.

Most recently, the Budget Implementation Act, 2017, No. 1 introduced three additional measures to the Canada Deposit Insurance Corporation Act (CDIC Act) and the Bank Act:

- the purpose of the CDIC Act is to be the resolution authority for member institutions;
- D-SIBs have to develop, submit and maintain resolution plans; and
- both acts will aim to provide OSFI with greater flexibility in setting the requirements for the D-SIBs to maintain a minimum capacity to absorb losses.

These additions follow the recent 2016 Budget Implementation Act's legislative framework for a bail-in regime for Canada's D-SIBs. This regime is intended to protect Canadian taxpayers in the unlikely event of a large bank failure by reinforcing that bank shareholders and creditors are responsible for the bank's risks by converting the bank's eligible long-term debt into common shares to recapitalise the bank. Regulations and guidelines setting out further features of the bail-in regime are being developed for consultation.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The federal government enacted the Office of the Superintendent of Financial Institutions Act, which established OSFI as the primary regulator of banks in Canada. OSFI administers the Bank Act and supervises banks in accordance with its published Supervisory Framework, which involves assessing the safety and soundness of banks, providing feedback and intervening when necessary. Under the Supervisory Framework, OSFI's primary supervisory goal is to safeguard depositors against loss. As such, OSFI focuses on material risks to banks on a consolidated basis, which involves an assessment of all of a bank's material entities (including subsidiaries, branches and joint ventures), both in Canada and internationally.

Where OSFI identifies issues that may impact the stability of the financial system, it reports those issues to the Financial Institutions Supervisory Committee (FISC). The FISC comprises representatives from the federal Department of Finance, the Bank of Canada, OSFI, the Canada Deposit Insurance Corporation (CDIC) and the Financial Consumer Agency of Canada (FCAC). The FISC meets regularly to share information, coordinate actions and advise the federal government on financial system issues.

The FCAC is an independent agency of the government of Canada and is responsible for, inter alia:
- supervising and monitoring compliance with federal consumer protection measures;
- promoting the adoption by financial institutions of policies and procedures designed to implement voluntary codes of conduct designed to protect the interests of their customers;
- monitoring the implementation of voluntary codes of conduct that have been adopted by financial institutions;
- promoting consumer awareness about the obligations of financial institutions and of external complaints bodies under consumer provisions applicable to them;
- fostering, in cooperation with other government departments and participants, an understanding of issues relating to financial services;
- monitoring trends and issues that may affect consumers of financial products and services; and
- collaborating its activities with stakeholders to strengthen the financial literacy of Canadians.

Also, the FCAC is similarly responsible for supervising payment card network operators.

The CDIC, a Canadian federal Crown corporation, insures eligible deposits held at member financial institutions to protect consumers in the event of a bank failure.

Additionally, the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), Canada's financial intelligence unit, oversees compliance with the PCMLTFA and its regulations. FINTRAC's mandate is to facilitate the detection, prevention and deterrence of money laundering and the financing of terrorist activities. As such, FINTRAC requires all banks and certain other entities to keep and retain prescribed records, to submit reports for certain types of transactions, to take specific steps to identify prescribed individuals or entities, and to implement a compliance programme.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The CDIC insures eligible deposits up to C$100,000 (principal and interest combined) per depositor, per institution. To qualify as an eligible deposit, the deposited funds must be in Canadian dollars and payable in Canadian currency. Eligible deposits include:
- savings and chequing accounts;
- term deposits repayable no more than five years after the date of deposit;
- accounts holding funds to pay realty taxes on mortgaged properties;
- money orders;
- bank drafts; and
- certified cheques; and
- travellers' cheques issued by a member institution.

The CDIC does not protect against fraud or theft and does not insure most:
- debentures;
- treasury bills;
- investments in mortgages;
- stocks;
- bonds; or
- mutual funds.

As of 1 February 2017, 81 financial institutions, including 45 banks, are CDIC members. CDIC members fund CDIC deposit insurance through premiums paid on the insured deposits they hold. CDIC members are required to display CDIC signage, file annual returns and comply with additional member requirements set out in the CDIC Act, the Financial Administration Act and the CDIC by-laws.

Neither the federal government nor any provincial government has taken any ownership interest in banks or other financial institutions.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Subject to certain limited exceptions under the Bank Act, a bank cannot enter into any transactions with a related party, including providing a guarantee on behalf of a related party, making an investment in the securities of a related party, assuming a loan owed by the related party or taking a security interest in the securities of a related party.

A related party includes:
- a person holding a 'significant interest' in the bank;
- an entity in which the person who controls the bank has a significant investment;
- directors or senior officers of the bank or a bank holding company; and
- the spouse, common-law partner or child under 18 years of age of any of the foregoing persons.

Federally regulated banks are prohibited from engaging in any business other than the business of banking and any business that generally belongs to it, except as specifically permitted under the Bank Act.

The business of banking includes:
- the provision of financial services;
- investment counselling and portfolio management;
- acting as financial agent; and
- issuing of payment and credit cards.

Also, a Canadian bank or a major shareholder or parent of a Canadian bank may not hold a substantial investment in entities engaging in:
- fiduciary activities (unless such subsidiary is a federally registered trust company);
- certain restricted securities activities;
- restricted leasing activities (such as automobile leasing);
- restricted residential mortgage activities (such as high loan-to-value mortgages); or
- certain insurance activities.

Foreign governments and agencies or entities controlled by them (other than foreign banks) cannot incorporate a bank in Canada or acquire a significant ownership interest in a Canadian bank.

6 What are the principal regulatory challenges facing the banking industry?

The primary regulatory challenge facing the Canadian banking industry is OSFI's implementation of the Basel III capital and liquidity requirements and the systems, administration and accounting changes that result from the imposition of these requirements.

Canadian banks are also affected by regulatory changes taking place in the United States, both as a result of conducting a considerable amount of business in the United States but also because of the potential extraterritorial reach of certain US laws. The Volcker Rule and its related set of US laws have meant that large Canadian banks with US subsidiaries have to deal with two very different regulatory environments on cross-border and transnational business lines.

Similarly, the recent adoption of the Foreign Account Tax Compliance Act (FATCA) in the US has been a cause for concern for Canadian banks. On 5 February 2014, Canada and the US entered into the Intergovernmental Agreement for the Enhanced Exchange of Tax Information under the Canada – US Tax Convention to implement FATCA in Canada, which came into force on 27 June 2014. Under this Intergovernmental Agreement, information related to US residents and citizens is reported to the Canada Revenue Agency rather than directly to the United States' Internal Revenue Service in compliance with Canadian privacy laws. Furthermore, certain provisions of FATCA are not applicable to Canada, including the withholding tax, and certain accounts are exempt from reporting requirements.

Moreover, Canada's prolonged period of low interest rates, paired with concerns over a stable and secure housing market, have prompted OSFI to revise the capital requirements for loans secured by residential real property. Canada's Minister of Finance has also announced that the minimum down payment required for insured residential mortgages for house prices over C$500,000 will be increased to 10 per cent, from the current 5 per cent. The 10 per cent requirement only applies to the portion of house price exceeding C$500,000.

Recently, OSFI has prioritised attention to cybersecurity and outsourcing risks, which in part are aimed at the rise of fintech. Fintech is likely one of the greatest regulatory challenges currently facing the banking industry as innovation in technology and its application to the financial industry can often outpace regulatory developments. Regulators are facing the challenge of balancing the need to ensure the safety and soundness of the financial markets against the need to encourage further innovation that will allow Canadian fintech businesses to become global competitors.

7 Are banks subject to consumer protection rules?

FCAC is a federal government agency responsible for ensuring financial entities comply with consumer protection provisions in various federal acts including:

- the Bank Act;
- the Insurance Companies Act;
- the Trust and Loan Companies Act;
- the Cooperative Credit Associations Act;
- the Green Shield Canada Act;
- the Payment Card Networks Act; and
- the Financial Consumer Agency of Canada Act.

FCAC addresses consumer protection issues that arise from time to time. In 2016–17, FCAC reimbursed C$10.5 million to 1.2 million consumer accounts for issues relating to credit card statement disclosures, improper account changes, and inaccurate fees calculations.

In a 2014 landmark decision, *Bank of Montreal v Marcotte*, the Supreme Court of Canada held that consumer protection legislation applied to federally regulated bank credit card issuers. The decision indicates that in some circumstances provincial consumer protection law may apply to federally regulated financial institutions. The impact of the decision is that federally regulated financial institutions may need to consider both provincial and federal consumer protection laws.

In the emerging realm of fintech, such companies are revolutionising consumer banking and payments through alternative credit models that link lenders and borrowers directly and cut out the heavily regulated middlemen. With fintech's rapid growth, regulators are faced with the challenge of protecting consumers without stifling the innovations that consumers desire.

In April 2017, FCAC released a new Supervision Framework, which is expected to replace the current Compliance Framework in 2018. Although the core activities governing the FCAC's supervisory approach remain consistent, numerous enhancements have been incorporated into the new framework.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

The Canadian banking regulatory landscape will continue to evolve towards more principles-based regulation and oversight of individual banking institutions, and the banking industry as a whole. Regulatory policy resulting from OSFI's ongoing implementation of Basel III and increased attention to corporate governance will continue to develop over the next few years.

Financial institutions are adjusting to the increased regulatory burdens that have been imposed in recent years as a result of the implementation of Basel III. This includes more onerous liquidity requirements and leverage requirements and the implementation of the forward-looking accounting method, the IFRS 9, for D-SIBs. Increased focus on anti-money laundering and terrorist financing will likely place greater assessment and mitigation responsibilities on individual banking institutions. OSFI has indicated that operational risk management will become part of its ongoing supervisory activities and has published draft operational risk management guidelines that will require certain financial institutions to establish and maintain an enterprise-wide framework of controls for operational risk management.

As fintech becomes increasingly ubiquitous, it is anticipated that regulations specific to fintech will develop in relation to online payment methods, anti-money laundering regimes and crypto-currencies. For example, the Bank of Canada recently released a whitepaper on the merits of issuing its own national crypto-currency, and what the implications would be on traditional macroeconomic policies.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

OSFI requires disclosure from all federally regulated banks on a monthly, quarterly and annual basis. For example, banks must:

- file consolidated balance sheets, deposit liabilities and interbank exposures as at the last day of each month;
- income statements, statements of mortgage loans and non-mortgage loans, and a statement of retail portfolio on a quarterly basis; and
- an impairment charge filing on an annual basis.

Additionally, the Bank Act requires OSFI to conduct an examination of every bank on an annual basis to determine compliance with regulations and assess its financial condition.

In 2015–2016, high levels of domestic household indebtedness, low interest rates, sustained low oil prices and ongoing global financial uncertainty continued to be seen as sources of potential systemic vulnerability. OSFI took action to address the possible impact of these challenges and achieve its strategic priorities by communicating its expectations for risk management to federally regulated financial institutions and by conducting significant reviews in several areas, including:

- corporate and commercial lending;
- retail lending;
- outsourcing;
- cyber-risk;
- risk management; and
- compliance.

In 2016, OSFI conducted a standardised stress test on reinsurance related risks, and with the Bank of Canada, conducted a macro stress test with D-SIBS that explored severe but plausible scenarios and associated system impacts. In 2018, OSFI implemented changes to mortgage underwriting standards, creating a stress test for borrowers making a down payment exceeding 20 per cent. This will require banks to increase their loan-to-value ratios, which will be strictly enforced by OSFI.

10 How do the regulatory authorities enforce banking laws and regulations?

The Bank Act contains penalty and sanction provisions that can be exercised by OSFI. In practice, however, OSFI does not generally exercise these penal powers and instead relies on other mechanisms such as requiring binding compliance agreements or issuing compliance directives. In addition, the FCAC and CDIC also have limited enforcement powers (see question 7). CDIC has the authority to be appointed as a receiver over a troubled member bank with significant CDIC-insured deposits, but this power has not been exercised in the past decade.

OSFI has a four-stage intervention framework that enables OSFI and, where appropriate, CDIC, to work collaboratively with a bank to develop a process to bring the bank into full compliance with regulations or improve the bank's financial viability.

- stage one entails an early-warning system whereby senior management may be required to meet with OSFI (which may involve site visits by OSFI), and OSFI may issue public supervisory letters calling on the bank to undertake certain measures;
- stage two entails OSFI possibly requiring mandatory implementation of corrective measures and increasing its monitoring of the bank. OSFI may also engage an auditor to undertake an external audit of the procedures, processes and reporting mechanisms of the bank;
- stage three anticipates a future failure of the bank and involves assessing asset quality, full-time on-site monitoring and enhanced planning for full regulatory administration of the bank; and
- stage four denotes that the bank is no longer viable. OSFI will take over the affairs of the bank and commence restructuring under the Winding-Up and Restructuring Act (WURA), which likely results in the sale of assets of the bank to another institution approved by federal government.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

Based on the information released by OSFI, FINTRAC and the FCAC, there are no recurring regulatory compliance issues or common enforcement measures related to the banking industry in Canada. Supervisory and regulatory bodies rarely initiate enforcement action with the exception of consumer protection issues (see question 7).

In 2014, OSFI released a Guideline on the regulation of the benchmarking of CDOR (the Canadian Dollar Offered Rate – the Canadian equivalent of the London Inter-bank Offered Rate). The Guideline states that it is in furtherance of OSFI's work with banks to meet international standards. The Guideline is intended to complement OSFI's Corporate Governance Guideline and Supervisory Framework as well as OSFI's general principles-based approach. OSFI requires:

- adequate governance controls;
- annual reports by senior management to the bank's board of directors;
- independence between oversight functions and operational management; and
- timely disclosure of material breaches in the submission process to senior management and the board.

Banks are expected to include CDOR submission process compliance in their annual audit plans. OSFI will review banks' CDOR submission controls, may require copies of any related reports and may discuss findings with senior management, the board and the oversight functions.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

While the government is under no legal obligation to take over a failing bank, there is a widely held assumption that the government would not permit a large Canadian bank to fail because of the negative impact on the greater Canadian economy. Banks may be taken over by OSFI or the CDIC in cases of insolvency or regulatory non-compliance. OSFI's four-stage intervention process (see question 10) and the establishment by CDIC of a 'bridge-bank' are tools that these regulatory authorities may use to take over a bank.

Bank failures are rare in Canada and consequently, government or regulatory authority intervention by way of bank takeover is also rare. However, on 10 February 2016, OSFI temporarily took control of the Canadian branch of Maple Bank GmbH in an effort to preserve the value of the assets at the branch after German regulators suspended the bank's activities. Shortly thereafter, OSFI made a request to the Attorney General of Canada to apply for a winding-up order, which was subsequently granted by the Ontario Superior Court of Justice.

The Bank of Canada and the Canada Mortgage and Housing Corporation provided liquidity support during the global financial crisis, including short-term loans, purchasing mortgage-backed securities and providing guarantees for Canadian banks. The government was not, however, required to intervene in the Canadian banking industry to the extent witnessed in other jurisdictions, nor did the government take an equity stake in any Canadian bank during the crisis.

Canadian banking regulation is strongly focused around the protection of depositors. This is demonstrated by CDIC's insuring of a depositor's first C$100,000 of eligible funds in a given bank. OSFI tightened its capital requirements after the financial crisis to better protect depositors by providing additional funds in a bank crisis scenario, including requiring the inclusion of non-viability contingent capital provisions in non-common share capital instruments.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

If OSFI takes control of a bank pursuant to the four-stage intervention process (see question 10), directors' legal roles are suspended until either the period of control expires or a winding-up is requested. Once a liquidator is appointed by the court pursuant to a bank's winding-up proceedings, the directors' powers are vested in the liquidator.

Currently, banks are not required to have a resolution or 'living will' plan that sets out the protocol for a failure or recovery following a failure, but OSFI and the CDIC have been working with financial institutions to implement such plans from a prudential standpoint. However, D-SIBs are required to establish a resolution plan (see question 15). In addition, CDIC's by-laws require deposit-taking CDIC-insured institutions to provide certain information on an annual and on-request basis to facilitate resolution planning.

14 Are managers or directors personally liable in the case of a bank failure?

Officers or directors are not personally liable in the case of a bank failure, but directors may be liable for certain actions that could result in a bank failure. Directors are liable for any breach of a duty imposed under the Bank Act or other applicable legislation or a duty under common law. For example, directors may be liable under the Bank Act if the directors authorised subordinate indebtedness or a reduction in stated capital when there were reasonable grounds for believing that the bank was, or the reduction would cause the bank to be, in contravention of capital adequacy provisions or liquidity provisions. There is a two-year limitation period from the date the resolution passed authorising the prohibited action after which directors would no longer be liable. There are several defences available to directors including the 'business judgement rule', whereby a director would not be found liable for properly informed business decisions made in good faith and in the absence of conflicts of interest, fraud or illegality.

In the event of a bank failure, directors are also jointly and severally liable for up to six months of unpaid wages for each employee. There is a six-month limitation period from the date wages are owed but go unpaid, a winding-up order is issued or liquidation proceedings have commenced, and a two-year limitation period after the director ceases to be in that role. Banks can purchase directors' and officers' insurance in order to ensure indemnification for such claims.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

In 2015, the Canadian government announced that Canada's DSIBs would be responsible for preparing resolution plans, which would ensure the continuity of critical banking services to Canadians in the event of a large bank failure. CDIC has since provided guidance and expectations for the content and the implementation of resolution

plans. In setting these requirements, CDIC is guided by international efforts, including FSB guidance on:
- operational continuity;
- loss absorbency;
- funding;
- cross-border cooperation;
- effective resolution strategies; and
- removing obstacles to resolvability.

As part of its mandate, CDIC asks DSIBs to provide a wide range of information with respect to their operations so that they may assess the means by which their legal, financial and operating structure will facilitate an orderly resolution of a range of severe events. This includes the banks':
- corporate profile;
- strategies to ensure continuation or wind-down of material operations;
- scenario analysis; and
- the operational feasibility of the strategies outlined in the plan.

Banks are additionally expected to detail and remediate any major obstacles to the successful implementation of their resolution plans. As the CDIC is responsible for reviewing and assessing these plans, to ensure feasible resolution and to help address any impediments, CDIC is ultimately responsible for selecting and implementing a resolution strategy in the event of a failure. Given that Canada has held D-SIBs to the same standards as G-SIBs, no new or different approach is expected in relation to Canada's new G-SIB.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The Bank Act requires banks to maintain adequate capital and permits OSFI to establish guidelines setting out these requirements. The current Capital Adequacy Guidelines (2018) implement the Basel III Accord. The Capital Adequacy Guidelines require banks to have capital requirements that meet or exceed the Basel III minimums. Among those requirements, Canadian banks must have total capital ratios of 9.875 per cent for 2018, which will gradually increase to 10.5 per cent by 2019 through the phase-in of a capital conservation buffer that began in 2016. Banks that issue preferred shares or subordinated debt must contractually provide for the conversion of such instruments into common equity should the institution become non-viable, as discussed above.

The 2018 version of the CAR Guidelines introduced changes related to the treatment of allowances as a result of the expected adoption of IFRS 9 by banks in 2018. Further changes in respect of holdings of instruments issued by G-SIBs and D-SIBs are expected at a later date. OSFI implemented a Leverage Requirements Guideline in 2014. Beginning in the first quarter of 2015, institutions must maintain a leverage ratio that meets or exceeds 3 per cent at all times. Individual institutions may be prescribed their own authorised leverage ratios by the Superintendent.

In June 2017, OSFI published a draft Total Loss Absorbing Capacity (TLAC) Guideline (TLAC Guideline) in preparation for the coming into force of subsection 485(1.1) of the Bank Act associated with the proposed bail-in regime for D-SIBs (see question 19), which will require D-SIBs to maintain a minimum capacity to absorb losses. The purpose of the TLAC requirement is to provide a non-viable D-SIB with sufficient loss absorbing capacity to support its recapitalisation that would facilitate an orderly resolution of the D-SIB while minimising adverse impacts on the stability of the financial sector, ensuring the continuity of critical functions, and minimising taxpayers' exposure to loss.

Banks are required to establish and maintain policies relating to liquidity consistent with OSFI's current Liquidity Guideline. These policies must be approved by the board of directors and reviewed annually. In 2014, OSFI revised the Liquidity Adequacy Requirements Guideline consistent with Basel III, including the liquidity coverage ratio and net stable funding ratio. The revised and reissued Liquidity Adequacy Requirements Guideline has been in effect since January 2015.

Foreign banks carrying on business through a foreign subsidiary incorporated in Canada are subject to the same capital requirements and regulatory framework as domestic banks. Foreign banks operating through a foreign bank branch (whether through a full-service branch or a lending branch) are not subject to Canadian capital requirements. The rationale for this approach is that foreign banks operating through a foreign bank branch are subject to capital requirements and regulation in their home jurisdiction. Full-service branches are required to hold a capital equivalency deposit (CED) of C$5 million or 5 per cent of their branch liabilities, whichever is greater, with an approved Canadian financial institution. A lending branch is only required to hold a CED of C$100,000.

17 How are the capital adequacy guidelines enforced?

Section 628 of the Bank Act obliges banks to provide OSFI with such information, at such times and in such form as OSFI may require. OSFI requires banks to submit quarterly reports detailing compliance with capital adequacy requirements. If issues are identified, OSFI will subject the bank to the four-stage intervention process described above.

18 What happens in the event that a bank becomes undercapitalised?

Undercapitalisation may result in OSFI requiring a bank to increase its capital. OSFI has the ability to intervene through its four-stage intervention process. Ultimately, OSFI has the ability to take control of a bank's assets or take control of a bank for an interim period. Also, the federal government is permitted to invest in the shares of a bank if it believes it will assist in stabilising the financial industry.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

Once OSFI controls a bank, it may request that the Attorney General apply to wind up the bank under WURA. A liquidator of a bank must be either CDIC itself or a trustee licensed under the Bankruptcy and Insolvency Act. The statutory duties of a liquidator are set out in WURA and include:
- controlling all property of the bank;
- carrying on business that is beneficial during the winding-up;
- repaying indebtedness; and
- distributing assets.

The CDIC Act permits CDIC to take certain measures if a CDIC-insured bank becomes insolvent. Such measures include requesting an order vesting the shares of the bank with CDIC so as to be sold to a third party and also the option to request the establishment of a 'bridge-bank' from the Minister of Finance such that the bank's viable assets could be sold to a third party.

On 22 June 2016, a bail-in regime was introduced which, among other things, allows the federal government to direct CDIC to convert certain of a DSIB's liabilities and shares into common shares of the DSIB or its affiliates such that, in the event of failure, losses would be covered by the bank's shareholders and certain investors instead of taxpayers or depositors. The mechanics of how such a bail-in will work have not yet been published owing to finalisation.

In June 2017, three regulations were proposed by the Department of Finance to facilitate implementation of the bail-in regime, including the Bank Recapitalization (Bail-in) Conversion Regulations, Bank Recapitalization (Bail-in) Issuance Regulations, and Compensation Regulations. Together, these Regulations define the conditions for the conversion of instruments eligible for bail-in, outline terms that must be adhered to upon issuance of an eligible bail-in instrument and establish a framework to determine compensation for those entitled under the regulations. Final versions have not yet been published.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

As described above, the Basel III capital adequacy requirements have been implemented for Canadian banks through the revised Capital Adequacy Requirements Guidelines. In addition, as previously noted, in March 2013, OSFI designated the six largest Canadian banks as D-SIBs and announced a 1 per cent common equity surcharge for all D-SIBs.

As of 1 January 2018, D-SIBs are required to meet the target common equity Tier 1 (CET 1) ratio of 6.375 per cent of risk-weighted assets (after applying the applicable capital conversation buffer) that all institutions are already required to meet, plus the additional 1 per cent owing to its D-SIB designation. The surcharge will be periodically reviewed in light of national and international developments. Such restrictions were implemented in recognition of the importance of D-SIBs to the Canadian economy, as the largest six banks account for more than 90 per cent of total banking assets. G-SIBs are subject to additional loss absorbency requirements depending on a bank's global systematic importance.

In December 2016, OSFI released revisions to its Capital Adequacy Requirements Guideline that amended the regulatory capital requirements for loans secured by residential real estate properties. These revisions are now in effect and impact the regulatory capital requirements for deposit-taking institutions using internal models for mortgage default risk. The revisions to the Capital Adequacy Requirements Guideline included:

- clarification on how the Capital Adequacy Requirement Guideline applies to federal credit unions, particularly with respect to qualifying capital instruments, deductions from capital and transitioning of non-qualifying instruments;
- revisions to the treatment of insured residential mortgages aimed at emphasising that credit risk insurance is a risk mitigant that relies on the due diligence of a mortgage originator with respect to the requirements of a mortgage insurance contract;
- clarification on how OSFI will exercise national discretion in the implementation of countercyclical buffer, including the reciprocity of counter cyclical buffers put in place in other jurisdictions; and
- OSFI's implementation of the equity investment in funds rules issued by the Basel Committee on Banking Supervision.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Limitations on the ownership or control of Canadian banks will vary depending on the size of a bank's equity. Banks are divided into three categories for the purposes of determining the applicable ownership rules:

- large banks, which have an equity capitalisation of C$12 billion or more;
- medium banks, which have an equity capitalisation of C$2 billion or more but less than C$12 billion; and
- small banks, which have an equity capitalisation of less than C$2 billion.

Large banks must be widely held, such that no single shareholder may own more than 20 per cent of any class of voting shares, or more than 30 per cent of any class of non-voting shares. A bank holding company may control a large bank, so long as the bank holding company is itself widely held.

Medium banks may be closely held, so long as at least 35 per cent of the voting shares of the bank are listed on a recognised stock exchange in Canada and are publicly held.

Small banks are not subject to ownership limits as long as the Minister of Finance is satisfied with the character and integrity of the applicant or, for a corporate applicant, its reputation for being operated in a manner that is consistent with the standards of good character and integrity.

In addition to these constraints on ownership, no person may acquire or increase a 'significant interest' in a bank without the consent of the Minister of Finance. A 'significant interest' is more than 10 per cent of any class of shares of a bank.

22 Are there any restrictions on foreign ownership of banks?

If a foreign bank that is not a resident of a World Trade Organization (WTO) member country wishes to acquire or increase a significant interest in a bank, prior to approving the transaction, OSFI (acting on behalf of the Minister of Finance) must be satisfied that banks are treated similarly in the jurisdiction in which the applicant principally carries on business, either directly or through a subsidiary. The government of a foreign country, or any political subdivision or agent thereof, cannot acquire shares of a Canadian bank.

Update and trends

Fintech will continue to be one of the most interesting challenges facing the banking industry in 2018 as regulators try to keep pace with technological advances relating to the provision of financial services. One such technological advance that has generated a great deal of discussion is the concept of 'open banking' whereby consumers would have the right to share their own banking information with other financial service providers. Potential applications of distributed ledger technology are being considered by major stakeholders in Canada and may also shape the way banking is provided in the future. We anticipate regulatory changes as fintech innovations become more prominent. Cybersecurity and cyber resiliency will also continue to be of major concern to the banking industry as systems become more interconnected worldwide. Additional regulatory and legislative safeguards are anticipated over the next year as regulators and government seek to limit the banking industry's exposure to potentially disastrous cyber attacks.

23 What are the legal and regulatory implications for entities that control banks?

An entity that seeks approval from the Minister of Finance to acquire or increase a significant interest in a bank must provide a range of information that enables the regulator to investigate the applicant, including information that demonstrates that the applicant has sufficient resources to provide continuing financial support to the bank, and that the applicant's business record and experience is appropriate. The proposed ownership structure will be scrutinised.

An application for approval of a significant interest in a bank must also include an acknowledgement in writing of OSFI's expectation that the applicant will provide ongoing financial, managerial and operational support to the bank if such support becomes necessary (Support Principle Letter). Such ongoing support may take the form of additional capital, the provision of managerial expertise or the provision of support in such areas as risk management, internal control systems and training for bank employees. Importantly, the Support Principle Letter does not create a legally binding obligation on the applicant to provide such support.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

See question 23.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

Under the Bank Act, shares issued by a bank are non-assessable, so a controlling entity is not liable to the bank or its creditors by virtue of holding such shares. OSFI will take over the affairs of an insolvent bank or commence restructuring under the WURA (or both), which will likely result in a sale of assets of the bank to another approved institution. In the event of liquidation, a controlling entity would be likely to lose the entire value of its investment since depositors and other creditors rank ahead of shareholders in a distribution of the proceeds from the liquidation.

As noted in question 23, although the controlling entity or individual will have provided a Support Principle Letter, the letter does not create a legally binding obligation on the applicant to provide such support in the event of, or to prevent, an insolvency.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The Minister of Finance must approve the acquisition of control of a small or medium bank. With limited exceptions, no person may control a large bank. Under the relevant statutory provisions, 'control' means control in fact and not necessarily a legally defined concept of control. Many factors are relevant in determining whether an entity has 'control in fact' of another entity such as:

- the size or value of ownership stake, or both;
- the ability to assert economic pressure on the entity; and

- the influence over corporate governance, operations or life of the entity, or both.

These factors are non exhaustive and a specific analysis is required in each case to make a determination. OSFI will review an application and then make a recommendation to the minister.

A closely related concept is that of a 'significant interest'. An acquisition or accumulation of more than 10 per cent of any class of shares of a bank (referred to as a 'significant interest') requires the approval of the Minister of Finance.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

See question 22 regarding foreign ownership. In addition, the investment rules applicable to foreign banks, including their ability to acquire or hold control of, or a substantial investment in, Canadian banks, are comparable to the rules applicable to Canadian banks. Section 522.22 of the Bank Act requires ministerial approval for a foreign bank to acquire or hold control of, or a substantial investment in, a Canadian bank.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

In determining whether or not to grant approval for the acquisition of control of a bank, the Minister of Finance will assess whether the applicant is suitable to control a bank. In this regard, the minister will consider various factors relevant to the application, including:

- the financial resources of the applicant;
- the soundness and feasibility of the plans of the applicant;
- the business record and experience of the applicant;
- the character and integrity of the applicant and its reputation;
- whether the bank will be operated responsibly;
- the impact of any integration of the businesses and operations of the applicant with those of the bank;
- the extent to which the proposed corporate structure of the applicant and its affiliates may affect the supervision and regulation of the bank; and
- the best interests of the financial system in Canada.

29 Describe the required filings for an acquisition of control of a bank.

The transaction instructions describe the information to be included with an application to OSFI and provide administrative guidance about the application process. In addition to certain basic information about the applicant, the applicant is also expected to provide information that will help OSFI make a determination about whether the applicant is 'fit and proper' to control a bank, including a business plan and financial information. Background and security assessments must be conducted for certain key individuals of the applicant, and an OSFI security information form must be submitted for each such individual for this purpose. The applicant must submit a Support Principle Letter (see question 23).

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

Applicants should always ensure that an application is complete and that an OSFI security information form is submitted as early as possible in the application process, as OSFI does not control how long it takes to complete these background assessments. The Minister is not subject to a specified time limit on the assessment of applications. Where an applicant is a WTO-member foreign bank, additional information may be requested and the process may take longer.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

German banking law lays down rules for banks and financial service providers that need to be observed during their establishment and when they are carrying out their business. These rules are essential for the supervisory authorities to counteract undesirable developments in the banking sector that may endanger the security of the assets entrusted to institutions or impair the proper conduct of banking business. The proper functioning of the banking sector can be seen as the primary objective of banking supervision.

Banking supervision is risk-oriented (ie, it depends on the risks incurred). In this context, supervisors examine whether institutions have adequate capital and liquidity and whether they have established appropriate risk control mechanisms.

2 Summarise the primary statutes and regulations that govern the banking industry.

The principal regulations governing the German banking sector are:
- the key provisions of German banking supervisory law are laid down in the German Banking Act (KWG) and the Capital Requirements Regulation (Regulation (EU) No. 575/2013 (CRR). The KWG sets out the requirements and duties that have to be fulfilled by credit institutions and financial services institutions;
- the Payment Services Regulation Act covers the supervision of payment services and implements the European Payment Services Directive into German law;
- the Capital Investment Code covers the provision of investment services and implements the Undertakings for Collective Investment in Transferable Securities Directive 2014/91/EU as well as the Alternative Investment Fund Managers Directive 2011/61/EU;
- money-laundering prevention is subject to the Money Laundering Act; and
- the provision of services relating to securities and financial instruments is subject to the Securities Trading Act (WpHG).

These laws are accompanied by ancillary laws and regulations, most of which deal with details of specific regulatory aspects. For example, certain details on capital requirements are set out in the Solvability Regulation (SolvVO), and details on liquidity requirements in the Liquidity Regulation. Detailed provisions on loans totalling €1 million or more are set out in the Regulation on Large Scale Exposures. In addition to laws and regulations, Federal Financial Supervisory Authority (BaFin) and Deutsche Bundesbank have published numerous circulars, explanatory notes and decisions regarding certain aspects of regulatory law. These circulars, explanatory notes and decisions are binding for the issuing authorities. In contrast, they are not binding for the European Central Bank (ECB), which is only bound by EU law and German statutory law transforming EU law.

3 Which regulatory authorities are primarily responsible for overseeing banks?

German banks are supervised by the Single Supervisory Mechanism of the ECB and BaFin, or both, and by the Deutsche Bundesbank. The responsibility of either the ECB or BaFin depends on the allocation of competencies set out in Regulation (EU) No. 1024/2013 (SSM). Pursuant to article 6, paragraph 4 of the SSM Regulations, the ECB is competent for the supervision of all German credit institutions with respect to the licensing and withdrawal of licences as well as for the assessment of notifications of the acquisition and disposal of qualifying holdings in such credit institutions. Additionally, the ECB is competent for all aspects of the supervision of credit institutions that are deemed to be 'significant', which is the case in any of the following categories:
- a credit institution has a total value of assets of more than €30 billion;
- the total assets exceed €5 billion and the ratio of the total assets to German gross domestic product exceeds 20 per cent;
- BaFin and the ECB mutually decide that a credit institution shall be deemed to be significant;
- the ECB unilaterally decides that a credit institution that has subsidiaries in Germany and in another EU member states and whose cross-border assets or liabilities represent a significant part of its total assets or liabilities, shall be deemed to be significant; or
- a credit institution has requested or received financial assistance directly from the European Financial Stability Facility or the European Stability Mechanism.

In contrast, BaFin remains responsible for the supervision of all remaining credit institutions and financial services providers, ie, entities that only qualify as credit institutions under German law, but not under the CRR (eg, banks that only lend and are not licensed to accept deposits from their customers). Further, BaFin is responsible for the supervision of all credit institutions within the meaning of the CRR that are not deemed to be significant in accordance with the five categories listed above, whereby the ECB is in any event competent for the licensing and withdrawal of licences as well as for ownership control decisions regarding CRR credit institutions (see above). Moreover, BaFin remains the responsible authority for dealing with anti-money laundering law and the supervision of payment services providers.

In addition to the direct supervision of credit institutions by the ECB or by BaFin, the Deutsche Bundesbank is responsible for receiving and analysing data submitted by the banks. The ECB, BaFin and the Deutsche Bundesbank cooperate closely and share observations and findings that are necessary for the performance of their respective tasks. In their internal relationship, the final decision about whether supervisory measures are taken or how to construe the law is taken by the ECB or BaFin.

BaFin has offices in Bonn and in Frankfurt. The office responsible for supervising most parts of the banking sector is located in Bonn. BaFin's superior authority is the German Federal Ministry of Finance.

The Deutsche Bundesbank is based in Frankfurt am Main. Its supervisory functions are carried out mainly through its eight regional offices, which are located in Berlin, Düsseldorf, Frankfurt am Main, Hamburg, Hannover, Leipzig, Munich and Stuttgart.

The ECB has its seat in Frankfurt am Main.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Owing to the implementation of the Directive on Deposit Guarantee Schemes (Directive 2014/49/EU in 2015, the existing legal framework for deposit protection has recently been subject to change. Pursuant to the new Deposit Guarantee Act (EinSiG), all CRR credit institutions are required to become a member of a deposit guarantee scheme (DGS). Additionally, branches of credit institutions with head offices in other EU member state are also obliged to do so. The DGSs are financed by contributions made by their members. The obligation of each member institution is based on the amount of covered deposits and the individual risk profile.

In the event of loss of deposits, the EinSiG provides depositors with a statutory compensation claim of up to €100,000 per depositor and bank. Under the new legal regime, eligibility is open to private depositors and most companies alike. Further, certain privileged depositors are protected by up to €500,000 per depositor and bank.

The event of loss of deposits will be determined by BaFin, if the credit institution concerned appears to be unable to repay the deposit owing to its financial situation and the institution has no prospect of being able to do so. Within seven days after the determination, the depositors shall be automatically compensated by the DGS. For this reason, the credit institutions are required to be able to provide all relevant information, such as the current amount of the individual deposits, at any given time.

Apart from the statutory protection scheme, deposits of customers are also protected by voluntary deposit protection schemes. Most private banks in Germany participate in the Association of German Banks' (BdB) Deposit Protection Fund (DPF). The DPF is a voluntary scheme aimed at protecting deposits of banks' customers beyond the protection level provided under the statutory deposit protection scheme. The DPF is held and administered by the BdB and is funded by contributions from all participating banks. In order to avoid the DPF requiring an insurance licence, bank clients do not have an enforceable claim against the DPF. The payments made by the DPF with respect to the customers of a failed bank are voluntary. However, the DPF is not known to have ever refused payments on the grounds of the voluntary nature of the protection scheme. The DPF's statutes require that any controlling (direct or indirect) shareholder of the participating bank has to issue an indemnity declaration to the DPF and, thereby, indirectly assume liability for the bank's deposits.

Further deposit protection schemes exist for the cooperative and public bank sector.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Pursuant to section 13c of the KWG, a CRR credit institution that is a subsidiary of a mixed-activity holding company must notify BaFin and the Deutsche Bundesbank of significant intra-group transactions with mixed-activity holding companies or their other subsidiaries. The CRR credit institution may conduct these transactions only on the basis of a unanimous decision by all the managing directors.

Moreover, the KWG provides for certain restrictions regarding institutional loans (eg, loans to managing directors or partners of the institution who are not managing directors (section 15 of the KWG)). Such loans may be granted only by virtue of a unanimous decision by all the managing directors of the institution and only in prevailing markets' terms and only with the explicit approval of the supervisory board.

6 What are the principal regulatory challenges facing the banking industry?

Germany is a member state of the European Union and as such is subject to EU legislation regarding financial supervisory law. Therefore, Germany is required to transpose EU regulations into German law. Owing to the implementation of the Markets in Financial Instruments Directive (MiFID II) and the Market in Financial Instruments Regulation (MiFIR), the new Market Abuse Directive (MAD II) and Market Abuse Regulation (MAR), and the new Payment Services Directive (PSD II) etc, in the past year, many existing German laws were subject to significant changes (eg, WpHG and KWG). This flood of regulations is accompanied by increasing requirements that the institutions need to observe or modify. Moreover, there are also new legislative proposals. In November 2016, the EU Commission published a legislative proposal for amendments to the CRR and CRD IV, as well as to the BRRD and SRMR. This proposal would also require significant changes in German supervisory laws. In addition, every year the European supervisory authorities publish a numerous guidelines, reports and opinions which must be implemented.

7 Are banks subject to consumer protection rules?

In Germany, banks are subject to extensive consumer protection rules. For instance, in the case of loan agreements, the consumer protection rules oblige the bank to provide detailed information to the customers at the time the agreement is entered into and during the contractual relationship. Further, the consumer protection rules give customers specific revocation and termination rights with respect to the loan agreement. Therefore, German consumer protection rules significantly restrict the contents of loan agreements that are granted to retail customers.

BaFin is only responsible for the collective protection of consumers. In doing so, BaFin supervises the financial institutions by monitoring the stability of these institutions and looking into irregularities at the supervised entities. The representation of individual consumers lies within the responsibility of ombudsman services, dispute resolution entities and consumer organisations. If they are unable to resolve a conflict in individual cases, it can only be settled by a court.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

As discussed in question 6, the EU Commission published a legislative proposal for amendments to the CRR and CRD IV, as well the BRRD and SRMR in November 2016. The proposal aims to eliminate certain weaknesses identified in the current banking regulation system while taking into account the role banks have for the economy. It includes agreed measures within the Basel Committee on Banking Supervision and the Financial Stability Board.

Among the propositions is a binding leverage ratio of 3 per cent for all institutions that fall within the scope of the CRD, with adjustments being possible under specific circumstances. A requirement for a stable funding based on the ratio of an institution's stable funding to the required stable funding over a one-year period (net stable funding ratio) is introduced in order to prevent institutions from relying on excessive amounts of short-term wholesale funding to finance long-term activities. This requirement would become effective from two years after the proposed regulation has entered into force. The rules for calculating the capital requirements for market risk, which are applicable to trading book positions, would be amended in order to reflect more accurately the actual risk to which banks are exposed. However, to allow for a more proportionate solution, there would be derogations for banks with small trading books and a simplified standardised approach for medium-sized banks (applicable two years after the entry into force of the legal framework). It is further proposed that the Commission's implementing power be replaced by a delegated power, enabling the EU Commission to exempt entities from the CRD where certain conditions are fulfilled and to decide about whether such institutions fall within the scope of the CRD or CRR again once these criteria are no longer fulfilled.

In order to improve the effectiveness of resolution and to protect public funds, global systemically important institutions would be required to hold sufficient amounts of capital and other instruments that absorb losses in the case of a resolution (total loss-absorbing capacity). Moreover, the proposal provides for an EU-harmonised approach to a bank creditor's insolvency ranking. To this end, a new statutory category of unsecured debt that ranks just below the most senior debt and other senior liabilities would be introduced. The legislative proposal also includes a moratorium tool enabling the suspension of certain contractual obligations for a short period of time. Several proposed changes are intended to enhance proportionality (eg, small institutions would be subject to less frequent and less extensive reporting and disclosure requirements).

The Brexit referendum result from June 2016 could have potentially significant implications for the financial sector in Germany. As it stands, it cannot be discounted that EU–UK negotiations result in a 'hard Brexit'. This means that the UK would leave the European single market. Supervised credit institutions and financial services institutions that are located in the UK would then have to be prepared for the possibility that they would no longer be able to conduct regulated business in other EU or European Economic Area (EEA) member states from the UK in future. Specifically, such institutions may, post-Brexit, no longer be able to rely on the European passport regime that enables them to conduct business on a cross-border basis without any other local licences. If they wish to continue conducting such business, they need to consider relocating out of the UK to another EU or EEA state.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

As described above, BaFin and ECB, where applicable, exercise supervision over their respective assigned institutions on an ongoing basis. As part of their statutory mandate, they may issue orders that are appropriate and necessary to prevent or remedy violations of regulatory provisions. They assess the rules, strategies, procedures and processes that have been established by the institutions in order to comply with the regulatory framework. Particular attention is paid to the institutions liquidity and funds, and to whether an effective risk management and stable risk coverage are in place. In addition, regulatory authorities may carry out supervisory stress tests on an institution.

The frequency and intensity of these reviews, assessments and stress tests depends on the size and systemic relevance as well as the type, volume and complexity of the transactions of an institution.

10 How do the regulatory authorities enforce banking laws and regulations?

There is an extensive catalogue of supervisory measures that can be taken by supervisory authorities (ECB, BaFin or Deutsche Bundesbank) in Germany. The measures are set out in specialised legislation.

Most available measures are preventative in nature and may include the request of information, the submission of documents and the ordering of (ad hoc) audits.

However, if an undertaking is conducting unauthorised business, BaFin can prohibit the continuation of such business and order the liquidation of the existing business. BaFin can also conduct inspections if there are strong suspicions that such business is taking place.

Authorities may also impose administrative fines that are aimed at warning parties to comply with their statutory obligations. It can issue warnings against managers and demand their dismissal if they do not have the adequate professional qualifications or are considered to be unreliable.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

As indicated in BaFin's annual report for 2016, BaFin ordered 183 special audits for less significant institutions during the past financial year. Of the total number of these special audits, 19 were impairment-related special audits and 149 concerned section 25a, paragraph 1 of the KWG (risk management).

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders?

The German Federal Agency for Financial Market Stabilisation (FMSA) will be integrated into BaFin as an independently operating unit at the beginning of 2018. Consequently, the uncertainties arising from the previous cooperation of BaFin and the FMSA should be reduced, however, it remains to be seen how this institutional change will affect the processes and 'culture' of the resolution authority.

In the course of implementing the BRRD and aligning with the Single Resolution Mechanism Regulation (Regulation (EU) No. 806/2014), a new legal framework for recovery and resolution of banks was established. Under the new resolution regime, the Recovery and Resolution Act (SAG), the Single Resolution Board is competent for resolution decisions regarding CRR credit institutions under the supervision of the ECB. BaFin and the FMSA are competent for such decisions regarding other credit institutions and act on the basis of the SAG. Further, the FMSA is competent for the conduct of the resolution measures regardless of who took the underlying resolution decision.

Under the SAG, the FMSA can take various resolution measures regarding CRR credit institutions that are not supervised by the ECB under certain circumstances, which were substantially amended in 2015.

Resolution requires a threat to the existence of the affected credit institution. Further, at least one resolution purpose, in particular the protection of the credit institution's customers, must be pursued by way of resolution. It is also required that the respective purpose cannot be fulfilled by a regular insolvency proceeding to the same extent. In addition, it is necessary that the threat to the existence of the credit institution cannot be removed by alternative measures, including measures by private deposit protection systems.

The German Act on the Adjustment of the National Law on the Resolution of Institutions to the Single Supervisory Mechanism and the European Provisions for the Bank Levy, which entered into force on 1 January 2016, significantly extended the scope of application of banking resolution law. While the law previously required that the resolution aim at preventing a systemic threat or avoiding the use of public funds, it now suffices that the resolution serves the purpose of protecting certain depositors or financial assets of other customers. Consequently, resolution may become a relevant topic for small and medium-sized institutions as well.

If the requirements set out above are met, the FMSA can order adequate measures for resolution in principle. In particular, the FMSA can make use of the bail-in tool, which provides for the possibility of making certain claims against the affected credit institution valueless. The involvement of the owners of relevant capital instruments tool enables the FMSA to transform relevant capital instruments into shares in the credit institution. The sale-of-business tool provides for the possibility of transferring shares in the affected credit institution or its assets to a private purchaser. The purpose of the sale-of-business tool is to achieve a separation of parts of the financial institution to make continuation of the financial institution's business possible. This also applies to the bridge institution tool, which is closely linked to the sale tool since it can be used in preparation for a future sale of the financial institution's business. Further, it is possible to transfer assets of the credit institution to an asset management company.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

If an institution becomes insolvent or over-indebted, the managing directors shall report this and submit informative documentation to BaFin without undue delay.

Under the SAG, institutions are required to prepare a recovery plan (see question 15).

14 Are managers or directors personally liable in the case of a bank failure?

The liability of managers or directors depends on their damaging behaviour and the general rules of German corporate law. For instance, pursuant to the Limited Liabilities Companies Act, a director may be liable to the company for breaches of his due care. Further, regulatory authorities could take the view that a director is not sufficiently trustworthy due to the bank failure.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

The SAG transposes the European Recovery and Resolution Directive into German law (see question 12). The SAG now provides detailed provisions regarding the recovery and resolution of banks.

Pursuant to section 12 of the SAG, institutions are obliged to prepare a recovery plan once the supervisory authority has asked them to do so. The time limit for the preparation of the recovery plans may not exceed six months. However, an institution may apply for an extension of up to six months. In the recovery plans, the institutions have to explain the measures that will ensure or restore the financial stability in case of a crisis. The SAG provides for a very detailed description of the content of these plans. The intention of such recovery plans is to give an institution a tool for handling a crisis by its own efforts. In doing so, the resolution of institutions right from the outset can be avoided. BaFin will intensively assess the institutions' recovery plans and encourage their improvement. If BaFin comes to the conclusion that the recovery plan does not meet the requirements of the SAG, it can notify the institution about its assessment and request a revised recovery plan. Moreover, BaFin and the Deutsche Bundesbank may stipulate simplified requirements for the content of the recovery plan, the time limit for its preparation and the frequency of updates.

Another key section of the SAG covers the resolution of institutions and financial groups. Pursuant to section 62 of the SAG, certain conditions for resolution must be fulfilled in order to implement resolution measures. One condition, for example, is that the institution is failing or is likely to fail. An institution is deemed to be failing if it breaches the requirements associated with the KWG in a way that would justify the suspension of the licence by BaFin, if the assets of the institution are below the level of its liability or if the institution is over-indebted. Another condition for implementing a resolution measure is that the measure is in the public interest and that the failure of the institution cannot be equally prevented by other means within the available period of time.

Once these conditions are met, resolution measures can be implemented. There are basically four resolution tools:

- sale of business;
- transfer to a bridge institution;
- asset separation; and
- bail-in.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

As a EU member state, Germany is subject to the CRD IV and CRR under which it had to implement the Basel III framework into German law. Basel III was implemented and has been in force since January 2014. The capital requirements are set out in section 10 of the KWG in connection with article 25 et seqq of the CRR and SolvVO. Section 10 of the KWG provides that banks, bank groups and financial holding companies must have adequate funds in order to meet their obligations towards their creditors, and in particular, to safeguard the assets entrusted to them. In addition to the common equity Tier 1 capital, the KWG requires institutions to have a capital conservation buffer and an institution-specific countercyclical capital buffer, both consisting of common equity Tier 1 capital. Moreover, BaFin may order institutions to have a capital buffer for systemic risks. This buffer may be ordered for risks exposures located in Germany or in another non-EEA state. The details regarding the calculation of risks and own funds are set out in the CRR and SolvVO.

17 How are the capital adequacy guidelines enforced?

The enforcement of the capital adequacy guidelines falls within the supervisory mandate of the supervisory authorities. This means that BaFin, and or the ECB, can take measures to improve the institution's own funds and liquidity (see question 18). Furthermore, in cases of danger (eg, if the discharge of an institution's obligations to its creditors is endangered, the authorities can take temporary measures to avert the danger). In particular, the authorities may issue instructions for the management of the institution's business or prohibit the acceptance of deposits or funds or securities from customers and the granting of loans.

18 What happens in the event that a bank becomes undercapitalised?

If the authorities have any reason to presume that an institution will not be able to comply with the CRR provisions regarding capital adequacy, it may order the institution to take measures to improve its own funds and liquidity. In particular, the authorities may order:

- the preparation of a substantiated presentation on the development of the institution's material business activities;
- an examination of the measures for better protection from risks identified by the institution as being material or measures for reduction of such risks and corresponding risk concentrations;
- a report on measures suitable to increase the Tier 1 capital, own funds and liquidity of the institution; or
- the presentation of a plan to avoid a potentially dangerous situation.

In addition, the authorities can also appoint a special commissioner and delegate to the special commissioner the exercise of duties and powers of a managing director or the monitoring of compliance with orders issued by the supervisory authorities.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

If an institution becomes insolvent or over-indebted, the managing directors shall report this fact and submit explanatory documentation to BaFin without undue delay (section 46b of the KWG). The application for the initiation of insolvency proceedings over the institution's assets may only be filed by BaFin. The creditors must be notified by the insolvency court once the decision on the institution of proceedings has been rendered.

The rules on the insolvency procedure are governed by the German Insolvency Code.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

The Commission's legislative proposal includes substantial amendments to the CRD IV and CRR (see question 8).

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

A controlling interest in a bank is given if the party holds a direct or indirect participation of 10 per cent or more of the reported shares or voting rights in an institution or can exercise significant influence over the management of the institution.

22 Are there any restrictions on foreign ownership of banks?

There are no general restrictions.

23 What are the legal and regulatory implications for entities that control banks?

Many private banks in Germany participate in the BdB's DPF. The DPF is a voluntary scheme aimed at protecting deposits of banks' customers beyond the protection level provided under the statutory deposit protection scheme. The DPF is held and administered by the BdB and is financed by contributions from all participating banks. The DPF's statutes require that any controlling (direct or indirect) shareholder of the participating bank has to issue an indemnity declaration to the DPF and, thereby, indirectly assume liability for the bank's deposits.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

Entities that control banks are subject to comprehensive notification requirements. For example, the holder of a qualifying holding must notify the supervisory authorities in writing of every newly appointed legal or statutory representative or new general partner, as well as the facts essential to assessing their trustworthiness. Moreover, such holders have to notify the supervisory authorities of their intention to increase the amount of the qualifying holding when certain thresholds are met.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

The insolvency of a bank does not entail a direct payment obligation of the controlling entity or individual. However, if the affected bank participates in the DPF, the controlling shareholders might be liable towards the DPF on the basis of its indemnity declaration (see question 23).

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

German law requires any person intending to acquire a qualifying holding in an institution to notify BaFin and the Deutsche Bundesbank of its intention. A 'qualifying holding' means a direct or indirect holding in an undertaking that represents 10 per cent or more of the capital or of the voting rights or which makes it possible to exercise significant influence over the management of that undertaking.

If the notification relates to a participation in a credit institution within the meaning of the CRR, BaFin itself does not decide on the intended acquisition but instead prepares a draft decision and submits this draft to the ECB, which is responsible to take the final decision. In order to implement standardised procedures for cooperation with the ECB and other national regulators involved in cross-border transactions, a central unit within BaFin was set up. Related amendments to the Ownership Control Regulation (InhKontrollV) are expected.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

From our experience, the regulatory process makes no distinction between German or foreign acquirers.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

Under certain circumstances, BaFin or the ECB may object to the intended acquisition of a qualifying holding. This includes, for example:

- the assumption that the acquirer is not trustworthy;
- that the institution will not remain able to meet the requirements of supervision; or
- that a future managing director is not reliable or qualified.

29 Describe the required filings for an acquisition of control of a bank.

Together with the notification, the interested acquirer has to provide a substantial package of information to BaFin laid down in the InhKontrollV regarding not only itself, but also other entities of its group of companies. The following documents and statements shall be attached, inter alia, to the notification:

- general documents such as proof of identity of the notifying party and a description of the business activities of the notifying party;
- statements and documents regarding the reliability of the notifying party;
- information regarding the participation held by, and in, the notifying party;
- a detailed description of the financial and other interests of the acquirer;
- a description of the financial position and credit worthiness of the notifying party; and
- a business plan including a description of the strategic objectives and plans.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

After receipt of the full notification, BaFin has a period of 60 business days in which to decide to prohibit the acquisition or not. The period can be extended to up to 90 business days. However, the assessment period begins at the date of confirmation of completeness by BaFin. In our experience, BaFin usually raises several queries prior to confirming completeness.

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Ghana

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The government of Ghana is pursuing a policy that provides appropriate mechanisms to minimise financial system instability and deal with emerging risks using effective supervision and regulatory measures. Through the policy, the government seeks to make the financial sector of the country the preferred source of finance for domestic companies and further develop, strengthen and modernise the financial sector to support the government's economic vision and transformational agenda. The Bank of Ghana (BoG) shall support the general economic policy of the government by promoting economic growth, effective and efficient operation of banking and credit systems in the country. The BoG, in order to create a stable and efficient financial system, has the following on its agenda:

- increased disclosure requirements for financial institutions in line with Pillar III of the Basel accord;
- strong capital adequacy of financial institutions so that they will be Basel II and III compliant; and
- effective supervision and regulatory measures.

2 Summarise the primary statutes and regulations that govern the banking industry.

The Banks and Specialised Deposit-Taking Institutions Act 2016, Act 930, is the primary statute governing banking industry in Ghana. This came into force on 14 September 2016 to repeal the Banking Act 2004, Act 673. The new banking law has consolidated the laws relating to deposit taking and regulates institutions that carry on deposit-taking business. It does not apply to credit unions and leasing companies that are licensed and supervised under the Non-Bank Financial Institutions Act 2008, Act 774.

The new Act is wider in scope compared with the repealed Banking Act 2004, Act 673. It has given the BoG increased supervisory powers.

A concept of financial holding company has been introduced under the new Act. A person will not be permitted to serve as a financial holding company of a bank save where it has registered with the BoG. The BoG is vested with the powers to exempt a foreign bank or other foreign company from the registration requirements of a financial holding company. The BoG may grant that exemption to a foreign bank or other foreign company provided it is regulated and supervised in another jurisdiction. There should be some evidence that the foreign bank or company is supervised on a consolidated basis in its home country or another host country where it has substantial operations.

It imposes personal liability on principal officers or directors of a financial institution for non-compliance with a regulatory requirement.

It gives the BoG the power to formulate corporate governance directives and rules for financial institutions in Ghana, such as:

- the Ghana Deposit Protection Act 2016, Act 931, in force on 14 September 2017. It provides for the creation of a deposition protection scheme, A deposit protection fund, Ghana Deposit Protection Corporation (GDPC) and other related issues. It seeks to give protection to small depositors in the event that a bank fails;
- the Payment Systems Act 2003, Act 662, deals with the operation and supervision of electronic and other payment, clearing and settlement systems and it also provides for the rights and responsibilities of transacting and intermediating parties and for other related matters;
- the Borrowers and Lenders Act 2008, Act 773, provides the legal framework for credit, standards of disclosure of information required by borrowers and lenders, and other related matters. It imposes obligation on lenders to register charges and collaterals used by borrowers to secure credit facilities from lenders with the Collateral Registry;
- the Anti-Money Laundering Act 2008, Act 749, applies to the prevention of money laundering;
- the Mortgages Act 1972, NRCD 96, regulates the creation of mortgages and its associated matters;
- the Anti-Terrorism Act 2008, Act 762, imposes obligations on the banks to help combat terrorist financing;
- the Income Tax Act 2015, Act 896 (as amended), provides for the taxation of banking business and its related matters;
- the Credit Reporting Act 2007, Act 726, deals with the legal framework for credit bureaus and creates the needed conditions for credit reporting;
- the Foreign Exchange Act 2006, Act 723, regulates the exchange of foreign currency, for international payment transactions and foreign exchange transfers and also regulate foreign exchange business;
- the Securities Industry Act 2016, Act 929, applies to financial institutions that are engaged in business on the capital market; and
- the Companies Act 1963, Act 179 (as amended), applies to the banking industry.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The BoG is the only institution vested with the supervisory and regulatory authority in all matters regarding deposit-taking business. It supervises banks and non-bank financial institutions. It is responsible, inter alia, for the promotion of the safety and soundness of banks and specialised deposit-taking institutions, consideration and proposal of reforms of the law relating to deposit-taking business. It also deals with unlawful or improper practices of banks and specialised deposit-taking institutions.

The BoG has the sole responsibility to licence banks and specialised deposit-taking institutions, to grant approval of foreign banks in relation to the establishment of representative offices and to register financial holding companies. It regulates and supervises banks, specialised deposit-taking institutions and financial holding companies on a solo basis.

The Securities and Exchange Commission regulates the activities of banks that participate in the capital market.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Deposits are not insured by the government of Ghana. However, a Deposit Protection Scheme has been created under the Ghana Deposit Protection Act 2016, Act 931, to serve somewhat as insurance of deposits with financial institution. Banks and specialised deposit taking institutions are required to insure stated deposits held by them with the Scheme. The Scheme is managed by the GDPC.

Although the Scheme is expected to have commenced with the coming into force of the law on 14 September 2016, it has not yet started. It is expected to be implemented in 2018.

The Scheme will serve as an insurance of deposits for customers of banks and specialised deposit-taking institutions. The aim of the scheme is to protect small depositors in the event of revocation of licence or insolvency of bank or special depositing institution. In other words, it will provide a safety net for depositors in the event of a bank failure.

The Scheme is at no cost to customers of banks and special depositing institutions. It will be funded by premiums and other fees collected by the GDPC from banks and special deposit-taking institutions that are members of the scheme. At the start of the Scheme, a member of it shall pay an initial one-off premium of 0.1 per cent of its minimum paid-up capital to the GDPC. The minimum paid-up capital of banks and specialised deposit-taking institutions varies. Banks and specialised deposit-taking institutions will be required to pay also annual premiums in respect of the Scheme to the GDPC. The annual premium may range from 0.3 per cent to 1.5 per cent of the average deposits insured by the Scheme at the end of the preceding year. It should be noted that banks and specialised deposit-taking institutions do not pay the same annual premiums. An assessed annual premium will have to be paid on pro-rata basis within 30 days of the end of each quarter.

The Scheme entitles a customer of a financial institution to be compensated to a certain limit in the event that an insurable event crystallises. An insurable event has defined to mean an event that necessitates the revocation of the licence or appointment of a receiver or a liquidator of a bank or specialised deposit-taking institution. The maximum amount that a customer of a bank can be paid by the GDPC is 6,250 Ghana cedis.

By the same token, a customer of a specialised deposit-taking institution can receive a maximum of 1,250 Ghana cedis. A customer whose money with a financial institution is more than what he or she received from the GDPC, may have recover the difference from the receiver of the financial institution.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Transactions between a bank and its affiliates are subject to sections 64 and 65 of the Banks and Specialised Deposit-Taking Institutions Act 2016, Act 930.

A bank must not allow a financial exposure of an affiliate to be outstanding except on terms that reflect an arm's length. That is, a bank must ensure that matters such as the creditworthiness, interest rate or the value of the collateral and the terms of the transaction do not differ from the terms of a comparable transaction between independent persons.

Similarly, a bank cannot accept a financial exposure of an affiliate if the total financial exposures of the affiliate is more than 25 per cent of the net own funds. Where the financial exposure of the affiliate is less than 25 per cent of the net own funds, the bank can take on the exposure.

For this purpose, 'affiliate' of a company means:

- a body corporate of which the company is a subsidiary;
- a subsidiary of the company; or
- a body corporate that is under a common control with the company.

Also, transactions between a bank and its affiliates are subject to transfer pricing rules under the Income Tax Act 2015, Act 896 (as amended) and the Transfer Pricing Regulations 2012, LI 2188.

A person shall not engage in a regulated activity except it is licenced by the BoG. A person who carries out a deposit taking business without a licence commits an offence and shall be liable to a fine between 30,000 and 60,000 Ghana cedis in case of a body corporate. Further, the principal officers of the body corporate operating without a licence shall be slapped with a fine between 18,000 and 36,000 Ghana cedis or imprisoned for two to four years. Consequently, banks and special deposit-taking institutions must therefore obtain authorisation from the BoG to accept deposits from the public.

Permissible activities for banks and special deposit-taking institutions are:

- acceptance of deposits and other repayable funds from the public;
- financial leasing;
- money transmission services;
- guarantees and commitments;
- trading in money market instruments, foreign exchange or transferable securities;
- safe custody of valuables;
- bank assurance;
- electronic banking;
- portfolio management;
- lending;
- investment in financial securities;
- issuing and administering means of payment;
- credit reference services;
- keeping and administration of securities;
- corporate finance;
- payment and collection services;
- non-interest banking services; and
- participate in securities issues and provision related services.

Specialised deposit-taking institutions are precluded from engaging in the trading of foreign exchange or render services that are denominated in foreign currencies.

Some of the permissible activities for financial institutions falls under the purview of other legislations, and in that case, it is required that the financial institution must comply with the relevant legislation concern in respect of registration, licensing and authorisation requirements. For example, where a financial institution plans to list on the Ghana Stock Exchange or issue securities, it would have to comply with the Securities Industries Act 2016, Act 929 and its attending regulations.

There are restrictions on a financial institution in engaging directly in a commercial, industrial or agricultural business.

A ring-fencing rule applies to the financial industry. The banking business of a financial institution will be deemed as separate from other business activities of the same financial institution.

6 What are the principal regulatory challenges facing the banking industry?

Anti-money laundering compliance

Financial institutions are required to report suspicious transactions or flag issues of money laundering to the appropriate authorities. The complexity of technology is exposing a risk to financial institutions to be able to identify and report any suspicious transaction. Most financial institutions have anti-money laundering officers to report on these matters and regular training is being provided to assist in this respect. The establishment of the Financial Intelligence Centre and Economic and Organised Crime Office are providing support to the banking industry in respect of anti-money laundering compliance.

Liquidity compliance

It is said that liquidity is the life blood of every bank. Likewise, banks are required to report on their liquidity positions to the BoG. For example, each bank must have a reserve of 9 per cent of its weighted average deposit with the BoG. The obligation is on the banks to monitor so that it does not fall below the required threshold, otherwise it will be penalised in monetary terms.

Capital adequacy requirements

Banks must comply with the capital adequacy requirement and this poses a challenge for them.

Registration of charges

Banks must register collaterals provided by customers to secure a loan within 28 days. Failure of a bank to comply renders the collateral provided by the customer to be of no effect as security for a borrower's obligations for repayment of the money secured. The money secured shall immediately become payable despite any provision to the contrary in any contract. Banks are having difficulty in complying in this regard because of bureaucracy with government agencies.

7 Are banks subject to consumer protection rules?

Banks are subject to consumer protection rules. The BoG has the responsibility to enforce consumer protection rules. It is clothed with the statutory duty of developing appropriate consumer protection measures to ensure that the interests of bank customers and the specialised deposit-taking institutions are adequately protected. On 10 February 2017, the BoG issued Consumer Recourse Mechanism Guidelines for Financial Service Providers in the light of the power granted it under the Banks and Specialised Deposit-Taking Act to issue measures to protect consumers. The Guidelines are applicable to banks, non-banking institutions, specialised deposit-taking institutions, financial holding companies, affiliates of banks, non-banking institutions specialised deposit-taking institutions and financial holding companies regulated by the BoG.

The BoG has a unit called the Investigation and Consumer Reporting Office (ICRO) that has the responsibility for protecting consumers of financial products and services and also educate customers on their rights and responsibilities. If the ICRO receives complaints from bank customers and specialised deposit-taking institutions, they will investigate with a view to protect customers.

Some of the consumer protection rules have been set out below. Financial institutions are required to:

- honour customer cheques up to the credit balance or overdraft limit, provided they are in order and there is no stop order;
- uphold strict secrecy about customer affairs, while the account is operational or after it had been closed; accept the disclosure is by an act of parliament or a court order, the disclosure is in the public interest, the disclosure is in the bank's interest and the disclosure is with the express or implied consent of the customer;
- give reasonable notice to close an account in credit;
- provide an accurate statement of account as per the agreed time period or within reasonable time;
- receive money and cheques for collection and credit customers' accounts;
- advise a customer immediately that it suspects forgery or fraudulent deals in the operations of the account;
- exercise due care and diligence in the operation of a customer account; and
- give customers complete information on each product provided.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

Changes in the legal and regulatory regime in Ghana regarding the financial services industry will be driven by the need to respond to the volatility in the banking sector and the ability of banks to support the developmental projects of the economy. The BoG may increase the minimum capital requirements of banks to reach the overarching objective to strengthen the financial system.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Banks are subject to extensive legislation and supervision. The BoG conducts periodic on-site and regular off-site examinations on regulated banks. The on-site visit is influenced by the off-site examination undertaken by the regulator. It issues reports on the banks' concerns and expect corrective measures to taken by these banks. Where the affected banks fail to remedy the matter set out its report, the BoG may in the worst-case scenario revoke the licence of the financial institution concerned.

10 How do the regulatory authorities enforce banking laws and regulations?

The Banks and Specialised Deposit-Taking Institutions Act gives the BoG a number of supervisory measures and powers to enforce the law. Set out below is a brief overview of the different supervisory measures generally used by the BoG. An action taken by the BoG is not made public except in circumstances where it is severe.

Directives

The BoG occasionally issues directives to financial institutions to give effect to the provisions of the law or the necessary information to ensure the overall stability of the financial system in Ghana. A directive issued by the BoG must be adhered to by the financial institutions. Non-compliance will be attended with a pecuniary penalty imposed by the BoG. A penalty within the range of 24,000 and 120,000 Ghana cedis may be suffered by a financial institution for not complying with a directive. Apart from the penalty imposed by the BoG, it may apply any other penalty or take any remedial action that is appropriate in the circumstance.

Information request and periodic returns

Banks are required by the BoG to submit periodic returns and information. The BoG uses this information and returns for the purpose of supervising these banks. Financial institutions submit daily, weekly, monthly, quarterly, bi-annual and annual returns to the BoG. The information submitted by banks cover liquidity assets, minimum adequacy ratio, income statements, statement of financial positions, cash flow statements and in other information that the BoG considers appropriate.

There is a penalty for not submitting required information or a return to the BoG. This is not likely to exceed 6,000 Ghana cedis for non-compliance. The penalty is imposed on the financial institution or the key management personnel responsible for the submission of the information and the returns. There is a penalty of 600 Ghana cedis for each day of default of the financial institution not having submitted the required information and returns.

Examinations

The BoG employs both on-site and off-site examination to supervise the activities of financial institutions.

The off-site examination is when officers of the BoG reviews returns and other information that has been filed by the financial institutions from their desk. This is like a desk-top audit. The officers of the regulator examine the information and returns to assess the financial institution's compliance with laws and directives. It gives the regulator insight as to the affairs of these financial institutions. The off-site examinations are done frequently because there are some returns and information that must be submitted daily, weekly, monthly, quarterly, bi-annually and annually.

The BoG carries out on-site examinations on the financial institutions from time to time. The degree of on-site examinations will be influenced by the risk posed by a bank, specialised deposit-taking institution and the financial holding company. The officers physically visit the premises of the financial institution to examine its books and operations. During an on-site examination, the officer of the regulator may take records, files or documents which he or she considers relevant for the purposes of examination. However, the officer is required to give notice to the financial institution concerned.

Investigations

The BoG may conduct investigation into the affairs of a financial institution when it considers it appropriate to do so. It may do the investigation without notice to the financial institution concerned. This is based on complaints received from customers of a bank.

Supervisory and examination reports

The BoG issues formal examination reports to the regulated financial institutions on a periodic basis. It contains criticisms, findings in respect of the institutions' operations and directives from the BoG as to how best remedy the deficiencies or the concerns raised in the report. Examination reports are confidential and may not be released by the institutions to the public.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

In recent years, the most common enforcement issues with relevant consequences for the banking sector have been:

- forex transfers without the required documentations;
- anti-money laundering non-compliance issues;
- non-compliance with submission of returns due to the BoG;
- non-compliance with the 9 per cent primary reserve requirements;

- non-compliance with the single obligor limits; and
- non-compliance with the capital adequacy requirements.

The BoG issues directives and training to these financial institutions to help mitigate non-compliance.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Bank nationalisation is very uncommon in Ghana. However, the government may invest in a bank to save it from collapsing.

A bank deemed by the BoG to be insolvent or likely to be insolvent within 60 days may have its licence revoked. In order to ensure financial stability, the BoG may invite interested banks to bid to take over the assets and liabilities of the insolvent bank. The process of inviting banks to bid to take over the assets and liabilities are professionally managing not to erode public confidence in the banking system. There are instances where the bank may take over only the assets of the insolvent bank leaving the BoG, to appoint a receiver to take over the liabilities.

In practice, there have been two such incidents where the GCB Bank took over all the deposits and selected assets of UT Bank and Capital Bank. These banks were considered as insolvent banks and, consequently, their licences were revoked by the BoG. GCB Bank did not take over some of the liabilities of the two insolvent banks, so a receiver had to be appointed by the BoG.

Under the Deposit Protection Act, depositors will be compensated up to the statutory cap. Depositors may also recover from the receiver any difference over the statutory cap paid.

Shareholders, creditors, employees and others will have to depend on the receiver for potential payment out of the realised assets of the insolvent bank.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

The management and directors do not play an active role in the case of a bank failure. That said, the management and directors may be required to assist with the smooth transition to the assets and liabilities to the acquirer.

Members of the management team may be employed by the bank taking over the insolvent bank or the failed bank.

14 Are managers or directors personally liable in the case of a bank failure?

Bank failure does not automatically result in personal liability for the managers or directors. However, the directors may be prosecuted for offences under the Banks and Specialised Deposit-Taking Institutions Act, which might have contributed to the failure of the bank.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

There is no requirement to have a resolution plan in place.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The BoG sets the capital adequacy requirements for banks from time to time, with regard to the risk exposure and vulnerability of the financial system. Banks are required to be adequately capitalised. On 11 September 2017, the BoG revised the minimum paid-up capital for existing banks and new entrants from 120 million to 400 million Ghana cedis. Existing banks have up to 31 December 2018 to comply with this new capital requirement. The capital must be unimpaired by losses or other adjustments that may be recommended by the BoG.

Existing banks may satisfy the new capital requirements by the injection of fresh capital, capitalisation of income surplus or a combination of fresh capital injection and capitalisation of income surplus.

All banks that have been granted approval prior to the issuance of the capital adequacy requirement directive have up to the end of December 2018 to comply with the new minimum capital levels.

All new applications for banking licence are required to meet the new minimum capital requirement of GHS 400 million Ghana cedis.

The minimum capital adequacy ratio is 10 per cent of the bank's assets. The capital ratio is a percentage of the adjusted capital base to the risk-weighted financial exposure. The methodology for calculating the minimum capital adequacy ratio may be reviewed by the BoG from time to time.

The BoG may suggest that the capital requirement be applied on a consolidated basis to a bank.

Apart from the minimum capital adequacy ratio of 10 per cent, a bank must have a capital buffer of at least 3 per cent.

17 How are the capital adequacy guidelines enforced?

The BoG enforces compliance of the capital adequacy requirements. Banks are required to submit period returns to the BoG that enables it to assess compliance of the capital adequacy rules. Banks are duty bound to notify the BoG of any failure to meet the capital adequacy requirement.

18 What happens in the event that a bank becomes undercapitalised?

The bank will need to notify the BoG of its being undercapitalised and submit a capital restoration plan to correct the undercapitalisation. The capital restoration plan must indicate how the bank intends to restore the bank to meet the capital adequacy with 180 days. The capital restoration submitted by the bank must be considered appropriate by the Bank of Ghana. The capital restoration plan must specify:

- the steps that the bank will take to be adequately capitalised;
- the levels of capital to be obtained during the period that the plan is in place; and
- how the bank will comply with the restrictions applicable to it.

In addition, the BoG may impose any restriction such as:

- preventing the bank from dividend declaration and distribution if they will cause the bank not to comply with the capital adequacy requirements; and
- prohibiting the bank from increasing emoluments and salary packages for directors and management as well as awarding bonuses.

In the event that a bank is significantly undercapitalised, the BoG shall take same actions as undercapitalised bank discussed above. In addition, it may take any of the following actions:

- appoint a suitable person to advise and assist the bank in designing and implementing the capital restoration plan;
- restrict the bank from opening new branches;
- restrict the bank from engaging in new businesses;
- impose restrictions on growth of assets or liabilities of the bank this it deems appropriate;
- restrict the rate of interest on all interest earning deposits payable by the bank to the rates that the Bank of Ghana prescribes;
- enter into an agreement with the board of directors to rectify the significant undercapitalisation within 90 days and restore the capital adequacy within 180 days or for period that the BoG may suggest; or
- prevent the bank from engaging in new 'off-balance sheet' transactions.

With respect to a significantly undercapitalised bank, the BoG may revoke its licence when the situation is not likely to improve.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

First, the BoG revokes the licence of the insolvent bank. The BoG then appoints a receiver to take over the assets and liabilities of the insolvent bank. A notification is given by the BoG to the GDPC of its decision (see question 12).

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

Yes. It may be changed depending on the risk and vulnerability identified in the financial system (see question 16).

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

There are no restrictions on the types of entities and individuals that may have a controlling interest in a bank in Ghana. Both companies and individuals, regardless of whether they are domestic or foreign, may acquire an interest in a bank.

A person acquiring a stake of at least 5 per cent in the equity of a bank is deemed as a significant shareholder. Thus, that person will be required to seek consent from the BoG (see question 26).

The BoG is given power to restrict the ownership of a person in a bank or to cap ownership at a certain percentage for all or some types of owners.

22 Are there any restrictions on foreign ownership of banks?

There are no restrictions on foreign persons owning banks in Ghana.

23 What are the legal and regulatory implications for entities that control banks?

Where the entity is a financial holding company (parent) of the bank, it shall register with the BoG. The BoG may waive this registration requirement for a foreign bank provided it is satisfied that bank is subject to supervision on consolidated basis in another country. The entity is expected to invest in companies that are individuals in financial services. It will be precluded from acquiring interest in a commercial, agricultural or industrial company or unincorporated entity. Such entities are required to seek consent from the BoG before it can acquire control (directly or indirectly) in any entity of another financial group.

Apart from financial holding companies, there are generally no restrictions on the acquirer of an interest in a bank. A bank may be partly owned by a person whose business activities are wholly non-financial in nature.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

An entity or individual that controls a bank must comply with the provisions on transfer of shares affecting shareholding set out in the Banks and Specialised Deposit-Taking Institutions Act. An approval of the proposed transaction must be sought from the BoG (see question 26).

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

No specific consequences have been prescribed for a controlling entity or individual. Consequently, the treatment will be the same as any shareholder. They may have to rely on the receiver for possible payment after all priority claims have been paid.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

In order to acquire control of a bank in Ghana, an application for approval must be filed with the BoG three months before the date of the proposed transaction. The BoG has up to six months from the receipt of the notice to consent or object to the proposed acquisition of control or agreement to transfer shares. In practice, the approval process can be as shorter if the appropriate disclosures have been made.

The supervisory thresholds that require notification to the BoG for an approval as to an acquisition are 5, 10, 20, 30, 50 or 75 per cent of the shares of the bank.

If the acquirer is a foreign bank, it must seek consent from its home supervisor to the effect that it has no objection to the proposed transaction, otherwise the BoG will not approve it.

Apart from the BoG, an approval is required from the SEC where the acquisition is a takeover or merger or amalgamation of a publicly traded bank.

'Control' is defined as where a person or a group of persons acting in concert (directly or indirectly):

- owns at least 25 per cent of the voting rights;
- has the power to appoint or remove the majority of the members of the board of directors;
- exercises a significant influence on the management or policies; or
- has the ability to direct the activities of the person so as to affect the financial returns on any investment made with the person.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

Yes. The regulatory authorities are receptive to foreign acquirers. The nationality of an acquirer or the place of incorporation of the acquiring company is not relevant. There is no discrimination in the process for approval.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The BoG will consider the factors set out below in deciding whether to consent to, or refuse a sale of business, mergers or amalgamations or reconstructions:

- financial resources of the acquirer;
- the experience and management capabilities of persons of the acquirer;

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- the background of the acquirer;
- the source of the funding;
- the impact of the proposed transaction on competition;
- risk exposure to the stability of the financial system;
- convenience and the needs of the community;
- the effective of the existing bank to comply with compliance requirements; and
- whether the proposed transaction does not amount to money laundering and terrorist financing.

29 Describe the required filings for an acquisition of control of a bank.

The first step is to submit an application for approval on a prescribed form to the BoG. The form should be supported with the following documents:

- a certified copy of the Regulations and incorporation documents of the acquirer;
- the names, addresses and occupations of the persons including corporate affiliations of significant shareholders and their respective values of shares;
- the sources of funds for the acquisition;
- a letter from the home country of the acquirer's supervisor that it has no objection to the proposed transaction in Ghana;
- a statutory declaration by each director of the acquirer that they have not been declared bankrupt, qualified from practising a profession or convicted of an offence by a court or subject to insolvency proceedings; and
- corporate governance policies of the acquirer.

The BoG, having received this notice, may require additional information or documents which it deems appropriate.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The time frame for regulatory approval is the same for both domestic and foreign acquirer (see question 26).

Hungary

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The main elements of regulatory policies related to the Hungarian banking sector are:
- governmental control (including authorisation and supervision);
- financial and monetary stability;
- strict capital and risk-management requirements as well as organisational regulations;
- insurance of deposits; and
- regulation of information in the interest of the protection of bank secrecy, transparency and consumer protection.

2 Summarise the primary statutes and regulations that govern the banking industry.

The most important regulations regarding the banking sector are:
- Act XXXVII of 2014 on the further development of the system of institutions strengthening the security of the individual players of the financial intermediary system (Resolution Act);
- Act CCXXXVII of 2013 on credit institutions and financial enterprises (Banking Act);
- Act CXXXIX of 2013 on the Hungarian Central Bank (Central Bank Act);
- Act LXXXV of 2009 on the Pursuit of the Business of Payment Services;
- Act CIV of 2008 on strengthening the stability of financial systems (Stability Act);
- Act CLXII of 2009 on Consumer Credits;
- Act CXXII of 2011 on Central Credit Information System; and
- Act CXXXV of 2013 on the Integration of savings cooperatives and amendments to economic related acts.

Furthermore, in some aspects Act CXX of 2001 on Capital Markets, Act LIII of 2017 on the Prevention and Combating of Money Laundering and Terrorist Financing, Act CCXXXV of 2013 on Payment Providers and Act XVI of 2014 on Collective Investment Trusts and Their Managers, and on the Amendment of Financial Regulations, also have significant effects on the banking sector.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The financial markets are exclusively supervised by the Hungarian Central Bank (Central Bank). While the Hungarian Financial Supervisory Authority (HFSA) was almost exclusively responsible for their supervision and had the necessary instruments for this responsibility, in 2013 the HFSA was integrated into the Central Bank. This means that the Central Bank assumed all functions, duties and responsibilities of the HFSA and the latter ceased to exist on 1 October 2013. Even though the HFSA ceased to exist without a legal successor, continuity was preserved as, according to the Central Bank Act, the rights and obligations (including authority over certain state assets) transferred to the Central Bank, and the Central Bank took the place of the HFSA in ongoing procedures.

The reformed Central Bank is responsible for mitigating and managing risks potentially arising in the financial sector at system level (macroprudential policy) and for overseeing the safety and stability of individual financial institutions (microprudential policy). It has also assumed the functions of consumer protection and market supervision, as well as capital and insurance supervision, while keeping its 'old' duties and responsibilities such as naturally, the fundamental function of being responsible for monetary policy.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The Hungarian system for insuring deposits consists of two elements.

Deposit insurance

For this purpose, the National Fund for Deposit Insurance (FDI) was established by Act CXII of 1996 on credit institutions and financial enterprises. This Act was replaced by the Banking Act in 2014, but the regulation has basically remained the same.

Each credit institution must be a member of the FDI (membership is a condition of foundation). According to the Banking Act, credit institutions shall, upon joining the FDI, pay a one-off affiliation fee at the rate of half-a-percent of its subscribed capital to the FDI within 30 days of receiving the authorisation.

In addition, credit institutions shall pay ordinary, and in some cases extraordinary, annual fees to the FDI. The amount of annual fee to be paid shall not be higher than three thousandths of the aggregate total interest holdings indicated under accrued and deferred liabilities on deposits insured by the FDI and kept with the member institution on 31 December of the previous year and the deposits insured by the FDI.

In the case of deposits being frozen, the FDI undertakes to provide compensation to the depositors for the principal and interest on frozen deposits. The above undertaking may not be higher than the amount of principal and interest placed in the credit institution in question. Furthermore, only registered deposits will be insured by the FDI. The capital and interest amount of the deposits will only be reimbursed by the FDI up to €100,000 per person and per credit institution as compensation.

Receiving ordinary credit

The second element, laid down in Act CXXXIX of 2013 regarding the Hungarian Central Bank, is the opportunity to receive extraordinary credit, which may be provided by the Central Bank for credit institutions and to the FDI in the event of emergency. For this purpose, 'emergency' means that the insolvency of the credit institution endangers the stability of the entire monetary system. The Central Bank has discretionary power to provide such extraordinary credit.

The Hungarian government increased the direct and indirect state's stake in the Hungarian banking system in recent years. The current state ownership in credit institutions is around 50 per cent, including the Hungarian Development Bank and the Hungarian Export-Import Bank.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

In accordance with the Banking Act, an 'affiliate' means any company over which a parent company effectively exercises a dominant influence. All affiliates of affiliate companies will also be considered affiliates of the parent company.

From the regulatory viewpoint, a parent company or an affiliate will be considered a client; therefore, in cases of transactions between a parent company and an affiliate the general prudential rules of the Banking Act will apply, including the rules for limitation of exposure.

Furthermore, some indirect limitations also apply if the parent company qualifies as a credit institution and its affiliate is also:

- a credit institution;
- a financial enterprise;
- an investment enterprise;
- owned by the parent company's holding in the institution; or
- if the credit institution's parent company is a financial holding company.

In such cases the companies are subject to supervision on a consolidated basis, which means that they must meet the prudential and exposure rules of the Banking Act, both jointly and severally, and this provision may influence the transactions between the companies concerned.

Members of groups qualifying as subject to the supplementary supervision, such as financial conglomerates, must also meet the prudential provisions both jointly and severally. Credit institutions subject to supervision on a consolidated basis and all other entities covered by supervision on a consolidated basis may enter into a group financial support agreement under which a party to the agreement is to provide financial support to any other party to the agreement affected by the measures, exceptional measures to be taken by the Central Bank upon the occurrence of events invoking such measures.

Pursuant to the Banking Act, financial institutions, in addition to financial services as determined by the Banking Act, are exclusively entitled to perform the following activities:

- activities auxiliary to financial services:
  - currency exchange activities;
  - operation of payment systems;
  - money processing activities;
  - financial brokering on the interbank market; and
  - credit consultancy services;
- insurance mediation services;
- securities lending or borrowing, acting as nominee for shareholders, providing investment services pursuant to Act CXXXVIII of 2007, auxiliary services, intermediary activities and commodity exchange services;
- transactions in gold;
- keeping registers of shareholders;
- trust service;
- activities in support of the lending operations of the Student Loan Centre;
- recruiting new members for voluntary mutual insurance funds;
- activities relating to the management of collateral held any other form of security with a view to reducing or avoiding losses from financial services;
- activities relating to management and enforcement claims as an agent;
- sale and purchase of information related to financial instruments;
- conveyance of subsidies from the European Union, and the state;
- activities in connection with the acquisition of right of road usage pursuant to Act LXVII of 2013 on the fees payable for usage of motorways, highways and main roads in proportion to the distance that was taken; and
- services in connection with managing deposits.

Financial activities not listed above are prohibited activities with regard to financial institutions.

In addition, the provisions of the Banking Act limit certain market activities of financial institutions in the area of risk management in accordance with the relevant EU legislation. Such limitations include limitation of exposure related to the acquisition of ownership, and restrictions on investment activities, including real estate investment restrictions.

6 What are the principal regulatory challenges facing the banking industry?

Hungary is facing similar regulatory challenges faced by other EU countries. On December 2017, the Basel Committee on Banking Supervision (BCBS) published a package of proposed reforms for the industry's global regulatory framework (Basel IV). These packages comprise reforms of the standardised approach for credit risk, the IRB-approach, the quantification of company voluntary arrangements' risk and operational risk approaches. One principal feature is the way banks calculate risk-weighted assets (RWA). The implementation of the Basel IV framework is a remarkable challenge for the European banking industry, because methodologies for the determination of capital requirements are to be revised. The BCBS proposes a nine-year implementation timetable, which allows considerable time for preparation. A five-year 'phase-in' period would commence on 1 January 2022, with full implementation anticipated from 1 January 2027. For banks, this means that the next steps for efficient implementation must be planned and managed at an early stage and integrated into the organisation's strategy. Further regulatory challenges arise from the new EU payment system regulations (PSD2) as well as from the new EU data protection regulation (GDPR), Regulation (EU) No. 2016/679. The Hungarian government also continues to decrease the bank levy volume in 2018, which is aimed at boosting credit institution lending activity.

7 Are banks subject to consumer protection rules?

The CXXXIX Act of 2013 on the National Bank of Hungary states that it aims to protect the interests of parties using the services rendered by financial organisations and to strengthen the public confidence in the financial system. The main pillars of the consumer protection policy overseen and enforced by the Central Bank are efficient supervision, efficient enforcement of sanctions and the protection of defenceless groups in society.

The Central Bank, upon request, or of its own motion, monitors compliance with consumer protection provisions of Hungarian law and opens the proceeding. Proceedings for the protection of consumers' interests may not be opened more than five years after the infringement. The administrative time limit for these proceedings is six months. In this period the Central Bank has the power to carry out trial transactions and to conduct direct inquiries or general inquiries. If the Central Bank finds any infringement it may impose sanctions such as:

- issue a warning for taking the measures necessary for compliance with the relevant legal provisions, and for eliminating the discrepancies detected;
- order the cessation of the infringement;
- prohibit any further infringement;
- order the infringer to terminate within the prescribed time limit the deficiencies and disparities exposed, and notify the Central Bank concerning the measures carried out to eliminate such deficiencies and disparities;
- ban or impose conditions regarding the pursuit of the activity or the supply of services involved in the infringement, until the infringement is eliminated; and
- impose a consumer protection fine.

The most common practices that have attracted the attention of the Central Bank are practices such as unilateral increment of fees and misinforming consumers.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

In Hungary the legal and regulatory policies regarding the banking sector correspond to related policies of western European countries and the European Union. The above regulations rest on three main principles:

- security (the main aspects of security are described in question 1);
- competition (securing equal conditions and fair competition); and
- consumer protection.

Future regulation, in correspondence with EU legislation, is likely to focus on enhanced liquidity and risk management of financial institutions and to expand regulatory control in the banking industry. It shall be a continuous function of the legal and regulatory policies to increase the ability of the banks to be shock resistant, generate and ensure sustainable and fair competition between banks and as well as increase consumer protection. On the other hand, as the banking industry is in 'post-crisis' condition, the government and the Central Bank also have a role of boosting the loan operation activity of the industry.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The basis of supervisory control is regular disclosure of data and the supervisory procedure performed by the Central Bank. The Central Bank highlighted the main areas of its prudential supervision for year 2018 regarding the financial market, liquidity risk management, the analysis of the business model of banks from the perspective of the viability of their activity and the sustainability of the sound operation of the financial system and the examination of the recuperating credit and interest risks. The banks and Hungarian branch offices of credit institutions established in other EU member states have to provide the Central Bank with a report at least once a year, and must report certain events (eg, an increase or decrease of capital, suspension, limitation and cancellation of certain financial services and activities auxiliary to financial services). Furthermore, the Central Bank is entitled to compel the banks to supply data on certain issues. In the event that they find themselves in danger of breaching the rules on prudence, banks are obliged to notify the Central Bank.

During the supervisory review, the Central Bank reviews the strategies, policies, processes and methods relating to the capital adequacy of credit institutions and evaluates their exposure in accordance with the Hungarian regulation and Regulation (EU) No. 575/2013. The frequency and extent of the review and evaluation are determined by the Central Bank, based on the size and the extent of the activity of the bank in question. It must, however, be updated on at least an annual basis.

The Central Bank may conduct comprehensive inspections and direct inquiries into financial organisations in connection with a specific problem or, if the same problem arises at several financial institutions, a general inquiry. It may also conduct post-inspections or may request information concerning compliance with its resolutions. Comprehensive inspections and direct inquiries may take no longer than six months; in the event of general inquiries the deadline is nine months, but these may be prolonged by six months if there is a reasonable cause.

The Central Bank conducts a market surveillance procedure if a suspicion of unlawfulness arises, inter alia, if operations or services are conducted by a bank without proper authorisation or notification. The Central Bank may also conduct enquiries, ex officio or upon an application, into breaches of the consumer protection laws.

Credit institutions (financial holding companies) that are supervised on a consolidated basis must comply with the provisions concerning prudent operation, risk exposure and capital adequacy not only separately but also collectively.

10 How do the regulatory authorities enforce banking laws and regulations?

On the one hand, laws are enforced during an authorisation procedure by the rejection of authorisation and the withdrawal of authorisation; on the other hand, the Central Bank may choose between measures determined in the Banking Act according to the seriousness of the violation.

Concerning the regulatory instruments, other supervisory tools also exist. These supervisory tools, such as recommendations, supervisory guidance, samples for bylaws, can help, inform and guide the banking sector in connection with the supervisory interpretation of the legislation and the expectations of the Authority.

In the event of a bank violating the laws concerning it, the Central Bank will consider taking measures (eg, calling upon the bank and the legal person other than a financial institution engaged in providing financial services or financial auxiliary services, or both, to take the necessary steps to comply with the regulations of this Act and regulations relating to prudential requirements, requiring the extraordinary supply of data, obliging the financial institution to draw up and execute an action plan, or adopting a resolution to declare the fact of infringement). In the event of considerable violations of the provisions and where the Banking Act orders it to do so, the Central Bank will take the necessary measures prescribed in the Banking Act. In the event of any serious infringement, and where the Banking Act orders it to do so, the Central Bank will take the necessary measures or extraordinary measures (eg, delegate a supervisory commissioner to the credit institution, or limit or prohibit certain transactions and payments).

The Central Bank may (simultaneously with a measure or extraordinary measure or by itself) impose fines and penalties. Penalties may be imposed both on banks and executive officers failing to fulfil the provisions on operation, breaching their own internal regulations or an obligation set out by the Central Bank in its Resolution or late compliance with those provisions. The basic penalty is between 100,000 and 2 billion forints. The penalty varies according to the nature and severity of the violation. It could amount to 200 per cent of the supervisory fee (basic fee and variable fee) if this exceeds 2 billion forints. The penalties imposed on an executive officer may be between 100,000 and 500 million forints that cannot be paid off by the bank itself.

An inquiry by the Central Bank may be initiated by a foreign financial supervisory authority.

If the Hungarian branch of a financial institution established in another EU member state or the cross-border financial services and activities in the territory of Hungary of a financial institution established in another member state violates the provisions of Hungarian law, the Central Bank first calls upon the branch or bank to rectify the situation. If it refuses to comply, the Central Bank will notify the supervisory authority of the other EU member state and request that the supervisory authority take appropriate action. If the supervisory authority fails to act, the Central Bank may take the issue to the European Banking Authority.

If the Central Bank considers that the continued anomalous situation presents a serious threat to the stability of the financial system or the interests of customers, it is entitled to act directly. In that event, the Central Bank informs the supervisory authority of the concerned member state about the measures applied, as well as any extraordinary measures, and the reasons for them.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The primary supervisory issues facing the Central Bank concerning the banking sector in 2018 are ensuring (if they need enforcing) the prudent operation of the sector, in line with EU rules, ensuring:

- the stability and uninterrupted operation of the financial markets;
- providing a framework for safe, competitive and sustainable growth;
- identifying poor market practices in the mortgage-lending market and risks threatening the liquidity of certain financial institutions;
- handling already known risks, including conduct risks;
- providing substantiation for reorganisation plans;
- proactively and consistently protecting consumers' rights and interests;
- providing a forum for resolving disputes;
- educating consumers;
- strengthening public trust in the financial system; and
- helping EU-level supervision.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

In order to maintain financial stability, ensure the continuous availability of the critical functions provided by the financial sector, efficiently manage any institutional crises and minimise the use of taxpayer funds for crisis management purposes and establish a framework for the administrative restructuring of distressed financial Institutions, the Parliament has adopted the Resolution Act, according to which the Central Bank shall, in the case of a systemic crisis, notify the minister in charge of monetary regulation and the capital and insurance market if the objective of resolution actions applied by the Central Bank has not been accomplished.

Based on the notification in his or her decision, the minister in charge of the monetary regulation, capital and insurance market may resolve that the state financial stabilisation instrument is to be applied. A state financial stabilisation instrument may take the form of a capital increase or take the form of temporary nationalisation of the shareholdings. Upon temporary nationalisation in the context of the state financial stabilisation instrument, the shareholdings in the institution, financial holding company, mixed financial holding company or mixed activity holding company under resolution, having its registered office in Hungary, shall be transferred to the state or a solely state-owned enterprise. In the course recapitalisation by the state and temporary nationalisation, it shall be ensured that the institution concerned or the financial undertaking keeps operating on a commercial basis and that on the principle of private investment in the market the role of the state as the owner of the equity elements is taken over by market players through a public auction.

According to the Banking Act, the Central Bank may appoint a supervisory commissioner if the dissolution procedure opens after the date of the resolution, at the same time it passes the resolution of dissolution (if this has not happened earlier). The commissioner's assignment shall end at the time when the receiver takes over, and he shall have powers to stop all payments until the time of the opening of the dissolution procedure.

When taking the resolution actions and exercising the resolution powers, the shareholders of the institution under resolution bear losses first. No shareholder shall incur greater losses directly related to the application of the resolution actions than would have been incurred if the institution had been liquidated. After the execution of the resolution action it shall be assessed by the independent asset appraiser, whether the shareholders and the creditors would have been treated better by having the institution under resolution liquidated. That valuation shall be distinct from the independent valuation specified in the Resolution Act. If the assessment carried out determines that any shareholder or creditor has incurred greater losses than it would have incurred in the case of liquidation, it shall be entitled to indemnification.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

If a bank failure is caused by reasons set out in the Banking Act, the Central Bank may pass a resolution in which it appoints a supervisory commissioner. In certain cases, the Central Bank does not have the right to decide and must appoint a commissioner. The board of directors and members of the supervisory board have the right to seek remedy against such resolution of the Central Bank.

During the period of the supervisory commissioner's appointment, members of the board of directors cannot perform their duties or exercise their signatory rights as described in the statutory provisions governing business associations and cooperatives. For the period of appointment, the supervisory commissioner exercises the rights of board members described by law and the charter documents.

14 Are managers or directors personally liable in the case of a bank failure?

The liability of the members of the board and the supervisory board is regulated by different acts. The Hungarian Civil Code sets out the general rules, according to which the board and supervisory board members will act with due care and diligence bearing in mind the best interests of the company. The board and supervisory board members are both personally and financially responsible towards the company for any damages they have caused by breaching the rules, the charter document or resolutions of the general meeting or by breaching their managerial duties.

Concerning liability, specific regulations are laid down in the Banking Act.

The executive officers, members of the board and the supervisory board of the financial institution are liable to ensure that the financial institution carries out the licensed activities in accordance with the provisions set out by the Banking Act and other laws.

The executive officers and employees of the financial institution will act at all times with due diligence and expertise consistent with the professional requirements applicable for their respective positions, also in view of the interests of the financial institution and its customers, and in compliance with the relevant regulations.

The notification obligations described in question 17 will be fulfilled by the executive officers of the credit institution.

The case is different from the foregoing if a manager or a director is an employee of the credit institution, because in that case the rules of the Labour Code will apply to his or her liability.

Since the Central Bank continuously monitors the operation of credit institutions, it should notice when a credit institution does not operate prudently. In those cases, the Central Bank tries to enforce the prudent operation and, as stated in question 10, it can impose penalties, including fines, on executive officers who fail to fulfil provisions or who breach the law or the internal regulations of the bank.

If any actions of executive officers breach any section of Economic Crimes of the Criminal Code, the officers will also be held responsible for such actions.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

Credit institutions must have written policies and procedures for the identification, measurement, management and monitoring of liquidity risk (costs and benefits, too) over an appropriate period of time. According to the Banking Act, credit institutions are required to distinguish between pledged and unencumbered assets that are available at all times, in particular during emergency situations. They also take into account:

- the legal entity in which assets reside;
- the country where assets are legally recorded either in a register or in an account and their eligibility to be used as extra liquidity buffers;
- monitor how assets can be mobilised in a timely manner; and
- existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets among entities, both within EU member states and in third countries.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Banks may be founded with a minimum subscribed capital of 2 billion forints. A branch office of a third-country credit institution may be established with a minimum of 2 billion forints in endowment capital.

The requirement of prudent operation as it relates to banks means that they have to manage the funds placed in their custody, as well as their own resources, in order to maintain liquidity and solvency at all times. Credit institutions shall have sufficient own funds at all times to cover the risks of its activities, covering at least the minimum capital requirement defined in article 92 of Regulation (EU) No. 575/2013, the extra capital requirement prescribed in the framework of a supervisory review; but it may not be less than the minimum amount of subscribed capital prescribed as a precondition for authorisation.

The provisions concerning the equity capital, solvency margin, reserves, limitations of exposure (ie, limitations and restrictions on high exposure, investments, acquisitions, qualification of assets, risk reserves), collections of resources and the approximation of maturity and liquidity come within the requirement of prudent operation.

Banks must place 10 per cent of their annual after-tax profits into a general reserve to offset losses incurred during their activities. Upon request, a credit institution may be exempted by the Central Bank from the obligation to maintain general reserves. Credit institutions are allowed to use general reserves only to cover operating losses arising from their activities.

As Regulation (EU) No. 575/2013 and Directive 2013/36/EU influenced the Banking Act, in accordance with the cited EU legislation, credit institutions also have the obligation to maintain a capital conservation buffer and an institution-specific countercyclical capital buffer. Special rules apply to the capital buffers of global and other systemically important institutions.

17 How are the capital adequacy guidelines enforced?

Banks have certain notification and data disclosure requirements as regards the Central Bank, in particular that the banks comply with the capital requirements. The board of directors of a credit institution must immediately notify the Central Bank in writing:

- if the danger of illiquidity is imminent;
- in occurrences of danger with respect to the activities of the credit institution (for example, in case of insolvency);
- if the solvency margin has diminished by 25 per cent or more; or
- if the credit institution has suspended its payments or it has stopped its operations or financial service activities.

Furthermore, the board of directors of a credit institution must notify the Central Bank within two business days in writing if the subscribed capital is increased or reduced, or their certain financial activities have been suspended, limited or terminated. Credit institutions operating as a branch office have additional reporting obligations.

Through the supervisory review, the Central Bank reviews the strategies, policies, processes and methods relating to the capital adequacy of credit institutions and evaluates their exposure.

Measures and extraordinary measures will also be applied (besides fines) in the case of infringement of capital adequacy requirements.

18 What happens in the event that a bank becomes undercapitalised?

If the amount of a bank's equity capital falls below the minimum amount of subscribed capital prescribed by the Banking Act, the Central Bank may give the credit institution a maximum of 18 months to bring its equity capital to compliance level. If the amount of equity capital of a bank falls below the amount of the subscribed capital, the Central Bank may compel the financial institution's executive board to convene a general meeting. In this case, the general meeting will decide whether the financial institution should reduce the subscribed capital or the owners who have a qualifying holding should provide for the financial institution's equity capital to be restored to at least the level of the mandatory subscribed capital.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

The Central Bank applies extraordinary measures in lieu of bankruptcy proceedings; for example, it may:

- prescribe the selling of certain assets of the credit institution;
- set a deadline for the financial institution to settle its capital structure;
- prohibit certain transactions and payments;
- set the maximum of the interest applicable by the credit institution;
- compel the board of directors to convene the general meeting;
- delegate a supervisory commissioner; or
- revoke its consent to the appointment of liable executive officers; and
- may call upon the owner of the financial institution to take the necessary measures.

If the board of directors fails to convene the general meeting, the Central Bank can turn to the court of registry.

If the bank becomes insolvent, the board of directors must immediately notify the Central Bank in writing. In the event of insolvency, liquidation proceedings will ensue. The liquidation proceedings can be initiated either by the bank in question itself or the Central Bank at the Metropolitan Court.

The Central Bank initiates liquidation proceedings against the bank or the branch office of a third-country financial institution in the event that the Central Bank withdraws the credit institution's authorisation on the basis of it failing to pay any of its undisputed debts within five days of the date on which they are due, or it no longer possesses sufficient funds (assets) to satisfy the known claims of creditors. Furthermore, liquidation proceedings will commence if the person in charge of the dissolution procedure of a credit institution informs the Central Bank that the assets of the credit institution will not cover the claims of the creditors and the owners or members do not pay the outstanding amount, or, in the case of a branch office, if insolvency proceedings have been initiated against the foreign financial institution that is operating the branch office in Hungary. The Hungarian branch office of a credit institution established in another EU member state may not be liquidated under Hungarian law.

The court must decide on the request for liquidation within eight days of its submission.

During the liquidation of a financial institution, creditors shall present their claims within 60 days of the publication of the court ruling ordering liquidation.

The court appoints the liquidator in the order adopted on the liquidation. Only the non-profit business association specifically established for liquidating organisations covered by Act CXXXIX of 2013 on the National Bank of Hungary shall be appointed as the liquidator or receiver of a financial institution.

The Central Bank may, from the submission of the request for liquidation, order the prohibition of all payments until the starting date of the procedure (the date of the order's promulgation in the Official Gazette). The Central Bank's permission is also required for the settlement's approval during the settlement process if the further operation of the bank constitutes a condition of the settlement. If no settlement has been reached or the court refuses to confirm the settlement, the court issues an order concerning, inter alia, the satisfaction of the creditors, the conclusion of the liquidation and the dissolution of the debtor and any subsidiary of it.

Special rules apply to credit institutions that operate branch offices in other EU member states or provide cross-border services. In these cases, the Central Bank informs the supervisory authorities of the EU member states where the credit institution under liquidation proceedings operates any branch offices or provides cross-border services. The liquidation order's effect applies to all EU member states.

The provisions of the Act on Bankruptcy and Liquidation Proceedings will apply in the case of issues not covered by the Banking Act.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

The Banking Act has been amended to conform with Regulation (EU) No. 575/2013 and Directive 2013/36/EU. The first amendment is the Capital Requirements Regulation (CRR), the second is the Capital Requirements Directive (CRD). These legal acts comprise the new Capital Requirements Directives (CRD IV). The CRD is the legal framework for the supervision of credit institutions, investment firms and their parent companies in every EU member state and the European Economic Area. The CRR has been in force since 27 June 2013, while the supervised entities within its scope are subject to it as of 1 January 2014. The CRR is directly applicable to anyone in the European Union and is not transposed into national law, though the Banking Act makes references to it and complies with its provisions. Much of the CRR is derived from the Basel III standards issued by the Basel Committee on Banking. It includes most of the technical provisions governing the prudential supervision of institutions. The future implementation of the Basel IV framework is a remarkable challenge for the European banking industry, because methodologies for the determination of capital requirements are to be revised.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

According to the Banking Act, in the Hungarian regulation 'qualifying holding' has the same meaning as laid down by Regulation (EU) No. 575/2013. It means a direct or indirect holding in an undertaking that represents 10 per cent or more of the capital or of the voting rights, or that makes it possible to exercise a significant influence over the management of that undertaking.

In respect of the acquisition of a qualifying holding, the Banking Act does not discriminate between persons or types of entities. The acquirer must obtain the permission of the Central Bank.

According to the Banking Act, any person who wishes to acquire a qualifying holding in a credit institution must be independent of any influences that may endanger the institution's sound, diligent and reliable (collectively, 'prudent') operation, must have goodwill and the capacity to provide reliable and diligent guidance and control of the credit institution, and also its ownership structure as well as business connections must be transparent so as to allow the competent authority to exercise effective supervision over the credit institution. Moreover, the legitimate source of the remuneration paid for the qualifying holding must be proved.

If the credit institution is a public limited company the provisions of the Act on Capital Markets regarding acquisition of a qualifying holding will also apply.

22 Are there any restrictions on foreign ownership of banks?

There are no restrictions.

23 What are the legal and regulatory implications for entities that control banks?

Once the permission described in question 21 is obtained in accordance with the Banking Act, there are no further special implications for entities that acquired a qualifying holding. However, the requirements specified above shall also be fulfilled during the course of the credit institution's operation.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

The essential requirements against persons and entities with a qualifying holding are diligent and reliable operation, goodwill, transparency and guidance and control of the financial institution (see question 21).

For this purpose, the main duty of acquirers is to provide the credit institution's capital. The amount of the credit institution's own funds may not be less than the minimum amount of initial capital prescribed by the Banking Act. The owners will, however, not be directly compelled to provide further capital contributions; the prudent operation is simply not the owners' responsibility. Therefore, if the amount of a credit institution's own funds falls below the minimum level of the initial capital, the Central Bank will give the credit institution (in essence, the owners) a maximum of 18 months to bring its own funds into compliance, or it may compel the financial institution's board of directors to convene a general meeting. In this case, the general meeting will decide whether the financial institution should reduce the subscribed capital or if the owners who have a qualifying holding should provide for the financial institution's own funds to be restored to at least the amount of prescribed initial capital.

Pursuant to the Banking Act, the Central Bank may also take certain measures and necessary exceptional measures if the owner of a financial institution violates the Banking Act itself, the legal provisions on effective, reliable and independent ownership and prudent operation, or obviously conducts its activities without due care. For example, the Central Bank must consider the need for such measures if the credit institution's own funds fail to reach the capital requirements described by the Banking Act, or the owners violate any of the regulations on exposures, on the determination, analysis, evaluation and definition of exposures, on the management of exposures or on the management and reduction of risks. There are also certain circumstances when the Central Bank must take measures, or exceptional measures, against the credit institutions or the owners.

In the foregoing circumstances the Central Bank may, inter alia:

- stipulate an extraordinary supply of data;
- require the credit institution to take measures for reinforcement of the arrangements, processes, mechanisms and strategies relating to its internal control mechanism, corporate governance functions, risk-management procedures and internal models for the assessment of capital adequacy; or
- prohibit, limit or make subject to conditions payment of dividends, raising of loans by the owners of financial institutions, or rendering services to them by credit institutions that involve any exposure.

When applying exceptional measures, the Central Bank may limit or prohibit the credit institution concluding transactions between the owners and the credit institution. The Central Bank may also simultaneously call upon the owner of the financial institution that has a qualifying shareholding to take any necessary measures.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

For insolvency the regulations do not contain special implications for entities or individuals with a qualifying holding; therefore, the general regulations for the owners will apply.

Update and trends

With the adoption of the revised payments directive (PSD2), the European Parliament mandated a radical change in the European payment industry. The main scope of the PSD2 is to encourage new players to enter the payment market, and mandates banks to open up the bank account to external parties. These third-party players are divided in two types: account information service providers that can connect to bank accounts and retrieve information from them and payment initiation service providers, that can initiate payment transactions. PSD2 was implemented to Hungarian law and came into effect in 13 January 2018. As a consequence, new services will arise in the form of payment methods and customers will potentially benefit from the competition.

Owing to growing concerns around the safety of personal data from identity theft, cyberattacks, hacking or unethical usage, the European Union has introduced the new GDPR. The European Union aims to standardise data privacy laws and mechanisms across industries, regardless of the nature or type of operations. The GDPR is creating challenges requiring action in the banking industry with relevance for the organisation, processes and systems of banks in order to achieve compliance with it. Liability in the event of any breach is significant and, apart from the monetary effect, a gap in the data protection framework of a bank can lead to a significant loss of reputation. All organisations must ensure compliance by 25 May 2018.

In the event of insolvency, essentially the same measures and exceptional measures described in question 24 may be taken by the Central Bank, such as compelling the financial institution's board of directors to convene a general meeting and calling on the owners of the financial institution with a share of 5 per cent or more to take the necessary measures.

Following the foregoing call upon the owners, the credit institution's board of directors must take immediate action to ensure that deposits and other owners' receivables due from the credit institution are blocked, that lending to companies in the sphere of interests of the owners is suspended and that no financial services involving exposure of the owners are rendered.

The board of directors of the credit institution must keep these restrictions in effect until the owners resolve the reason the measures were imposed or the credit institution's liquidation is ordered by the court.

If the financial institution fails to comply with the supervisory measures, the Central Bank may convene a general meeting of the financial institution at the court of registry.

If the measures taken by the Central Bank were insufficient to prevent the insolvency, the Central Bank must initiate the liquidation of the credit institution pursuant to liquidation rules governed by the Act on Bankruptcy and Liquidation Proceedings (see also question 19).

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

For this purpose, 'control' is defined as in question 21.

According to the Banking Act, the Central Bank's permission must be obtained before executing a contract regarding the acquisition of a qualifying holding in a credit institution, as well as regarding the acquisition of additional qualifying holding by which 20, 33 or 50 per cent of ownership share or voting rights would be reached. Accordingly, the owner of a credit institution may only enter into contracts regarding ownership rights, voting rights or to secure advantages in excess of such rights with the Central Bank's permission.

Finally, the Central Bank's permission must be obtained before executing a contract for the acquisition of majority ownership in a company with a qualifying holding in a credit institution.

The permissions must be obtained in each case prior to the conclusion of the contract. Accordingly, following the conclusion of the contract the Central Bank must be informed within 30 days about the execution of the above transactions.

In cases specified in the Competition Act the acquirer must also obtain the approval of the Competition Authority.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The process basically corresponds to the general process prescribed for any acquirers. There are two supplementary rules, however, provided for foreign acquirers as follows:

- If there is a foreign-registered financial institution, insurance company or investment company among the founders wishing to acquire a qualifying holding, in addition to the general requirements, a statement from the competent supervisory authority of the country of origin stating that the enterprise conducts its activities in compliance with prudential regulations must also be attached to the application for authorisation.
- If the applicant is a financial institution, investment firm, insurance company, reinsurance company or a UCITS management company authorised in another EEA member state or is the parent of either of the companies, or controls any of these companies, the Central Bank shall forward the application without delay to the competent supervisory authority of the place where the applicant is established.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

While considering an application, the Central Bank must investigate whether the applicant's activity and its influence over the credit institution endangers the prudent guidance and control of the credit institution. The Central Bank will also investigate whether the applicant's transparency in business connections and ownership structure and the structure of its direct or indirect holding in other businesses allows the competent authority to exercise effective supervision over the financial institution. The Central Bank shall refuse to grant the authorisation if the applicants' or its members' or executive officers' activities, influence on the financial institution is considered harmful to the financial institutions independent, sound and prudent management, business activities or relations, or direct or indirect members' share or holdings in other companies is structured in a manner to obstruct supervisory activities, or good business reputation is lacking.

The Banking Act only gives examples of the circumstances when the applicant's or its owner's activity or its influence on the credit institution endangers its prudent operation.

According to the Banking Act, prudent operation is endangered particularly if:

- the applicant's or its owner's financial and economic standing is inconsistent with the extent of the acquisition of ownership share as proposed;
- the legitimacy of the origin of the funds used for acquisition of the ownership interest or the authenticity of the information the person specified as owner of the funds is not sufficiently evidenced;
- the applicant or its owner fails to meet the conditions determined for the credit institution by the Central Bank in the extraordinary action plan;
- the Central Bank has suspended its right to exercise voting rights within the five years before the notification; or in the case of individuals, he or she:
  - has a criminal record;
  - has seriously or regularly breached the banking regulations, and this has been stated in a final decision less than five years ago;
  - has been established as having personal responsibility for the liquidation or a situation close to insolvency of a credit institution; or
  - does not have a good business reputation.

29 Describe the required filings for an acquisition of control of a bank.

When applying for acquisition authorisation, the following filings are necessary according to the Banking Act:

- in the case of credit institutions that are subject to supervision on a consolidated basis or supplementary supervision, a description of the apparatus for the conveyance of information related to supervision on a consolidated basis or supplementary supervision and a statement from the persons with close links to the credit institution guaranteeing to provide the Authority with the data, facts and information necessary for supervising the credit institution on a consolidated basis or for supplementary supervision, and a statement from each natural person with close links to the credit institution containing his or her consent to have the personal data he or she has disclosed to the credit institution processed and disclosed for the purposes of supervision on a consolidated basis or supplementary supervision;
- the applicant's specific identification data as described in the Act;
- evidence concerning the legitimacy of the financial means for acquiring a qualifying holding;
- documents issued within 30 days in proof of having no outstanding debts owed to the tax authority (if the taxpayer is listed in the taxpayers' register as being free of tax debts it shall be recognised as equivalent), customs authority, health insurance administration agency or pension insurance administration agency of competence under the applicant's national law;
- a statement declaring that other holdings and business activities of the applicant are not harmful to the prudent management of the financial institution;
- for natural persons, an official certificate from the body operating the penal register for the purpose of verification of having no prior criminal record, or a similar document that is deemed equivalent under the applicant's national law;
- if other than a natural person, the applicant's consolidated instrument of constitution in effect on the date of application, a certificate issued within the last 30 days proving that the applicant was established (registered) in compliance with the relevant national regulations and is not adjudicated in bankruptcy, liquidation or dissolution proceedings, and its senior executives are not subject to any disqualifying factors;

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- if other than a natural person, a detailed description of the applicant's ownership structure supported by documentary evidence and information about beneficial owners, and if the applicant is subject to supervision on a consolidated basis a detailed description of these circumstances, furthermore, the consolidated annual account for the previous year of the credit institution or investment firm subject to supervision on a consolidated basis, if they are required to prepare a consolidated annual account;
- a statement declaring any and all contingent liabilities and commitments;
- statement of the applicant executed in a private document representing conclusive evidence that gives consent to attaching authentic documents to the application; and
- if there is a foreign financial institution proposing to acquire a qualifying holding a statement or certificate from the competent supervisory authority of the country of establishment stating that the enterprise conducts its activities in compliance with prudential regulations.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The applicant or the owner may exercise voting rights deriving from the qualifying holding or the rights deriving from the advantages secured by the agreement connected with acquisition of ownership or voting rights as of the 60th business day of the Central Bank's receipt of the application for authorisation, unless the Central Bank refuses to authorise the acquisition as of the 60th business day of the receipt of the application.

The Central Bank may, however, call the applicant for completion of documents. The duration for the completion is 20 business days, in the cases of companies seated in another EU member state it is 30 business days, and this period is not included in the aforementioned 60-business-day period.

India

Feroz Dubash, Sonali Mahapatra and Shruti Zota

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The Indian banking sector is regulated by the Reserve Bank of India Act 1934 (RBI Act) and the Banking Regulation Act 1949 (BR Act). The Reserve Bank of India (RBI), India's central bank, issues various guidelines, notifications and policies from time to time to regulate the banking sector. In addition, the Foreign Exchange Management Act 1999 (FEMA) regulates cross-border exchange transactions by Indian entities, including banks.

2 Summarise the primary statutes and regulations that govern the banking industry.

India has both private sector banks (which include branches and subsidiaries of foreign banks) and public-sector banks (ie, banks in which the government directly or indirectly holds ownership interest). Banks in India can primarily be classified as:

- scheduled commercial banks (ie, commercial banks performing all banking functions);
- cooperative banks (set up by cooperative societies for providing financing to small borrowers); and
- regional rural banks (RRBs) (for providing credit to rural and agricultural areas).

Recently, the RBI has also introduced specialised banks such as payments banks and small finance banks that perform only some banking functions.

The key statutes and regulations that govern the banking industry in India and particularly scheduled commercial banks are as follows:

RBI Act

The RBI Act was enacted to establish and set out functions of the RBI. It grants the RBI powers to regulate the monetary policy of India and lays down the constitution, incorporation, capital, management, business and functions of the RBI.

BR Act

The BR Act provides a framework for supervision and regulation of all banks. It also gives the RBI the power to grant licences to banks and regulate their business operation.

FEMA

FEMA is the primary exchange control legislation in India. FEMA and the rules made thereunder regulate cross-border activities of banks. These are administered by the RBI.

Other key statutes

The other key statutes include:

- the Negotiable Instruments Act 1881;
- the Recovery of Debts Due to Banks and Financial Institutions Act 1993;
- the Bankers Books Evidence Act 1891;
- the Payment and Settlement Systems Act 2007;
- the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002; and
- the Banking Ombudsman Scheme 2006.

Public sector banks are regulated by the BR Act and the statute pursuant to which they have been nationalised and constituted. These include:

- banks constituted under the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970 or the Banking Companies (Acquisition and Transfer of Undertaking Act) 1980; and
- the State Bank of India and subsidiaries and affiliates of the State Bank of India constituted and regulated by the State Bank of India Act 1955 and the State Bank of India (Subsidiary Banks) Act, 1959 respectively.

Unless otherwise specified, this chapter focuses on the regulatory regime governing private sector banks.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The RBI supervises and is responsible for managing the operation of the Indian financial system. In addition to issuing regulations and guidelines for banking operations, it also administers the provisions of the RBI Act, the BR Act and FEMA. It has wide discretionary powers and is authorised to inspect and investigate the affairs of banks and to impose penalties in the event of non-compliance.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The deposits placed with various banks are insured by the Deposits Insurance and Credit Guarantee Corporation (DICGC), which is a subsidiary of the RBI and is governed by the Deposits Insurance and Credit Guarantee Corporation Act 1961. The DICGC insures all deposits such as savings, fixed, current, recurring, etc, except the following:

- deposits of foreign governments;
- deposits of central and state governments;
- inter-bank deposits;
- deposits of the state land development banks with state cooperative banks;
- any amount due on account of any deposit received outside India; and
- any amount that is specifically exempted with prior RBI approval.

Each depositor of a bank is insured up to a maximum amount of 100,000 rupees. The premium for such deposit insurance is borne by the relevant bank.

In the past, the government of India (GOI) has nationalised a number of major commercial banks. There are currently 19 commercial banks that were nationalised in two phases: in the 1960s and 1980s. While the GOI has not made any moves for further nationalisation of banks, the BR Act gives the GOI the power to acquire undertakings of an Indian bank in certain situations, such as breach of banking policy by the bank. In addition, the GOI also establishes RRBs (which are primarily controlled by the GOI, directly or indirectly) in different states from time to time, as it considers necessary.

Since the early 1990s, the government has generally liberalised regulations and encouraged private sector involvement in the banking sector. Measures taken include:

- providing banking licences to private banks;
- granting licences to set up different types of banks such as payments banks, small sector banks and universal banks; and
- encouraging foreign banks to convert to wholly owned subsidiaries (WOS) with consequential liberalisation of branch licensing restrictions.

At present, the foreign direct investment (FDI) limit in private sector banks is 74 per cent. At all times, at least 26 per cent of the paid-up capital will have to be held by residents, except in regard to a WOS of a foreign bank. In public sector banks, the FDI limit is 20 per cent. The RBI is currently in discussions with various stakeholders for liberalising the sector and permitting 100 per cent foreign direct investment in private banks.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Transactions with affiliates (referred to as related-party transactions (RPTs)) are mainly regulated by the Companies Act 2013 (CA 2013). If the bank is a listed company, it will also need to comply with the norms set out for RPTs in the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 (the Listing Regulations). Related parties include:

- directors (or their relatives);
- key managerial personnel (or their relatives);
- subsidiaries;
- holding companies; and
- associate companies.

The relevant regulations set out separate thresholds and approval requirements (usually approval from board of directors or shareholders, or both) for entering into an RPT. CA 2013 and the Listing Regulations also provide exemptions to certain types of transactions from such compliance (eg, a transaction between a company and its WOS is exempted from the requirement of obtaining board or shareholder approval under CA 2013 and the Listing Regulations). Further, transactions entered into in the ordinary course of business and on an arm's-length basis are exempted from the approval requirements under CA 2013.

RPTs by a bank must be disclosed in the bank's annual accounts in accordance with Indian generally accepted accounting principles. In addition, banks are prohibited from entering into certain RPTs under the BR Act. For example, a bank cannot give loans or advances to, or on behalf of, or remit any amounts due to it by:

- any of its directors (or spouse or minor children of such a director);
- any partnership firm in which any of its directors is interested as a partner, manager, employee or guarantor;
- any company or subsidiary or holding company of a company in which any of its directors is interested as a director, managing agent, manager, employee or guarantor, or in which a director (together with its spouse and minor children) holds interest of more than 500,000 rupees or 10 per cent of the paid-up capital of the company, whichever is lower; and
- any individual in respect to whom a director is a partner or a guarantor.

An approval from the board of the bank will be required for any loans given to relatives of any directors of that bank or directors or relatives of directors of any other bank.

Further, all transactions between a bank and a subsidiary or mutual fund sponsored by it should be on an arm's-length basis. The bank will need to evolve appropriate strategies and undertake regular review of the working of the subsidiary or mutual fund to ensure this.

6 What are the principal regulatory challenges facing the banking industry?

The key regulatory challenges are as follows.

Basel III implementation

Indian banks are required to fully comply with the Basel III Capital Regulations (Basel Regulations) by 31 March 2019. Most of the public-sector banks will need additional capital infusion to meet the higher capital requirements, which will consequently reduce the return on equity. As a result, government support will be required, which may exert significant pressure on the government's fiscal position.

Specialised banking

The RBI has currently granted approximately 10 small finance bank licenses and approximately seven payments of bank licences. While the RBI has set up the mechanism for the use of these licences, the current provision of these services seems to be falling short of catering to the unbanked sectors that include rural areas and other underdeveloped and unorganised sectors. Further reorientation of regulatory and supervisory resources is likely needed to widen access to these systems, in light of the wider objective of financial inclusion.

Asset quality

The quantity of net non-performing assets (NPAs) of Indian banks has been increasing significantly. The RBI has, over the years, taken significant measures, both regulatory and structural, in order to tackle this issue. However, the rise in NPAs continues to be one of the most fundamental threats to the banking sector (see question 24 for a brief on the measures being taken).

Priority sector lending and NPAs

The RBI requires banks to provide mandatory credit to certain weaker sections of society and sets out targets for the same. In the past, banks have struggled to meet these targets. These sectors often yield low profits, and they adversely impact banks' profitability.

Separately, the agricultural sector (one of the main sectors for priority lending) has a high level of NPAs. The new measures introduced by the RBI to reduce stressed assets, as mentioned above, do not take into account agricultural NPAs.

Challenges from the cashless economy

The shift to a cashless economy has brought with it a specific set of issues, which primarily revolve around access. The RBI has taken concerted measures such as setting up an e-wallet linked to the unique identification number system (AADHAAR) set up (akin to the social security number structure in the United States) and encouraging retailers, as well as other local businesses, to provide discounts and cash-back schemes for using electronic means of payment. There is a severe lack of infrastructure in most parts of the country for such payment systems to be used regularly, ranging from a functional internet connection to the sophistication of its users. Recently, privacy concerns, and legal challenges on this basis, have been raised. While these issues are currently being grappled with, there is a long way to go before India becomes a cashless economy.

Enforcement of the new insolvency regime

The IBC, which was brought into effect in December 2016, has been in operation for a year and a notable shift has been seen in the approach of the RBI, as well as creditors, in bringing action against defaulters. The National Company Law Tribunal and the National Company Law Appellate Tribunal have provided judgments that have helped clarify some points that were unclear in the IBC itself. While the jurisprudence is gradually developing, the Ministry of Finance has been quick to identify the challenges and update the IBC with regulations aimed to make the process more efficient. It remains to be seen if the IBC process actually keeps pace with increasing NPAs, therefore improving the status of banks as creditors within the Indian financial system.

7 Are banks subject to consumer protection rules?

Banks in India are subject to consumer protection laws that act as an alternative and speedy remedy to approaching courts, a process that can be expensive and time-consuming.

The Consumer Protection Act 1986 (the Consumer Protection Act) is the primary legislation governing disputes between consumers and service providers. The relationship between a bank and its customer is regarded as that of a consumer and service provider, therefore bringing them under the ambit of the Consumer Protection Act. A three-tier mechanism has been established to deal with complaints:

- district forum: this operates at the district level and deals with consumer complaints of a value not exceeding 2 million rupees;
- state commission: this operates at the state level and deals with consumer complaints of a value between 2 million rupees and 10 million rupees. It also hears appeals against the orders passed by the district forum; and
- national commission: this operates at the national level and deals with consumer complaints of a value exceeding 10 million rupees. It also hears appeals against the orders passed by the state commission. An appeal from the order of the national commission can be directed to the Supreme Court of India.

In addition, banks are also subject to the Banking Ombudsman Scheme for the purpose of adjudication of disputes between a bank and its customers. The scheme provides for a grievance redressal mechanism enabling speedy resolution of customer complaints in relation to services rendered by banks. The banking ombudsman is a quasi-judicial authority appointed by the RBI to deal with banking customer complaints relating to deficiency of services by a bank and facilitate resolution through mediation or passing an award. A complaint under the scheme has to be filed within one year of the cause of action having arisen.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

The Financial Resolution and Deposit Insurance Bill 2017 (the Bill) proposes to set up a comprehensive recovery and resolution regime for the financial sector companies and to substitute the present regime for deposit insurance, systematically important banks etc. The Bill, if passed and implemented, would amount to a comprehensive reform of the bank recovery and resolution regulations in India and create a wholly new regime covering the sector. The Bill contains detailed provisions on monitoring and assessment of banks' health and proactive planning for distress scenarios, including insolvency events. The new law will mean a more active monitoring of banks with certain key powers being transferred from the RBI to the resolution corporation. The Basel III capital norms would also be fully implemented by 2019, which would mark an end to a long and significant transition phase for the banking sector. Specialised banks such as payments banks and small finance banks are being set up to promote financial inclusion. We may see further policy changes to encourage the spread of the banking sector in currently underbanked areas.

With an aim to provide for a consolidated time-bound framework for reorganisation and insolvency resolution of companies, partnership firms and individuals, the code is being brought into force in a phased manner (see question 6). It is envisaged that the code will be fully implemented by 2017. As an additional measure to protect the interests of the consumer, the RBI proposes to adopt a comprehensive consumer protection framework in relation to the activities conducted by all financial institutions (and not just banks). This proposal is currently in the planning stage and there is no visibility regarding its implementation.

A shift towards a cashless economy has been observed following the demonetisation in November 2016, and the 2017–18 Budget proposes certain additional changes towards this end. By way of example, cash transactions over a limit of 300,000 rupees have been prohibited subject to certain conditions, there is a strong impetus towards increasing digital transactions and promoting use of internet-based payment gateways by providing discounts and concessions specifically to transactions undertaken digitally.

Over recent years, the government has taken several measures to liberalise FDI into India, with a view to promote the ease of doing business. As stated in question 4, there is a move to permit 100 per cent FDI in private banks. It is uncertain what regulatory changes will need to be made in case there is a change in the ratio of public and private sector banks in India with the added value of increased foreign investment.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The RBI conducts periodic audits and also acts as a consumer disputes ombudsman for retail banking. Based on its findings, and sometimes suo moto, the RBI also supervises the Indian banking system through various methods such as on-site inspection, surveillance and reviewing regulatory filings made by the banks.

Each year, the RBI conducts an on-site financial inspection of a bank's books of accounts, loans and advances, balance sheet and investments. Following this, the RBI issues supervisory directions to banks highlighting the major areas of concern. Banks are then required to draw up an action plan and implement corrective measures to comply with the inspection findings.

The RBI also monitors compliance on an ongoing basis by requiring banks to submit detailed information periodically under an off-site surveillance and monitoring system. Based on this, the RBI analyses the financial health of banks between two on-site inspections and identifies banks that show financial deterioration that thereby require closer supervision.

Additionally, the RBI conducts:

- quarterly discussions with the banks' executives on issues emanating from analysis of off-site surveillance, status of compliance with annual inspection findings and new products introduced by banks; and
- bi-annual meetings with the chief executive officers of the banking groups identified as financial conglomerates.

The RBI has taken special initiatives to supervise weaker banks such as quarterly monitoring visits to banks displaying financial and systemic weaknesses, appointment of monitoring officers and direct monitoring of problem areas in housekeeping.

10 How do the regulatory authorities enforce banking laws and regulations?

The RBI issues directions from time to time to ensure compliance with the banking statutes and rectify non-compliance, if any. In the case of non-compliance with regulatory requirements, the RBI may impose a variety of sanctions, including fines, orders for the suspension of a bank's business and cancellation of the bank's banking licence.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The most common enforcement issues are discussed below:

- Deterioration of asset quality of the banking system: Deteriorating asset quality is often attributable to poor underwriting by bank staff while undertaking credit appraisal of the projects. The RBI conducts ad hoc asset quality reviews of banks' assets. Based on this review, the RBI issues directions to banks for them to comply with capital adequacy norms (see question 18). Additionally, the RBI has directed banks to take other corrective measures such as conversion of debt into equity and has permitted longer repayment schedules for long-term projects. In light of the demonetisation measures, there is speculation that the asset quality review that is generally conducted at the end of the financial year will be postposed to the next financial quarter.
- Deficiencies in compliance with know-your-customer (KYC) anti-money laundering (AML) norms by banks: In 2013, investigations carried out by the Cobrapost media portal exposed serious violation of KYC and AML norms leading to imposition of a total fine of 500 million rupees by the RBI on 22 banks. To combat such a breach, the RBI is also considering imposing operational curbs on banks in addition to the monetary fines. The RBI has advised banks to undertake employee training programmes on KYC and AML policy as violations have often been attributable to the staff's lack of familiarity with, and ability to monitor compliance with, the KYC and AML policy.
- Mis-selling of financial and structured products: A wide range of complex structured financial products were being sold by banks to unsophisticated customers (such as retail and individual customers) without providing sufficient information. In 2011, the

RBI imposed a total fine of 19.5 million rupees on 19 banks for mis-selling derivative products to clients and failing to match the complexity of products to clients with appropriate risk profiles and determining whether clients have appropriate risk management policies prior to investing in these products. The RBI has framed a Charter of Customer Rights as overarching principles to protect customers, pursuant to which banks must formulate board-approved customer rights policies and conduct periodic reviews.
- Internal fraud: In 2015, investigations revealed a sum of 60,000 million rupees being routed to Hong Kong for non-existent imports through Bank of Baroda, leading to the arrest of certain bank employees. To combat fraud, the RBI has issued instructions for banks to take corrective measures, such as investing in data analytics and intelligence, gathering and maintaining internal vigilance and undertaking employee background checks. Further, a central fraud registry has been established, which acts as a centralised database to detect such fraud. Some banks have set up internal investigation teams to probe fraud allegations and implement anti-fraud controls.
- Financial inclusion: For meeting financial inclusion targets, the RBI observed that banks were incorrectly classifying their contingent liabilities and off-balance sheet items (such as letters of credit, bank guarantees, and derivative instruments). The RBI asked banks to immediately declassify such credit facilities with retrospective effect. Failure to meet the priority sector lending targets results in penalties and can hamper regulatory approvals in the future.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

The RBI can conduct compulsory amalgamations:
- in the public interest;
- in the interests of depositors of a bank;
- to secure proper management of a bank; or
- in the larger interests of the banking system.

For this purpose, the RBI, after declaring a moratorium in relation to the distressed bank, prepares a draft scheme of amalgamation, which is sent to the depositors, shareholders and creditors of the bank for comments. This scheme, among others, may provide for a change in the management of the bank and a reduction of rights of members, depositors and creditors.

The final scheme is placed before the two houses of parliament and, if approved, is eventually sent to the GOI for implementation.

Separately, upon receiving a report from the RBI, the GOI may acquire or transfer a bank's undertaking to a transferee bank if the bank fails to comply with the RBI's directions or if the bank is being managed in a manner detrimental to the depositors' interests. The bank being acquired will be given a hearing prior to the acquisition. The GOI may, in consultation with the RBI, frame a scheme for the change of the management of the bank, the continuance of the employment of the employees, the payment of compensation to the shareholders of the bank and other ancillary matters. The principles for payment of compensation to the shareholders of the acquired bank and the method of computation of compensation are provided in the BR Act.

In addition, the RBI has wide powers in appropriate cases to:
- require banks to make changes in their management as the RBI considers necessary;
- remove any chairman, director, chief executive officer or other employee of a bank;
- appoint additional directors to the board of directors of a bank; and
- supersede the board of directors of a bank for a maximum period of 12 months and instead appoint an administrator.

Most amalgamations following the last wave of the nationalisation era were undertaken for the purpose of merging financially distressed banks with healthy public-sector banks.

The proposed Bill would, however, empower the resolution corporation to become the administrator of any bank that is facing material risks to its viability or where its failure is imminent. In such a scenario, the resolution corporation would have sweeping powers to resolve the bank concerned in manner that it deems fit.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

See question 15. The RBI issued a report in 2014 that envisaged that while all banks will eventually prepare recovery or resolution plans (RRPs) to deal with distress or failure and in the initial stages, only D-SIBs would have to prepare RRPs. The report also contemplated the establishment of a financial resolution authority under a separate legislative framework that would work with the relevant bank and the RBI to oversee drafting and implementation of RRPs. In spite of the fact that the RBI has designated two banks as D-SIBs, no legislation has been passed and a financial resolution authority is yet to be established.

The existing framework envisages that the RBI or the GOI in consultation with the RBI will intervene to resolve a failed bank. This can be done on an ad hoc basis and through a range of powers such as appointing and removing directors or employees of banks (or both), prohibiting banks from entering into particular transactions and ordering termination of contracts, and in extreme cases of failure, acquiring the entire business and undertakings of the bank itself or transferring the same to another bank. Typically, it is the RBI that will exercise its resolution powers to merge a distressed bank with a healthy bank.

Apart from recovery and resolution of a bank, the existing framework also provides for resolution by liquidation. The RBI can make an application to the High Court for the winding-up of the bank where:
- the bank has failed to comply with statutory requirements;
- has been prohibited from accepting fresh deposits;
- if, in the opinion of the RBI, the continuance of the bank is prejudicial to the interests of its depositors or the bank is unable to pay its debts;
- a compromise sanctioned by a court cannot be worked satisfactorily; or
- the High Court had earlier issued a moratorium in respect of the bank.

14 Are managers or directors personally liable in the case of a bank failure?

Managers and directors may be held personally liable if a bank fails, but only in certain circumstances, namely, where there has been a breach by the bank of the provisions of the BR Act leading to a failure of the bank, or where a director fails to meet the duties imposed on him or her in his or her capacity as a director under the law.

If a bank contravenes the BR Act, all persons who at the time of the contravention were in charge of, and responsible to, the bank, for the conduct of the business of the bank, are deemed to be guilty unless they prove that the contravention occurred without their knowledge or that they exercised due diligence to prevent the same. Where it is proved that the bank committed a contravention with the consent or connivance of, or it is attributable to any gross negligence by, a director or a manager, such director or manager is also deemed guilty of such contravention.

CA 2013 regards an 'officer who is in default' as liable for any penalty whether by way of imprisonment, fine or otherwise. The definition includes the manager, full-time directors and directors who are aware of contraventions (through participation in board meetings or upon receiving proceedings of the board) but fail to object to the same or through whose consent or connivance the contravention has taken place.

CA 2013 codifies the duties of the directors and imposes higher standards of governance on independent directors. Therefore, where directors or managers have not performed their duties as set out above, they can be held personally liable and be punished with fines.

Where a bank is being wound up or is undergoing a restructuring scheme, the court can:
- publicly examine a person whom the official liquidator has reported as having caused a loss to the bank;
- (in the case of winding-up) summarily try an offence committed under CA 2013 or the BR Act by a director or a manager; and
- require a manager or director to repay or restore any property of the bank that the director has retained or misapplied or in respect of which the director has committed a breach of trust.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

There are no stand-alone or specific bank recovery and resolution planning or living wills requirements applicable in India at the moment. However, some aspects of recovery planning have been built into the capital adequacy and assessment norms as well as the risk management and business continuity planning requirements. RBI also uses its general supervisory powers to direct banks to prepare recovery plans on a case-by-case basis. For banks whose financial health deteriorates below certain trigger points, the RBI's prompt corrective action framework is followed (see questions 17 and 18). One of the possible actions for stressed banks is to implement a pre-agreed plan with the RBI (see question 13).

One key provision of the proposed Bill is to impose mandatory recovery and resolution planning requirements across the financial sector for entities that reach certain levels of risk to viability. The Bill uses the terms restoration plan and resolution plan. The restoration plan would have to be submitted to the RBI while the resolution plan would be submitted to a specialist financial sector resolution corporation that would be formed. The two plans would have to be refreshed on an annual basis and all material changes would have to be notified by the concerned bank to the appropriate body. In a resolution scenario, the resolution corporation shall have the powers to unilaterally modify the resolution plan of the bank concerned.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

On 2 May 2012, the RBI laid down guidelines for Indian banks as recommended under the Basel III Capital Accord of the Basel Committee on Banking Supervision (BCBS) and introduced the Basel Regulations. The Basel Regulations have been implemented with effect from 1 April 2013 and are going through a transitional period that lasts until 31 March 2019. The capital adequacy framework is based on three mutually reinforcing pillars: minimum capital requirements (Pillar 1), supervisory review of capital adequacy (Pillar 2) and market discipline (Pillar 3).

The minimum capitalisation requirements under Pillar 1 require banks in India to maintain a minimum capital to risk-weighted assets ratio (CRAR) of 13 per cent for the first three years of commencing operations (subject to a higher ratio specified by the RBI) and 9 per cent on an ongoing basis (against the 8 per cent requirement under the Basel II accord). CRAR is the ratio of a bank's capital in relation to its risk-weighted assets. The requirement under Pillar 1 includes the total regulatory capital (comprising of Tier 1 and Tier 2 capital) and the different approaches for risk-weighting the assets in terms of their credit, operational and market risk (comprising of the standardised framework and basic indicator framework). Tier 1 capital, among others, consists of paid-up capital, stock surplus, statutory reserves and Tier 2 capital, among others, comprises debt capital instruments, preference share capital and revaluation reserves, etc.

In addition to the minimum 9 per cent requirement, there are contingent capital arrangements that a bank is required to make in the form of maintaining a capital conservation buffer (CCB), countercyclical capital buffer (CCCB) and Tier 1 leverage ratio.

Serial No.	Type	Ratio
1.	Capital conservation buffer	2.5 per cent
2.	Counter cyclical capital buffer	0 to 2.5 per cent
3.	Tier 1 leverage ratio	3 per cent

Payments banks are required to maintain a CRAR of 15 per cent on an ongoing basis and a minimum Tier 1 capital ratio of 7.5 per cent. These banks are not required to maintain a CCB and a CCCB ratio.

The Basel III framework applies to all scheduled commercial banks (except regional rural banks) and such banks are required to comply with the Basel Regulations on a 'solo and consolidated basis'.

Every year commencing from April 2015, the RBI categorises some systematically important financial institutions as D-SIBs under different buckets, who are then required to maintain certain additional capital. At present, three banks, namely State Bank of India, ICICI Bank Limited and HDFC Bank Limited have been declared as D-SIBs maintaining an additional current ratio of 0.6 per cent and 0.2 per cent respectively. The RBI requires the D-SIBs to maintain an additional common equity Tier 1 capital ratio ranging from 0.2 per cent to 0.8 per cent.

17 How are the capital adequacy guidelines enforced?

The capital adequacy requirements are enforced under Pillar 2 and Pillar 3 of the Basel III Regulations.

Pillar 2 provides for supervision at the bank level and at the supervisory authority level.

Supervision at the bank level includes assessment of capital adequacy of banks in relation to their risk profiles by implementing an internal process called the Internal Capital Adequacy Assessment Process (ICAAP). Every bank is required to have an ICAAP, which is the bank's procedure for identification and measurement of risks, maintaining appropriate level of internal capital in relation to the bank's risk profile and application of suitable risk management systems. Banks are required to annually submit the ICAAP report to the RBI.

Supervision at the supervisory authority level (ie, by the RBI) makes all banks subject to an evaluation process called the Supervisory Review and Evaluation Process (SREP). Pursuant to the SREP, the RBI reviews and evaluates a bank's ICAAP, indirectly evaluates a bank's compliance with the regulatory capital ratios and takes remedial action if such a ratio is not maintained. The RBI may consider prescribing a higher level of minimum capital ratio for each bank under the Pillar 2 framework on the basis of their respective risk profiles and risk management systems. Failure to comply with the minimum regulatory capital requirements, may subject the bank to fines that may extend to 10 million rupees and a further penalty of 100,000 rupees for every day of default. The relevant bank may also be subject to prompt corrective action by the RBI (see question 18).

Pillar III implements market discipline through extensive disclosures by banks that allow market participants to assess risk exposure, risk assessment process and capital adequacy of a bank. Every bank should have an internal disclosure policy that is approved by the board of directors and assessed periodically. The disclosures are to be made on a half-yearly basis and should either be published in the bank's financial statements or displayed on the bank's website.

18 What happens in the event that a bank becomes undercapitalised?

The RBI has a stringent control mechanism for monitoring the financial health and soundness of Indian banks. To this effect, the RBI has initiated a prompt corrective action plan as a measure to ensure adequacy of a bank's internal control system in terms of three parameters: CRAR, net NPA and return on assets (ROA). The RBI has put in place certain trigger points to assess, control and take corrective action on banks that are weak and troubled. The trigger points for CRAR are:

- CRAR less than 9 per cent but equal to or more than 6 per cent;
- CRAR less than 6 per cent but equal to or more than 3 per cent; and
- CRAR less than 3 per cent.

Similar trigger points have also been provided with respect to NPAs and ROAs.

Upon hitting any of the trigger points, the banks are required to immediately report to the RBI and simultaneously implement internal measures to regularise the relevant trigger point. The RBI also has the powers to initiate certain structured and discretionary actions, which, among others, include implementation of a capital restoration plan, prohibition on entering into a new line of business, imposing stringent credit and investment strategy controls and merger or amalgamation of the bank. The RBI also has the ability to impose a moratorium on the bank in the event the CRAR does not improve beyond 3 per cent, within one year or such extended period as the RBI deems fit.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

The BR Act deals with the provisions relating to insolvency (referred to as 'winding-up') of banking companies (including branches of foreign banks operating in India).

Winding-up (whereby all the affairs of the banking company are wound up, assets are realised, liabilities are paid and the balance, if any, is distributed to its shareholders in proportion of their holding in the company) can either be voluntary (by members or creditors of a solvent banking company) or compulsory (by the High Court under whose jurisdiction the bank operates).

The RBI has the power of winding-up of a banking company. An order for the winding-up of a banking company can be passed by a High Court:

- if it is unable to pay its debts;
- if an application has been made by the RBI; or
- on request of the GOI.

For winding-up, every High Court appoints a liquidator (as an officer of the court) to manage the assets and liabilities of a banking company and supervise the liquidation process. The liquidator is required to submit a preliminary report to the High Court in relation to the assets and liabilities of a banking company and also make a just estimate of the liabilities of the bank. For this purpose, creditors or depositors are required to provide evidence of the debt owed to them. Secured creditors are not required to prove their debt. They may choose to stay out of the winding-up proceedings and claim the amounts owed to them from the secured assets. The secured creditors also have the option to relinquish their security and to prove their debt in the same manner as an unsecured creditor.

The law relating to the winding-up of a banking company does not apply to government banks (ie, banks largely owned by the government and classified as government banks under different statutes). A government bank can only be placed under liquidation by an order and in the manner provided by the GOI. At present, there is also some ambiguity around the competent forum for filing and prosecuting any insolvency matters covering financial services providers, including the private banks. Theoretically, it may not be possible to apply for the liquidation of a bank at the moment without a special notification from the central government.

However, if the inability to pay its debts is temporary, the banking company may apply to the relevant High Court (accompanied by a report from the RBI declaring its ability to meet its obligations and pay all debts during such moratorium period) requesting an order of moratorium for staying the commencement or continuation of all actions and proceedings against it for a period not exceeding six months.

During the moratorium period, if the RBI is of the opinion that the affairs of the banking company are being conducted in a manner detrimental to the interests of the depositors or if in the opinion of the High Court, the inability of the banking company to meet its obligations or to pay its debt is not temporary, the court may call for the winding-up of the company. Note that the RBI would invariably intervene and declare a moratorium on payments rather than allow the winding-up of banks.

In addition, if the RBI is concerned about the financial health of a banking company, it may make a recommendation to the GOI in relation to its reconstruction and amalgamation with another banking company (generally a government bank) and prepare a scheme for the same. The RBI has wide powers and can provide in such a scheme for the reduction of the interest or rights that the members, depositors and other creditors have in, or against, the banking company before its reconstruction to the extent as the RBI considers necessary in the public interest or in the interest of the members. The RBI can also issue a direction to the banking company preventing it from entering into an agreement or honouring its obligations under any agreement. On sanction by the GOI, the banking company can be amalgamated under the provisions of the BR Act. In the past few decades, the RBI has been reconstructing or amalgamating weaker banks with stronger counterparts to avoid winding-up situations.

The Bill is expected to establish clear processes to respond to a bank failure. Among other things, the Bill would require banks with potential risks to their viability to have recovery and resolution plans. The resolution plan is proposed to include details of all assets, liabilities, specifics of operations, and possible strategies, etc. As per the Bill, the resolution corporation will be the administrator of the insolvent bank who will take all the necessary steps to ensure an orderly and safe resolution and will enjoy wide powers to achieve such objectives.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

India adopted the Basel I accord in April 1992. The RBI later announced the implementation of Basel II norms for internationally active banks from March 2008 and domestic commercial banks from March 2009 by way of the Prudential Guidelines on Capital Adequacy and Market Discipline – New Capital Adequacy Framework (NCAF Circular). With effect from April 2013, banks in India are now regulated by the Basel Regulations, which are still in the implementation phase so the NCAF Circular will have limited relevance for the purpose of transitional arrangements up to 31 March 2017. Since the Basel Regulations are in the implementation phase, no significant changes are currently expected in the capital adequacy guidelines. Recently, the RBI has introduced minimum capital requirement ratios to be maintained by a payments bank (see question 16). It is envisaged that the RBI may impose similar requirements for small finance banks.

The RBI had also issued draft guidelines on net stable funding ratio (NSFR) in May 2015 and the final guidelines are expected by March 2018. The draft NSFR guidelines provide guidance on the calculation of the available and required stable funding. The time frame to be considered was one year. It is possible that the final rules may prescribe the required NSFR ratio to be more than 100 per cent to ensure greater resilience in the system.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

All banks in India, whether domestic or foreign, need to obtain a banking licence from the RBI in order to commence operations. Licensing of universal banks in India is primarily governed by the BR Act and the 'Guidelines Issued for 'on tap' Licensing of Banks in the Private Sector' (also referred to as universal banks) (on-tap guidelines). The on-tap guidelines mark a shift from the previously adopted 'stop and go' licensing approach (under which the RBI would notify the licensing window during which a private entity could apply for a banking licence), to a continuous or 'on tap' licensing regime.

While the BR Act lists the requirements of a banking company to obtain a banking licence, the on-tap guidelines, in addition to other procedural requirements for eligible promoters to promote a bank through a non-operative financial holding company (NOFHC) model. Eligible promoters are defined as persons having a successful record in banking and finance for at least 10 years, who are:

- individuals resident in India;
- entities in the private sector that are owned and controlled by residents of India provided that if such entity has total assets of 50 billion rupees or more, its non-financial business should not account for 40 per cent or more of assets or gross income; or
- existing non-banking financial companies (NBFCs) that are 'controlled by residents' and compliant with specified income and asset tests.

It is not mandatory for the bank to be set up through a NOHFC in case the promoters are individuals or standalone promoters who do not have other group entities.

This NOFHC is to be registered with the RBI as an NBFC and is required to hold the bank as well as other financial service companies of the promoter group. The capital structure of the NOFHC is required to consist of:

- voting equity shares of 51 per cent held by promoters or companies forming part of the promoter group. If such shareholding is held by various individuals of the promoter group, each individual, together with his or her relatives and entities in which they collectively hold 50 per cent voting equity shares, can hold only up to 15 per cent of the voting equity shares of the NOFHC;
- voting equity shares of 49 per cent must be held by public shareholders, where each individual, together with his or her relatives and entities in which they collectively hold 50 per cent voting equity shares, can hold only up to 10 per cent of the voting equity shares of the NOHFC; and
- shareholding of the promoter group in the NOFHC should be only by individuals, non-financial service and core investment

Update and trends

See question 8. Additionally:
- The Bill, see question 8, is one of the most closely watched developments in India. This law is expected to bring sweeping reforms for the entire financial sector in India.
- Banks and NBFCs are required to switch to IndAS, India's new accounting rules modelled after the IFRS. Aside from operational challenges likely to arise in implementation, these rules are likely to cause an increase in capital requirements as well.
- The central government is seeking to infuse capital into 20 banks that are majority-owned by it to improve their financial health and to also enable them to comply with Basel III norms. This capitalisation would be in tranches and comprises bonds and other instruments.
- The RBI is now empowered to compel banks to resolve specific non-performing assets by pursuing insolvency and other remedies. In exercise of these powers, the RBI has directed various lenders to initiate action against some of the biggest defaulters across the board and many borrowers have now been taken by the banks to the insolvency tribunals. Such pro-active regulatory initiatives are expected to continue as long as the pressures on banks' balance sheets remain.

companies or investment companies in the promoter group (ie, no financial services entity is an eligible shareholder in the NOFHC).

The bank is mandatorily required to be listed on a stock exchange within six years of commencement of business.

Financial service entities whose shares are held by the NOFHC are not permitted to hold shares in the NOFHC.

The promoter and the promoter group or NOFHC are also required to hold a minimum of 40 per cent of the paid-up voting equity capital of the bank that shall be locked in for a period of five years. Any shareholding beyond this limit is required to be bought down to 40 per cent within five years of the date of commencement of business of the bank.

Additionally, no shareholder of a bank can exercise more than 10 per cent of the total voting rights in a bank irrespective of its actual shareholding. This may be raised at a later date to 26 per cent by the RBI. The 10 per cent voting limit applies to each person holding shares of the bank and affiliates, related parties and persons belonging to a common group are considered separate persons for this purpose.

In the event a shareholder acquires 5 per cent or more of the voting capital of the bank, prior approval from the RBI will be required (see question 26).

The RBI is likely to issue separate guidelines for small sector banks in relation to entities having a controlling interest.

22 Are there any restrictions on foreign ownership of banks?

Foreign investments in India are subject to restrictions and conditions imposed by the FDI policy.

A foreign company can carry out banking activities in India through:
- a branch;
- a WOS; or
- a subsidiary with aggregate foreign investment up to a maximum of 74 per cent in a private bank (49 per cent through the automatic route and up to 74 per cent on approval by the government).

Indian residents are required to hold at least 26 per cent of the paid-up capital of the bank at all times (except in case of a WOS). However, the aggregate non-resident shareholding from FDI, non-resident Indians and foreign institutional investors in the new banks cannot exceed 49 per cent for the first five years from the date of licensing of the new bank.

Foreign investment of up to 20 per cent of the paid-up capital of a public-sector bank is permitted on obtaining government approval.

Investments by foreign banking entities above 10 per cent requires approval. The RBI can permit a higher holding for a single entity under exceptional circumstances such as the restructuring of problem or weak banks or in the interest of consolidation of the banking sector.

While a foreign bank is allowed to operate in India and carry out banking activities through a branch, the RBI encourages banks to follow the WOS structure and provides near national treatment in respect of branch expansion. Foreign banks that commenced operations in India after 2010 and fulfil the prescribed criteria laid down by the RBI are required to mandatorily adopt the WOS structure. Such criteria, among others, include banks declared as being systematically important by the RBI, banks with complex structures, banks that are not widely held, banks not providing adequate disclosures in their home country and likewise. Foreign banks in India operating prior to 2010 have the option to continue their banking business through the branch mode or convert into a WOS.

23 What are the legal and regulatory implications for entities that control banks?

As per the on-tap guidelines, eligible promoters and promoter groups are required to satisfy the 'fit and proper' criteria in order to establish a bank. The eligibility criteria vary depending on the nature of the entity. These criteria, among others, include having sound credentials and a successful track record of at least 10 years. In respect of structures using the NOFHC model, ownership and management will have to be separate and distinct in the promoter and promoter group entities that own or control the NOFHC. In addition, the major shareholders (ie, shareholders holding 5 per cent or more) have to continue to maintain 'fit and proper' status, during the tenure of their holding.

The NOFHC is required to hold the bank as well as other regulated financial service entities of the group. The regulated financial services entities of the group including the bank must be ring-fenced from other activities of the group (such as commercial and financial activities not regulated by financial sector regulators) and also that the bank should be ring fenced from other regulated financial activities of the group.

Only those regulated financial sector entities in which the individual promoter or group have significant influence or control will be held under the NOFHC. Apart from setting up the bank, the NOFHC shall not be permitted to set up any new financial services entity for at least three years from the date of commencement of business of the NOFHC. However, this would not preclude the bank from having a subsidiary or joint venture or associate, where it is legally required or specially permitted by the RBI.

The activities not permitted to the bank would also not be permitted to the group (ie, entities under the NOFHC would not be permitted to engage in activities that the bank is not permitted to engage in).

The promoters, their group entities, the NOFHC and the bank are subject to consolidated supervision. The RBI will have to be satisfied that the corporate structure does not impede the financial services under the NOFHC from being ring-fenced, and that it will be able to obtain all required information from the group as relevant for this purpose smoothly and promptly. To date, most foreign banks continue to operate as branches in India.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

Any entity that controls a bank will be assessed based on the 'fit and proper' criteria (see question 28). The shareholders have to continue to meet these criteria for the duration of the holding and the bank must furnish an annual certificate to this effect.

Shareholders also have to comply with the share acquisition and transfer provisions set out in the response to question 26. Any acquisition or transfer above the prescribed threshold will require RBI approval. As part of the approval process, the shareholder is required to furnish the details of the source of funds to the RBI.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

No specific implications have been prescribed for a controlling shareholder and hence the treatment will be the same as any other shareholder. In the general order of priority of payments in winding-up, the shareholders are the last to recover their investment.

In the event that the RBI chooses to carry out a reconstruction or amalgamation procedure, it has the power to severely compromise or alter the rights and interests of the shareholders (without their consent).

As per the Bill, the controlling entity or individuals (including the board of directors) would cease to have any management control over an insolvent bank or its assets. The resolution corporation would be empowered to resolve the institution as it deems fit. The controlling entities or individuals may ultimately recover their investment, depending upon the legal nature of their investment and where they stand in the hierarchy of claims.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

In the event that a shareholder (directly or indirectly) acquires 5 per cent or more of the voting equity capital of a bank, prior approval of the RBI is required. On obtaining such approval, the stake can subsequently be increased to 10 per cent (without obtaining an additional approval). However, any change in shareholding beyond 10 per cent will require fresh approval. As discussed in question 21, while the minimum voting limit by a single individual or entity is 10 per cent, this limit can be extended up to 26 per cent by the RBI. The RBI also assesses whether the shareholder is 'fit and proper' to be a major shareholder (see question 28).

In the event a shareholder acquires 5 per cent or more of the voting capital of a NOFHC, prior approval from the RBI will be required. The shares of a NOFHC cannot be transferred to an entity outside the promoter group.

As per the FDI policy, control has been defined to include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of shareholding or management rights, or shareholders' or voting agreements.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

Regulatory authorities in India are generally receptive to foreign acquirers and the approval requirements discussed in question 26 apply equally to acquisition by residents and foreigners. As a part of this approval, the RBI is allowed to impose conditions as it may deem appropriate. Acquisition in excess of 25 per cent would, if the target bank is a listed entity, trigger the Indian takeover regulations and the acquirer would then have to make an open offer for at least a further 26 per cent of the shares in that bank.

If the applicant is a foreign entity, it must obtain prior approval of the regulator or supervisor of its country of incorporation. The RBI will grant a licence to such banks only if it is satisfied that the government or law of the country of incorporation does not discriminate in any way against Indian banks. The RBI also considers the economic, political relations and reciprocity with the home country of the parent bank, and the international ranking, international presence, home country ranking and the rating of the parent bank by a rating agency of international repute. The applicant bank should also ensure that it is subject to adequate prudential supervision as per internationally accepted standards, which includes consolidated supervision in its home country.

While generally welcoming, the RBI discourages acquisitions made for the purpose of circumventing the restrictions in place for the licensing of physical branches of foreign banks. Any acquirer will have to separately apply for new branch licences and cannot rely on simply taking over existing branches of the seller or opening new branches near the existing branches of the seller.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The RBI will undertake a detailed due diligence on the applicant to assess his or her 'fit and proper' status to be a major shareholder. The criteria for compliance with 'fit and proper' status vary depending on the percentage of stake acquired.

Acquisition of 5 per cent or more of shares or the voting rights of the bank

The RBI, among other things, will evaluate:
- the applicant's integrity, reputation and track record in financial matters (including any financial misconduct);
- the applicant's source of making such acquisition;
- the applicant's compliance with tax laws; and
- in cases where such an applicant is a body corporate, in addition to the above, the entity's financial strength and consistency with standards of good corporate governance are also assessed.

Acquisition in excess of 10 per cent of shares or voting rights of the bank
In addition to the factors listed above, the RBI, among other things, will closely evaluate:
- details in relation to the conglomerate group (if any);
- whether such an entity is a widely held, publicly listed and a well-established regulated financial entity with a good standing in the financial community;
- whether it has stability of funds for such an acquisition including any past experience in business acquisitions;
- the desirability of diversified ownership of banks; and
- whether such an acquisition is in the public interest.

It is to be noted that the 'fit and proper' criteria set out above are just an illustrative list, and the RBI may evaluate the applicant on such other parameters it considers necessary.

29 Describe the required filings for an acquisition of control of a bank.

The filings required for acquiring control in a bank vary according to the type of acquisition.

Acquisition of major shareholding in a bank
Every such entity must make an application to the RBI along with the prescribed declarations. The RBI will seek recommendations from the board of directors of the concerned bank.

FDI filings
Inward remittance for subscription to shares must be reported to the authorised dealer by the issuing company within 30 days of the receipt of remittance in the Advance Reporting Form along with the Foreign

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Inward Remittance Certificate. Upon the issuance of shares, the same must be reported by the issuing company within 30 days of issuance as per form FC-GPR. Sale of such securities held by a non-resident to an Indian resident must be reported by the Indian resident as per form FC-TRS within 60 days of the receipt of remittance.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

Any application made for an aquisition in a private sector bank between 49 per cent and 74 per cent of the stake of the banking company will require prior approval. Such application in relation to foreign investment should be approved within eight to 12 weeks from the date of application. If the proposed foreign investment exceeds 20 billion rupees, additional approval will need to be obtained from the Cabinet Committee on Economic Affairs, which may take another two to three weeks.

The RBI approval required to acquire a major shareholding, including a change of control, takes 90 days from the date of the application (the time taken by the acquirer in furnishing information sought by RBI is excluded in theory).In practice, however, it is likely that an acquisition of a majority or controlling stake in a private bank will be treated as if a fresh licence has been applied for. This process takes a significant amount of time, possibly greater than five years, although it is hoped that recent activity in this sector and the stringent guidelines for resolving applications set by the RBI itself will result in this time frame reducing considerably.

Italy

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The main principles of the Italian system aim to ensure the sound and prudent management of supervised entities, the stability of the entire banking and financial system as well as its efficiency and competitiveness.

The general structure of banking policy in Italy has, over the past three decades, been based on the obligation to comply with the principles and rules arising from Italy's membership of the European Union. As a consequence, the Italian banking system complies with the principle of the mutual recognition of banking authorisation granted in a EU member state.

The exercise of banking activities by authorised EU banks, both in relation to freedom of establishment and to freedom of service provision, must be preceded by a notice to the Bank of Italy from the competent supervisory authority in the bank's home state.

The structure of the Italian banking system is based on the presence of different kinds of institutions, which are entitled to conduct their business in relation to the following activities:

- banks: legally entitled, in principle, to carry out most types of banking activity (collecting savings from the general public, granting of loans and other forms of financing, payment services, issuing of e-money and, pursuant to specific rules, the exercising of investment services). Italian banks may be incorporated as companies limited by shares or as cooperative banks in the alternative form of *banca popolare* or *banca di credito cooperativo*;
- financial intermediaries: used to be entitled to provide financing, equity investments, brokerage on currencies and payment services (as reserved activities); however, after the reform of 2010, they are now entitled only to grant financing, which is now the sole reserved activity;
- payment institutions: entitled to carry out only payment services or other ancillary activities; and
- e-money institutions: entitled to carry out business in the electronic money and payment services sectors.

2 Summarise the primary statutes and regulations that govern the banking industry.

The main principles governing the banking industry are contained in two main legislative Acts: Legislative Decree No. 385/1993 (Italian Banking Act) (TUB) and Legislative Decree No. 58/1998 (Italian Financial Act) (TUF). In the past two decades, the connections between the banking and the finance industries have considerably increased; therefore, the most recent legislative acts affect both the banking and the finance sectors.

The TUB contains the principles regulating the carrying out of business by banks, other financial intermediaries, as well as by other entities operating in the banking sector. Moreover, the TUB is the principal legislative source for the framework of the powers and responsibilities of the regulatory authorities in Italy.

Both the TUB and TUF have been significantly amended in the past few years.

The other principal legislative Acts and regulations governing banking and financing activities in Italy are the following:

- Bank of Italy Circular No. 285/2013, which contains the new supervisory instructions for banks;
- Bank of Italy Circular No. 263/2006, which contains the precautionary guidelines for banks;
- Law No. 262/2005 on the protection of savings, which has profoundly affected the TUB; in particular, this law has reorganised: the powers of the Bank of Italy and its governor-general; the relationships, responsibilities and mutual cooperation of the two main public authorities respectively responsible for the supervision of the banking system (Bank of Italy) and of the securities market (Consob); and corporate governance for listed entities (including banks);
- Legislative Decree No. 206/2005 (Consumers' Code), which contains provisions concerning the distance marketing of consumer financial services, including the distance marketing of banking products;
- Legislative Decree No. 11/2010, which implemented in Italy Directive 2007/64/EC (Payment Services Directive) (PSD). In particular, this decree introduced the rules for payment institutions in Italy. Therefore, at present, the rendering of payment services is reserved to banks, e-money institutions and payment institutions. The PSD has recently been repealed by Directive (EU) 2015/2366 (PSD 2). The deadline for implementation of PSD 2 by the member states was 13 January 2018 although it has already been implemented by Italy in December 2017 (see Update and trends);
- Legislative Decree No. 231/2007, which implemented Directive 2005/60/EC on the prevention of the use of the banking and financial system for the purposes of money laundering and terrorist financing;
- Legislative Decree No. 141/2010, which implemented Directive 2008/48/EC on credit agreements for consumers. In particular, this decree introduced a set of provisions in the TUB regulating, inter alia, pre-contractual transparency duties, verification of the creditworthiness of consumers and the rights of consumers in case of withdrawal. This decree has also had a considerable impact on financial intermediaries. Indeed, this decree has cancelled from the list of reserved activities (towards the general public) equity investment and currency exchange services; and
- Legislative Decree No. 180/2015, which implemented Directive 2014/59/EU (Bank Recovery and Resolution Directive) (BRRD) establishing a framework for the recovery and resolution of credit institutions and investment firms.

In Italy, an important regulatory role is provided by the Bank of Italy. In carrying out this role, the Bank of Italy has adopted several regulations setting the requirement for pre-contractual transparency, the organisation and effectiveness of the alternative dispute resolution system provided by the TUB, the authorisation and supervision procedures over all supervised entities, etc.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The activity of overseeing banks is mainly carried out by the Bank of Italy, together with other public bodies.

The Ministry of Economy and Finance (MEF) is entitled to set out, in regulations enacted by it, the integrity requirements for shareholders and the experience requirements for persons responsible for administrative, management and supervisory functions in banks or financial intermediaries.

The MEF's Inter-Ministerial Committee for the Credit and the Savings (CICR) also has certain powers, strictly coordinated with the Bank of Italy. It regulates some aspects of transparency in customer relationships and the collection of savings.

The Bank of Italy undertakes the main supervisory and regulatory duties, exercising them through a range of administrative, regulatory and control powers.

The Bank of Italy is also in charge of the supervision of:
- financial intermediaries that are entitled to provide financing;
- e-money institutions; and
- payment institutions.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

According to the TUB, deposits are not insured by the government, but through a protection scheme originally set up on a voluntary and private basis, even though performing a public function.

The deposit protection schemes currently in force are the Inter-Bank Fund for the Protection of Deposits, to which any Italian bank (and in some cases also Italian subsidiaries of banks operating outside the EU area) must adhere, and the Insurance Deposit Fund for Cooperative Savings, which operates for cooperative banks.

In case of insolvency of a banking institution holding deposits, a minimum compensation is provided, currently limited to €100,000. The Bank of Italy is entitled to modify this limit in order to adjust it to the variation to the rate of inflation.

Some depositors (territorial entities, senior managers and directors of the same bank, banks and other credit institutions, etc) and some types of deposits and credits (credits resulting from bonds, promissory notes, share capital and reserves, etc) are excluded from the guarantee.

The refund in favour of the depositors shall be paid within 20 days from the commencement of the forced liquidation procedure of the relevant bank. This term may be extended by the Bank of Italy by a further 10 days, but only in exceptional circumstances.

Furthermore, it is notable that the Italian government recently set up a public guarantee system in support of banks in crisis.

With reference to the increasing exposure of the above-mentioned Non-Performing Loans (NPLs), Law Decree No. 18/2016 introduced a government guarantee to facilitate NPL transactions; the Guarantee on Securitisation of Non-Performing Loans (GACS), which is provided by the MEF to requesting intermediaries.

In particular, the GACS aims at facilitating the dismantling of NPLs. The Italian government, according to the GACS, can guarantee only senior tranches of securitisations.

The European Commission agreed that the measures under the GACS do not contemplate state aid that would distort competition.

At the end of 2016, Banca Monte dei Paschi di Siena, being a significant Italian bank and, in accordance with the provisions set forth in the BRRD, asked the European Central Bank (ECB) for access the 'precautionary recapitalisation' measures. The precautionary recapitalisation consists of an injection of own funds into a solvent bank by a EU member state when this is necessary to remedy a serious disturbance in the economy of this member state and preserve financial stability.

At the beginning of July 2017, the European Commission approved the Italian public support in the form of precautionary recapitalisation of MPS, consisting of €5.4 billion in state aid.

On 28 July 2017, in accordance with Law Decree No. 237/2016, the MEF approved by means of Ministerial Decree, inter alia, an increase in the capital of MPS in order to provide the subscriptions of the shares by the same MEF.

Following the recapitalisation and the conversion of the subordinated bonds into shares, the MEF holds about 53 per cent of the share capital of MPS.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Pursuant to Law No. 262/2005, the Bank of Italy, according to CICR Resolution 277/2008, provides the limits and conditions under which a bank may assume risks towards 'related parties'.

This concept includes both 'related entities' and 'entities connected to related entities'. 'Related entities' are:
- persons who carry out directive and control duties within the bank or the leading bank of the group;
- major shareholders who, under the TUB, needed prior authorisation for the acquisition of their share capital (see question 21);
- entities that may appoint, by virtue of agreements or of the articles of association, one or more members of the directing and controlling bodies;
- companies over which the bank or the banking group may directly or indirectly exercise a dominant influence; and
- other entities identified by the Bank of Italy by the application of the International Accounting Standards (IAS).

'Entities connected to related entities' are:
- companies directly or indirectly controlled by a related entity;
- entities that control directly or indirectly a related entity; and
- other entities identified by the Bank of Italy by the application of the IAS.

Pursuant to the provisions of the Bank of Italy, the full amount of the risk assets of a bank or of a banking group towards related parties cannot exceed certain diversified thresholds (in any case, no more than 20 per cent) of its regulatory capital.

Furthermore, persons who carry out directive and controlling duties within the bank, as well as a company of the banking group, can enter into obligations with the bank only under the prior authorisation of the board of directors.

In December 2011, the Bank of Italy approved the rules implementing the CICR Resolution 277/2008. According to this implementation's rules:
- in the approval of transactions with 'related entities' the role of the independent directors of the bank is particularly relevant since the bank shall constitute an executive committee (internal to the board of directors) exclusively composed of independent directors who are requested to communicate their prior opinion in respect of the relevant transaction by means of an express declaration in occasion of the vote in the board of directors called to resolve on the transaction; and
- the bank will set internal procedures aiming at regulating the transaction with related entities.

6 What are the principal regulatory challenges facing the banking industry?

As a consequence of the significant legislative and regulatory activity carried out in the past few years, the Italian banking industry has to take into account various legislative and regulatory requirements.

Based on the practical experience of entities operating in the banking system, the more frequent regulatory challenges, also in the light of the most recent business trends in Italy, relate to:
- the structural organisation that affects financial intermediaries (other than banks) already authorised to carry out payment services;
- the implementation of business plans featuring the integration between banks and payment institutions (eg, through the use of ATM networks owned by the banks for the offering to the public of money transfer services by payment institutions);
- the recent introduction of a new set of rules adopted by the Bank of Italy in respect of the transparency and fairness duties for the entities carrying out consumer credit;
- the need for the financial intermediaries to adapt their business, their corporate structure as well as the internal compliance function to the new legal framework that has now been implemented after the adoption of the secondary regulation of the Legislative

Decree No. 141/2010 and the Decree of the Ministry of Economics and Finance No. 53/2015;
- the duty to comply with the principles set out in the recent CICR Resolution 644/2012 which, by implementing new article 117-bis TUB, adopted new rules for limits and criteria for fees applied by banks in financing contracts in case of overdraft and overrun by the client;
- the implementation of the BRRD, introducing a new and more incisive bank resolution framework; and
- the implementation of Directive (EU) 2015/2366 on payment services in PSD 2 and, more generally, the development of a new business model based on the integration between traditional banking business and the fintech area, which may start a process of 'disintermediation' in the relations between the banks and their customers.

More generally, the most relevant challenge as regards regulation will be the gradual and organic implementation into the internal legal framework of the reforms that have been conceived and approved at EU level. This process has already begun and is expected to continue in the coming years until the new regulatory architecture is fully implemented.

7 Are banks subject to consumer protection rules?

Banks (as well as other financial intermediaries and e-money institutions) are subject to several consumer protection rules particularly under the profile of transparency.

This title includes specific rules for the sectors of consumer credit and payment services.

A specific section of the TUB provides a general set of transparency and fairness rules applicable to all the customers of a bank.

The main protections offered to consumers are the following:
- a written form is required for any banking contract;
- the banks shall comply with several pre-contractual requirements such as that to inform the customer in writing, inter alia, of the interest rates applicable to any financing contract to be entered into and the effective global interest rates applied in Italy; prices that will be applied and other economic terms; and the customer's right of withdrawal;
- within certain terms from the signing of the contract or from the unilateral amendment by the bank of the conditions contained in it, the consumer may withdraw from the contract; and
- in case of non-compliance by the bank, consumers have the right to complain, without bearing any cost, to the Banking and Financial Arbitrator (ABF), the Italian institute established for the resolution of controversies on banking and finance matters.

In particular, more detailed rules for consumer protection are contained in the Bank of Italy's Resolution of 29 July 2009, which implemented the primary level provisions through a set of highly detailed provisions aimed at ensuring that bank customers are informed in a fair, transparent and complete manner but, in particular, this Resolution focuses on the duty of the banks and intermediaries to comply with specific obligations in respect of consumer protection. The Bank of Italy Resolution of 29 July 2009 requires banks to provide a set of pre-contractual documents containing the main terms and conditions of the contract.

Furthermore, banks and intermediaries are also obliged to comply with documentary standard forms relating to periodical communications; rules regulating unrequired marketing messages; disclosure duties in respect of the economic conditions of any kind of contract; implementation of internal procedures for receiving and managing the complaints of consumers, etc.

In addition to the above, further regulations are provided in a specific section of the Consumer Code (Legislative Decree No. 206/2005) where specific requirements are set forth in respect of distance marketing to consumers of bank and financial services.

The Bank of Italy is responsible for the enforcement of such consumer protection rules in the banking sector.

As mentioned above, complaints may also be filed with the ABF, even though the decisions of the latter have no direct binding effect on the banks.

In recent years, particular attention has been focused on the non-compliance of certain financial intermediaries and e-money institutions that did not provide accurate pre-contractual information on the cost and interest rate to be applied to the service of revolving credit cards, and the consumers were found to be unaware of the very high costs generated by the service.

In April 2016 the government approved Legislative Decree No. 72, which implemented Directive 2014/17/EU (Mortgage Credit Directive) establishing harmonised rules in the field of mortgage loans entered by a consumer.

The new legal framework aims to increase consumer protection by specific new provisions on:
transparency and fairness in the contractual behaviour of banks;
- advice to consumers;
- an objective estimate of the value of the real estate given by the borrower as warranty; and
- the assessment of the consumer's creditworthiness.

The new legal framework also aims at preventing situations of over-indebtedness of the borrowers.

The Legislative Decree has given the CICR the task of adopting the implementing regulations with regard to several other aspects.

Moreover, as of 1 October 2016, the CICR Resolution of 3 August 2016 introduced important new developments for consumers with regard to the problem of compound interest.

The CICR Resolution contains the implementing measures of the second paragraph of article 120 of the TUB, as redefined by Law Decree No. 18/2016.

In particular, in relation to the protection of the consumers from the risk of unlawful application of compound interest, the new version of article 120 of the TUB assigned the CICR the task of identifying procedures and criteria for the calculation of the interest in transactions concerning the banking activity, providing that:
- in current account or payment account relationships the same frequency for the computation of interest, both creditor and debtor, in any case, for at least one year, must be ensured toward consumers, the interest is calculated on 31 December of each year and, in any case, upon termination of the contractual relationship; and
- debit interest accrued, including that related to loans under credit cards, cannot produce further interest except from a default interest, and it is calculated exclusively on the capital.

In January 2018, the public authority responsible for regulating the Italian financial markets (Consob) approved amendments to Regulation No. 11971 of 14 May 1999 aimed at adapting the secondary regulations to Regulation (EU) No. 1286/2014, relating to documents containing key information for Packaged Retail and Insurance-based Investment Products (PRIIPs), directly applicable to member states from 1 January 2018.

The Key Information Document (KID) is a document containing the key information that must be provided to customers who are retail investors purchasing PRIIPs, in order to facilitate understanding and comparability.

In particular, the new provisions of the amended Regulation establish mandatory reporting to Consob of the documents containing KID for PRIIPs, in accordance with the provisions set out in the TUF.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

Over the next few years various legislative and regulatory interventions are expected to be implemented in Italy.

In the coming years, in addition to the implementation of EU legislation, in particular Directive 2014/92/EU (on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features) (PAD), other regulatory measures in the banking sector are expected, with the aim to ensure greater transparency in the relationships between banks and customers and to strengthen the instruments for the protection of consumers.

In light of this, new legal provisions will be introduced with regard to matters that require the implementation of the EU framework, such as:
- the prohibition of additional expenses or charges for the 'portability' of payment accounts;
- the withdrawal right from door-to-door contracts; and
- the amendment of the alternative dispute resolution system with customers.

In particular, the general principles on correctness and transparency to be complied with by credit intermediaries in relations with customers will be further detailed.

With the introduction of the new European Standardised Information Sheet and the definition of a minimum seven-day period of reflection before entering into a credit agreement (new article 120-novies of the TUB, introduced by Legislative Decree No. 72/2016 on mortgage loan contracts concluded by a consumer), it has become increasingly evident that the attention of the legislator is oriented towards the improvement of pre-contractual information duties to protect the weaker party to the contract.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Banking supervision performed by the regulatory authorities, and in particular by the Bank of Italy, consists of three types:

- regulatory supervision: this covers the power to adopt provisions of a general nature;
- information supervision: this covers the acquisition, audit and assessment of periodical information provided by the entity supervised on a compulsory basis; and
- inspection supervision: this covers the Bank of Italy's power to carry out on-site inspections.

Regulatory supervision

The Bank of Italy's supervision aims at ensuring the sound and prudent financial management of supervised entities as well as the stability, efficiency and competitiveness of the banking and financial system as a whole. This aim is pursued through the enforcement of the rules and provisions regulating the credit sector.

Within the exercise of regulatory supervision, the Bank of Italy adopts provisions having as their purpose:

- capital adequacy;
- risk containment;
- ownership restrictions;
- permissible shareholdings;
- administrative and accounting organisation of the banks and internal audits; and
- public disclosure that supervised entities must provide with respect to the above points.

Inspection supervision

As far as inspection supervision is concerned, this authority is not only exercised over banks and other Italian supervised entities, but also over the branches of banks established in Italy by foreign banks.

Consolidated supervision

Banking supervision over a group of banks is defined as 'consolidated supervision' and implies a significant extension of the powers of the Bank of Italy also with respect to the following entities:

- companies in a banking group;
- banking and financial companies in which one of the companies of the group has an interest equal to at least 20 per cent of the capital;
- banking and financial companies that are not part of a banking group but are controlled by the natural or legal person that controls a bank or a group of banks;
- companies that control at least one bank; and
- non-banking companies and non-financial companies directly controlled by a single bank.

As well as the supervisory activity over banks and groups of banks, the Bank of Italy exercises its powers over other relevant entities such as financial intermediaries, e-money institutions and payment institutions.

As a general remark, each of the above-mentioned categories (banks, financial intermediaries, etc) is regulated by specific supervisory rules adopted by the Bank of Italy.

A group of banks means a group composed of:

- a leading Italian bank that controls other banking, financial (or instrumental to the banking activity) companies;
- a leading Italian financial company that controls other banking, financial (or instrumental to the banking activity) companies; or
- a leading Italian financial company, that has at least one bank within the company group.

10 How do the regulatory authorities enforce banking laws and regulations?

The supervision exercised by the Bank of Italy over the correct performance of banking activity by supervised entities is quite pervasive and includes the duty to provide periodical information, as well as the inspection power of the authority.

In cases of infringement of both laws and secondary level regulations by supervised entities, the Bank of Italy has a wide range of powers of intervention and sanction.

Supervision authorities and in particular the Bank of Italy, mainly enforce laws and regulations by the following means (in rising order of seriousness):

- written warnings;
- notice of infringement by the Bank of Italy (upon receiving the notice a full hearing of the parties starts in which the entities involved may file with the Bank of Italy a written defence and potentially block the adoption of a sanctioning resolution); and
- administrative pecuniary fines on persons and banks, companies or other bodies involved, should the written defence not be accepted.

If a serious irregularity is found in the management of the supervised entities or in case of a serious breach of the law or of regulatory or statutory provisions, the Bank of Italy may propose that the MEF withdraw the banking licence. If the MEF considers the reasoning of the Bank of Italy well founded, it may order, by means of ministerial decree, the withdrawal of the licence and the commencement of the administrative forced liquidation procedure against the supervised entity.

In addition, with regard to credit institutions at risk of insolvency, the Bank of Italy may issue a number of extraordinary provisions in case of violation of legislative, administrative or statutory provisions which regulate their activities.

These extraordinary provisions include:

- the prohibition against starting up new operations; and
- the order to close branch offices, which may affect individual branches of an Italian bank, including those located abroad, or one or more branches located in Italy of a non-EU member state bank.

With Regulation dated 3 May 2016, the Bank of Italy amended the provisions on sanctions and on the administrative procedure for imposing them, adopted by Regulation of 18 December 2012.

The procedure has thereby been adapted to the innovations on sanctions introduced by Directive 2013/36/EU (CRD IV) and to the new structure resulting from the establishment of the Single Supervisory Mechanism (SSM); this new system has granted the ECB a supervisory role to monitor the financial stability of banks based in the eurozone states, starting from 4 November 2014.

The new provisions have provided important clarifications with regard to the procedure, by setting thresholds, based on the companies' turnover, for the establishment of the relevant sanctions and by setting forth the requirements for the temporary interdiction from exercising banking activity.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

For the following data we refer to the last available annual report on supervision issued by the Bank of Italy, which relates to 2016, but also contains references to data collected in the first few months of 2017.

In 2016, the Bank of Italy played an active part in the SSM, where more than 7,400 corrective actions were undertaken, including periodic and targeted assessments, meetings with company representatives, requests of information or warnings, out of which 140 inspections were carried out, 45 of which at significant banks.

More than 520 administrative decisions regarding Italian banks were adopted.

To verify compliance with the rules on transparency, 153 inspections were carried out at the branches of banks and other intermediaries leading to notifications of compliance breaches and corrective measures against 94 intermediaries.

As a result, intermediaries returned about €35 million to customers for improper charging of fees.

In 2016, 45 sanction provisions were issued by the Bank of Italy (compared with 49 in 2015), against 363 natural persons and nine legal entities, the latter mainly sanctioned because of breaches of anti-money laundering provisions. The total value of applied sanctions was approximately €10 million (€9 million in 2015).

During the first two months of 2017, seven sanction provisions were issued against 47 natural persons and two legal entities, the latter mainly sanctioned because of breaches of anti-money laundering provisions, for a total amount of €930,000. Furthermore, the Bank of Italy has started some extraordinary administration procedures against banks and other non-banking entities. At the beginning of 2016, the Bank of Italy had 11 special administration procedures open relating to banks, asset management companies and other intermediaries, with only one procedure initiated in relation to a small bank.

Two of the procedures were closed with the intermediary's return to ordinary administration, five with their liquidation and two with mergers into their respective parent companies. At the end of the first quarter of 2017, three special administration procedures are still ongoing, of which two are in relation to banks.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Further to the privatisation of the Italian banking sector, which took place in the 1990s, the system as a whole tended to prevent state-owned capital from flowing into the bank's capital. Even during this period of crisis, public control (both in terms of governance and participation in the capital of the bank) is relatively limited.

In case of a crisis, if no other solution to restore the institution is viable, the Bank of Italy starts the procedure of resolution by identifying the specific measures to be taken (see question 15).

In any event, any loss suffered by the shareholders, partners or creditors will never be greater than the one suffered in the event of liquidation of the bank.

In the framework of the new Single Resolution Mechanism at European level (Regulation EU No. 806/2014), an intergovernmental agreement established the Single Resolution Fund (SRF) (active since 1 January 2016), which is funded with contributions from banks for total amount of €55 billion.

EU member states shall grant bridge financing to the SRF and, with regard to Italy, by decrees of the MEF, the supply of bridging finance up to €5,735 million will be disposed.

Moreover, the government, by means of recent Law Decree No. 237/2016 (see question 4), established a €20 billion fund, which will act as guarantor for future bonds issued by banks in crisis, in order to restore their medium- and long-term market-based funding capability.

Italian banks (or Italian holding companies of banking groups), which, based on the outcome of a stress test, need to strengthen their resilience by a capital increase are entitled to submit to the SSM a plan aimed at strengthening their capital.

Should the implementation of the plan fail, the bank can request the MEF to subscribe (or purchase) its shares. This request of capital intervention is submitted by the bank to the MEF, the Bank of Italy and to the SSM (as the case may be) and must indicate, inter alia, the amount of shares the bank expects to be subscribed by the MEF and the existing financial instruments already issued by the applicant bank to be converted into equity under the 'burden sharing' provisions.

With respect to relations between the intervention of public capitals into the stock capital of the banks, it must be underlined that no share of the banks can be subscribed or purchased by the MEF unless and until the 'burden sharing' mechanism is implemented. The burden sharing provisions contained in Law Decree No. 237/2016 provide for the conversion of different classes of instruments issued by the bank into ordinary bank shares or, alternatively, the cancellation of such instruments and the assignment to the respective holders of newly issued ordinary shares, with the purpose of limiting the use of public funds (the conversion is subject to, inter alia, the conversion of all other convertible financial instruments issued by the bank).

The conversion and the cancellation of financial instruments are made on the basis of the criterion of the 'no creditor worse off', according to which the relevant holder of the instruments cannot be treated worse than in a liquidation scenario.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

It is provided that, in case of crisis, banks can be subject to a specific extraordinary administration procedure (see question 16), which may be followed, in case of insolvency, by the special bankruptcy procedure provided for banks.

In respect of the bank's management and directors, it should be pointed out that from the date that the decree starting insolvency proceedings is issued, the governing body, controlling body and any other bodies are relieved of their duties.

The relieved bodies are replaced with specific insolvency proceeding bodies. The Bank of Italy appoints one or more liquidator commissioners (extraordinary commissioners) who, while carrying out their functions, are supported by a monitoring committee, which also supervises the liquidators' activity, provides opinions when required by the law and gives instructions on behalf of the Bank of Italy.

As a result of implementing the BRRD, it is provided that banks must have a resolution plan, approved by the Bank of Italy and regularly updated, specifying measures to be taken in the event of crisis (see question 15).

Furthermore, according to the recent implementation of the BRRD by means of Legislative Decree No. 180/2015 (see question 17), the management of a bank shall inform the Bank of Italy (or the ECB) in good time if the bank is affected by an event of failure, also if merely potential.

14 Are managers or directors personally liable in the case of a bank failure?

According to the general principle of the liability of directors (pursuant to the provisions set out in the Italian Civil Code) and under rules provided by the Italian Bankruptcy Law, managers and directors may be personally liable under both civil and criminal law in case of a bank failure.

From a civil point of view, liability action can be addressed to the directors for violations relating to their duty to preserve the integrity of corporate capital and, more generally, in case of breaches of the duties provided by the law and the by-laws, should those breaches cause damage to the bank or to the creditors of the same. The directors shall be also bound to compensate the damages caused as a consequence of the above-mentioned breaches.

If the bank is placed under extraordinary administration or under a resolution measure (see question 16) liability action against the former members of the disbanded governing bodies (including the managing director) may be proposed by the extraordinary commissioners, who will first be authorised to do so by the creditors' monitoring committee and the Bank of Italy.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

At the end of 2015, Italy implemented the BRRD by means of Legislative Decree No. 180/2015 (see question 1) and issued a second decree (Legislative Decree No. 181/2015) amending the TUB and TUF in order to transpose the BRRD provisions on recovery and resolution plans.

Pursuant to Legislative Decree No. 181/2015, banks are required to adopt and regularly update specific recovery plans that shall set out measures to be taken for the restoration of their financial position following a significant deterioration. Such plans must be detailed and they are to be grounded on realistic assumptions applicable in case of severe and critical scenarios.

In a recovery plan the bank shall, inter alia:

- map its legal and business structure;
- identify the core business sectors that have to be preserved in case of crisis; and
- outline the scenarios that the plan intends to address.

In addition to the recovery plans, the two above-mentioned Decrees set forth that the Bank of Italy shall prepare a resolution plan, following consultations in which they have to set out the resolution measures that the Bank of Italy may implement.

The purpose of a resolution plan is to determine an institution's critical functions, to identify and address any impediments to its resolvability and to prepare for its possible resolution.

The Bank of Italy is also in charge of the next execution of the resolution plan and, within this scope, it may adopt the following resolution tools:

- Sale of business: this tool has the scope to carry out a transfer of shares or other instruments of ownership issued by a bank under resolution, as well as assets, rights or liabilities, to one or more private purchasers that is not a bridge institution. This transfer may be carried out even without the consent of shareholders.
- Bridge institution: this instrument is functionally similar to the sale of business tool. Rather than transferring the significant asset of the bank in resolution to one or more private purchasers, the assets are transferred to an entity specifically set up by the Bank of Italy in order to preserve the bank's functions and business. The Bank of Italy is entitled to appoint the members of the management body of the new entity and to approve its articles of association. Being an entity wholly or partially owned by public authorities and controlled by the Bank of Italy, the main purpose and scope of the bridge institution is to ensure that the essential financial and banking services continue to be provided to the clients and that such essential activities will continue to be performed.
- Asset separation: the asset separation tool enables the Bank of Italy to transfer assets, rights or liabilities of the bank subject to resolution to a specific vehicle. This tool is used in conjunction with other tools to prevent an undue competitive advantage. Indeed, the vehicle manages the assets transferred with the scope to maximise the value through a possible sale or the winding-up and its capital shall be wholly or partially owned by one or more public authorities and controlled by the Bank of Italy.
- Bail-in: this tool implies that the stakeholders shall contribute to solve the bank crisis according to the level of risk of their financial instruments and investments. The bail-in, therefore, ensures that stakeholders and creditors of the failing institution may suffer losses and may be burdened with a portion of the costs arising from the failure of the institution with the aim of facing the insolvency, recapitalising the bank and restoring its viability. In order to protect holders of covered deposits, the bail-in tool does not apply to deposits protected under Directive 2014/49/EU (ie, covered deposits, secured liabilities and to other exceptional cases specified in Legislative Decree No. 180/2015).

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The legal and regulatory capital adequacy requirements divide into two types:

- requirements to be fulfilled in order to obtain a licence for banking activities; and
- requirements to be fulfilled during the course of business (regulatory capital).

As for capital requirements for access to banking activities, banks must be incorporated with a minimum capital of €10 million for banks incorporated as companies limited by shares, and with a minimum capital of €5 million for banks incorporated as cooperative or mutual banks. This minimum capital must be fully paid in.

With respect to regulatory capital requirements during the course of business, Italian legislation complies with the standards and criteria set out in Basel II and Basel III. These requirements are based on the general criteria according to which banks must have a capital at least equal to the minimum capital required for access to the banking activity (ie, the incorporation capital).

Furthermore, banks must also align their regulatory capital and the availability of liquidity with the structure of their risk allocation.

Regulatory capital is structured on three different levels (tiers). Tier 1 (basic assets) and Tier 2 (additional assets) are calculated on the basis of the sum of positive and negative financial items. Italian regulation also allows banks to use Tier 3 assets, which are constituted by medium- to long-term subordinate loans, but only to cover certain kinds of market risk.

17 How are the capital adequacy guidelines enforced?

The enforcement of capital adequacy guidelines is based on the banks' obligation to calculate their regulatory capital on a quarterly basis with respect to individual banks and on a six-monthly basis with respect to banking groups, while the consolidated data of the end of the financial period are calculated according to the criteria of reporting for the financial statements for the relevant accounting period.

The adequacy of the regulatory capital is also based on an ongoing enforcement based on the supervisory review process, which comprises two levels:

- internal capital adequacy assessment process (ICAAP), which relates to banks that internally assess their current and prospective capital adequacy; and
- supervisory review and evaluation process (SREP), carried out by the Bank of Italy, which examines the ICAAP and gives an overall assessment on the bank and its activity and may, if necessary, issue corrective measures.

By means of SREP, the Bank of Italy not only verifies a bank's compliance with the capital adequacy requirements but makes an evaluation of the corporate governance system and of the functionality of its internal bodies as well of the effectiveness of its internal supervisory capacity.

Should the SREP reveal anomalies, the Bank of Italy orders the bank to adopt corrective measures.

18 What happens in the event that a bank becomes undercapitalised?

Should a bank become undercapitalised and, in general, when it finds itself in a situation of non-compliance with the regulatory provisions on capital adequacy, it may be subject to several potential interventions from the supervisory authorities (with different responsibilities between the Bank of Italy and the MEF), which may vary depending on the seriousness of the infringement ascertained.

First, the Bank of Italy may prohibit, by means of an extraordinary provision, the commencement of new operations. This is aimed at preventing capital inadequacy from spiralling out of control.

If an irregularity ascertained under the capital adequacy profile is particularly serious or when such inadequacy involves the risk of degenerating into a significant financial loss, the MEF, upon proposal of the Bank of Italy, may order the dissolution of the administrative and directive bodies of the bank and directly appoint an extraordinary commissioner (see question 13).

Finally, if the capital adequacy infringement is exceptionally serious, the MEF, upon proposal of the Bank of Italy, may even adopt an order for administrative forced liquidation.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

A distinction must be made between situations of financial difficulty that are not yet serious enough to be likely to cause the irreversible insolvency of a bank, and cases of actual irreversible insolvency.

If the Bank of Italy deems, after a prudent assessment, that the financial crisis of a bank is particularly significant but not irreversible, the extraordinary administration procedure may be started.

As a result of the recent implementation of the BRRD, this procedure contemplates that Bank of Italy, and no longer the MEF, adopts a provision by means of which it orders the dissolution of the directive boards and the appointment of extraordinary commissioners.

By means of Legislative Decree No. 180/2015, a new regulatory procedure to manage a bank crisis was introduced. Indeed, if neither the extraordinary administration procedure nor other measures allow to overcome the bank failure, the Bank of Italy adopts a resolution programme, identifying the specific measures to be taken (see question 12).

Should a bank's crisis degenerate into an actual irreversible situation of insolvency, pursuant to Italian law, the only possible remedy is the insolvency procedure.

With respect to a banking group, the extraordinary administration of the lead company is provided also when a company of the banking group is subjected to an insolvency procedure and that circumstance may significantly alter the financial and business balance of the group.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

As mentioned in question 6, sustainable solutions decided at EU level in response to the eurozone's ongoing financial crisis to avoid the bankruptcy of banks have been implemented and more are expected in the near future. In fact, further to the implementation of the recent EU regulations aimed, inter alia, at restraining financial pro-cyclicality, as of 1 January 2014, the banks will improve the quality of their capital up to the common equity Tier 1, equal to 7 per cent of the risk-weighted asset, 4.5 per cent of which should serve as a minimum requirement and 2.5 per cent as a capital conservation buffer. Banks that fail to fulfil the capital buffer requirement will not be able to allocate dividends, variable remunerations and other elements used in the calculation of the required capital and must implement the measures necessary to re-guarantee the amount of regulatory capital.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

As a general rule, there are no longer any particular limitations regarding the types of entities and individuals that may acquire a controlling interest in a bank.

Nevertheless, prior authorisation by the Bank of Italy is required in the following cases:

- acquisition of at least 10 per cent of the capital or of the voting rights (even by means of several subsequent acquisitions);
- acquisition of shares that causes one to exceed the thresholds of 20, 30 and 50 per cent of the capital or of the voting rights; and
- acquisition of control of a company that already holds a controlling interest or exerts a dominant influence on a bank and, in any case, when it provides at least 10 per cent of the voting rights;
- the interest exceeds 10 per cent of the consolidated own funds of the acquiring entity; and
- the interest implies the acquisition of most of the corporate capital (control) or of a dominant influence on a bank located in a country outside the European Union, which is not Canada, Japan, Switzerland or the United States.

If the acquisitions of an ownership in the capital of a bank is carried out for a value exceeding the threshold of 1 per cent of the bank's own funds, the acquisition shall be reported to the Bank of Italy within 30 days from the execution of the relevant transaction.

Other specific quantitative restrictions are in force with respect to mutual and cooperative banks. According to these, in such banks the maximum stake, which can be owned by a single entity is such that the existence of a controlling shareholder is not permitted.

22 Are there any restrictions on foreign ownership of banks?

In Italy, there is no specific restriction on foreign ownership of banks. However, if the acquisition for which the Bank of Italy's prior authorisation is required (see question 21) is carried out by an entity (a natural or legal person) resident in a non-EU state that does not ensure reciprocity in favour of Italian citizens, the Bank of Italy must transmit the authorisation request to the MEF. The MEF, upon proposal by the prime minister, may prohibit and stop the relevant acquisition.

23 What are the legal and regulatory implications for entities that control banks?

See question 24.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

A natural person who controls a bank (see question 26) shall comply with the requirements of integrity provided by the MEF.

Should a legal entity control a bank, the persons that carry out administrative, directive and controlling duties within the controlling entity, shall comply, on a continuing basis, with integrity, professionalism and independence requirements. Should the controlling entity be a bank or a financial company (see question 9 for the concept of a banking group), it will draft the consolidated financial statements of the group and adopt internal procedures to ensure correct observation of the instructions of the Bank of Italy.

Furthermore, for banking groups, the non-fulfilment of the obligations mentioned above implies the risk that the controlling entity may be subject to the extraordinary administration procedure.

Update and trends

On 11 December 2017, the Italian government approved the text of the Legislative Decree that implemented PSD 2, repealing the PSD and adapting the national framework in order to make it compliant with the Regulation (EU) No. 2015/751 on interchange fees for card-based payment transactions (IFR).

PSD 2 is important for payment services providers (eg, banks, e-money institutions and payment institutions) and aims to promote the development of an efficient, secure and competitive retail payments market by enhancing payment service users' protection, promoting financial services by making use of software and modern technology (fintech) and improving the level of security of electronic payments.

As a consequence of this legislative intervention, it is likely that in the next year, the banking market will be involved in a process of progressive change of several business models that have been adopted until now. PSD 2 will have several impacts on the banking system. The payments industry is currently undergoing significant transformation, in particular with respect to the increase of the services rendered by the fintech players as well with respect to the widening of digital payment technology. This new era for the payment services is expected to constitute a serious threat for the revenues and customer base of traditional financial institutions.

PSD 2 will put the banking system under considerable pressure. Therefore, it is likely that an important trend in Italian banking regulation over the coming months will be focused on the necessity to issue new provisions aimed at regulating the payment services, as well the possible interaction between traditional banking services and the new digital payment services.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

If one of the companies of the banking group (see question 22) becomes insolvent, the Bank of Italy can also start the extraordinary administration procedure for the leading bank.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

As mentioned in question 21, the acquisition of control of a bank must be previously authorised by the Bank of Italy. The Bank of Italy identifies the entities that are required to file the request for authorisation when the rights resulting from the interest are attributed to an entity other than the owner of the interest.

The issuing of the authorisation also depends on the classification of the applicant in terms of transparency of its assets, quality of the governance, soundness and fairness in business conduct and its relationship with other entities that may affect the effectiveness of the supervision.

For this purpose, the notion of 'control' is met when:

- an entity has the majority of the voting rights exercisable in the shareholders' meeting;
- an entity has sufficient voting rights to exercise a dominant influence on the shareholders' meeting; or
- an entity can exercise its dominant influence on the bank by virtue of a particular contract with the bank.

The 'control' exercised through the dominant influence is presumed on the basis of the following (non-binding) legal presumptions:

- the entity owning the shares, on the basis of existing agreements, has the right to nominate or revoke the majority of the board of directors or of the board of statutory auditors or has the majority of the votes necessary to decide on the approval of the financial statement and on the appointment of directors;
- the entity owns an interest that entitles it to appoint the majority of members of the board of directors and of the board of statutory auditors;

- the existence of economic relations between the shareholders of the controlled entity which cause alternatively:
- the transmission of profits and losses;
- the coordination of management of the business activity with those of other business entities for a common purpose;
- the attribution of more powers than those directly deriving from the interest;
- the attribution of the power to choose the directors or the members of the supervisory board to entities other than the owner of the interest; and
- subjection to a common management.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The only difference between an Italian and a foreign acquirer is based on the need for the country of a non-EU acquirer that intends to acquire a capital participation in a bank higher than 10 per cent to ensure reciprocity in favour of Italian citizens.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The Bank of Italy would consider the structure of the acquisition operation and the acquirer's business strategy as well as the impact of the transaction on the prudential ratios of all the entities involved.

Alternatively, the assessment would focus on the relevant experience of the incoming management and the integrity of those who, in case of acquisition, would be entrusted with management and control duties in the bank.

29 Describe the required filings for an acquisition of control of a bank.

In evaluating whether to authorise a major shareholder of a bank or a bank holding company, as described in question 26, the Bank of Italy will consider the information contained, inter alia, in the following documentation:

For physical persons
- self-declaration certifying the absence of criminal convictions;
- anti-Mafia certificate from the competent prefecture or from the business registry of the relevant chamber of commerce (if applicable);
- outline of the business activity performed; and
- a list of interests directly or indirectly held.

For legal entities
- minutes of a meeting of the board of directors certifying the absence of criminal convictions against the directors and compliance with anti-Mafia requirements;
- a list of shareholders with more than 5 per cent of the capital;
- declaration of the directors with indication of the controlling entities; and
- a list of interests directly or indirectly held.

In addition, the acquirer must provide information about its economic equity situation (and, if appropriate, those of the other companies of the group), its business relations with the bank to be acquired and on the source of the financial funding available for the transaction.

Finally, the acquirer must provide the business plan for the transaction in order to allow the Bank of Italy to assess its stability and soundness.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The time frame for the approval of an acquisition of a relevant shareholding subject to the Bank of Italy's authorisation (see question 21) is the same for both a domestic and a foreign acquirer.

This time frame is defined in a regulation adopted by the Bank of Italy, which distinguishes between:
- acquisitions that are also subject to competition law, for which a time frame of 60 days for completion of the procedure is set; and
- acquisitions that are not subject to competition law, for which a time frame of 90 days for completion of the procedure is set.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The Financial Services Agency of Japan (FSA) says that the FSA's mission is 'to contribute to the national welfare by securing sustainable growth of national economy and wealth through achieving the following three sets of goals: (i) Financial stability and effective financial intermediation; (ii) Consumer protection and consumer benefit; and (iii) Market integrity and market vigor.'

2 Summarise the primary statutes and regulations that govern the banking industry.

The Banking Law (Law No. 59 of 1981)

The primary statutes and regulations that govern the banking industry are the Banking Law and the regulations enacted under the Banking Law. The Banking Law covers the scope of businesses, capital adequacy requirements, accounting, licensing, loan limits, limitations concerning subsidiaries, major shareholders and bank holding companies, branches of foreign banks, and so on.

The Law Concerning Concurrent Business, etc, of Trust Business by Financial Institutions (Law No. 43 of 1943)

The Law Concerning Concurrent Business, etc, of Trust Business by Financial Institutions sets out regulations for banks that conduct trust business concurrently with their banking business.

The Deposit Insurance Law (Law No. 34 of 1971)

The Deposit Insurance Law governs the deposit insurance system and includes provisions regarding purchasing of deposits and treatment of failed banks.

The Financial Instruments and Exchange Law (Law No. 25 of 1948)

The Financial Instruments and Exchange Law applies to financial institutions, including banks, that conduct securities business.

The Insurance Business Law (Law No. 105 of 1995)

The Insurance Business Law applies to financial institutions, including banks, that act as insurance agents.

The Foreign Exchange and Trade Law (Law No. 228 of 1949)

The Foreign Exchange and Trade Law applies to financial institutions, including banks, that conduct foreign exchange transactions and engage in international transactions.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The FSA is an affiliated agency of the Cabinet Office. The primary responsibility of the FSA is to inspect and supervise banks. Among others, the Inspection Bureau of the FSA conducts on-site inspections of banks to protect the best interests of consumers. The Supervisory Bureau of the FSA supervises banks by monitoring the soundness and appropriate management of the banks' business to prevent problems related to their financial intermediation functions, payment and settlement functions, and so on.

The Bank of Japan (BOJ), the central bank of Japan, is responsible for overseeing payment systems and supervising banks through on-site examinations for the purpose of understanding the business operations and the asset status of the banks. The BOJ executes its responsibilities pursuant to the contracts it has with the banks.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Deposits are protected by the Deposit Insurance System (DIS), operated by the Deposit Insurance Corporation of Japan (DICJ), which is a semi-governmental corporation established in line with the Deposit Insurance Law. Under the DIS, current deposits and other payment or settlement deposits are protected in full, and principal amounts and interests of deposits other than the above are protected if the principal amounts for such deposits are no more than ¥10 million per depositor at each financial institution. Any portion of such deposits in excess of that amount may be repaid based on the asset status of the failed financial institution (some amount may be cut off).

Neither the DICJ nor the FSA has the intention to maintain ownership interest in the banking sector; therefore, the DICJ will dispose the preferred shares, subordinated bonds and so on acquired for capital injections at a proper value that is hopefully above the acquisition value, when the soundness of the banks that received capital injections has improved and such disposition would not damage financial system stability.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

The Banking Law provides for certain limitations on transactions between banks and their affiliates. Under the Banking Law, a bank and its affiliate (which is defined under the Banking Law as a 'specified related person', described below) are prohibited from engaging in a transaction based on terms that are disadvantageous to either party, in light of the ordinary terms and conditions of a similar transaction with an unaffiliated company. However, the amended Banking Law, enforced in April 2017, permits flexible application of this arm's-length rule and allows exceptions to transactions between affiliate banks under their common holding company provided that their sound financial positions are ensured. This arm's-length rule also applies to a bank's transaction with a customer of its specified related person.

The 'specified related person' includes, without limitation:

- a subsidiary company of a bank;
- a major shareholder of a bank (as explained in question 21);
- a bank holding company (as explained in question 21);
- a subsidiary company of a bank holding company; and
- a bank agent for a bank.

6 What are the principal regulatory challenges facing the banking industry?

The FSA announced its 2017–18 'Strategic Directions and Priorities' on 10 November 2017, which states that the FSA will encourage banks to realise the following matters:
- to establish sustainable business models (especially for regional banks);
- to address changes in the global economy and market environment; and
- to improve governance resilient to changes in the business environment.

7 Are banks subject to consumer protection rules?

Banks that sell financial instruments to consumers are subject to the Act on Sales, etc, of Financial Instruments (ASFI). The ASFI obliges the financial instrument providers to explain to the customer important matters such as risk for loss of principal at the time of the sale of a wide range of financial instruments including savings deposits, trusts, insurance, securities, securities derivatives, etc. Further, it stipulates an obligation to the financial instrument providers to set out and disclose its solicitation policy, etc. In the event that the financial instrument provider violates the duty of explanation and its customer incurs damages, the financial instrument provider bears liability for damages to the customer regardless of its negligence.

In addition, the banks will be required to provide proper explanation or information under the Banking Law and the Financial Instruments and Exchange Law (FIEL). The inducement of customers by unjustifiable means is prohibited under the Act against Unjustifiable Premiums and Misleading Presentations. The FSA is the competent authority of the Banking Law, the FIEL and the ASFI.

The Consumer Contract Act will be also applicable to the banking business. Pursuant to this Act, consumers may cancel any contract resulting from unjust solicitation, and if a contract contains any unjust contractual clause, that contractual clause itself will be invalidated.

As regards financial inspections on banks, the FSA conducts examinations on the development and establishment of customer protection management systems by bank management. The compilation of problem cases in financial inspections includes cases of inadequate customer protection when banks sell risky products, such as investment trusts or variable pension insurances to customers.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

The FSA's 2017–18 'Strategic Directions and Priorities' states that the FSA is trying to realise new supervisory approaches of substance, foresight and holisticism, as follows:
- From the Form to the Substance: 'Focusing on whether minimum standards being formally met' to 'Focusing on whether high-quality financial services (best practices) are being provided';
- From the Past to the Future: 'Focusing on checking soundness at times in the past' to 'Focusing on whether sustainability of soundness are ensured in the long run'; and
- From Element by element analysis to Holistic analysis: 'Focusing on responding to specific individual problems' to 'Focusing on whether responces to truly important problems are successful from the whole business point of view'.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The FSA supervises banks by both off-site monitoring and on-site inspections in accordance with the Banking Law, supervisory policies and inspection manuals.

Under the Banking Law, a bank must prepare and submit to the FSA an interim business report and an annual business report for each business year which describe the status of the bank's business and property. If a bank has subsidiaries, etc, such bank must also prepare and submit the interim business report and annual business report on a consolidated basis. When the FSA deems it necessary to ensure sound and appropriate management of a bank's business, the FSA may require the bank (and if necessary, its subsidiaries or a person to whom its business is entrusted) to submit other reports or material.

When the FSA deems it necessary, the FSA may conduct an on-site inspection by having its officials enter the bank's premises, interview relevant personnel and inspect books, documents or other records. When necessary, the FSA officials may conduct a similar on-site inspection of the bank's subsidiaries, etc, or a person to whom the bank's business is entrusted.

The FSA is publishing the yearly Financial Monitoring Policy for supervision and inspection explaining the priority issues, in addition to the general guidelines for supervision and inspection manual.

The BOJ's on-site examination is conducted by sending its staff to the banks' premises and obtaining financial reports from the banks that have current accounts with the BOJ. The examination involves confirming:
- the quality of loans and other assets;
- the management of risks associated with borrowers' credit standing;
- fluctuations in interest rates;
- foreign exchange rates and stock prices; and
- the reliability and accuracy of operations.

10 How do the regulatory authorities enforce banking laws and regulations?

If the FSA deems it necessary to ensure the sound and appropriate management of a bank's business in light of the status of the business or property of such bank or the property of such bank and its subsidiaries, etc, it may instruct the bank to submit (or amend) a business improvement plan and, if and to the extent necessary, it may order the suspension of the whole or part of the bank's operations for a specified period of time or may order the bank to deposit the bank's property or to take other actions.

In relation to the capital adequacy requirements, certain actions may be taken as described in question 19. In addition, if a bank violates any laws or regulations, its articles of incorporation, administrative measures or disposition, or if a bank has committed an act that harms public interests, the FSA may order the suspension of the whole or part of the bank's operations or order the removal of its management, or may revoke its banking business licence. The bank that violates certain laws or certain enforcement procedures of the FSA may be subject to criminal sanctions.

After conducting an on-site examination, the BOJ provides guidance and advice based on the findings of the financial and management conditions to ensure the soundness of the banks.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

Upon its establishment in 1998, the FSA launched a policy of 'ex post facto supervision with emphasis on rules' in order to respond to urgent issues, such as problems with nonperforming loans. However, mechanically continuing such inspection and supervision methods merely centred on strict individual asset assessment and confirmation of compliance with laws and regulations would be detrimental. Furthermore, in responce to changes in the environment surrounding financial institutions, it is necessary to devise appropriate new inspection and supervision methods to encourage self-directed and diverse creative ingenuity by financial institutions themselves.

Therefore, the FSA has been working on reviewing the following inspection and supervision methods to date:
- 'respecting the judgement of financial institutions as much as possible in assessing individual assets';
- 'promoting conversion to financing by business analysis, not excessive dependence on collateral or guarantees';
- 'voluntary improvement through raising questions and dialogue based on future issues';
- 'finding the best practices of financial institutions and providing information subsequently'; and
- 'discovering issues surrounding financial institutions through dialogue with client companies of financial institutions'.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

If the Prime Minister recognises that, unless certain measures are taken in respect of a failed bank that is unable to pay its debts using its assets, there may be extreme adverse effect on the preservation of credit orders in Japan or in the area where the bank operates its business, then measures will be taken for the DICJ to acquire all shares in such bank.

Although the applicable laws have changed and the relevant provision has been amended several times, measures' predecessor was applied to the Long-Term Credit Bank of Japan and the Nippon Credit Bank in 1998 and to the Ashikaga Bank in 2003 pursuant to the provisions and laws applicable at that time.

Since the shareholders of a company (bank) with excessive debt have already lost their economic interests, the shares of stock of such shareholders may become void. The DICJ is able to fund the bank thereby protecting the whole amount of deposits. The DICJ must, at the earliest opportunity, merge the bank with another financial institution, transfer its business to another financial institution or transfer the shares to another financial institution.

There is another measurement for the purpose of overhauling the framework of orderly treatment of assets and liabilities of financial institutions, etc, to stabilise the financial system, where in the event that the Prime Minister gives specific approval that the prescribed measures should be taken, acknowledging the fact that otherwise it would bring considerable disruption to the financial market or other financial system. Under certain circumstances, the Prime Minister may order that the operation and the property of the financial institutions, etc, be managed by the DICJ when specific approval for specified type 2 measures has been given in respect of a financial institution, etc, with excessive debt or a suspension of payments (including threats).

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

When a bank is taken over by the DICJ, the FSA may request that the bank submit reports or materials regarding its business and financial status, and order the bank to prepare and submit a business plan and take such other measures as are necessary.

14 Are managers or directors personally liable in the case of a bank failure?

A bank taken over by the DICJ is required to file lawsuits and conduct other action to pursue the civil liability of directors, officers, and auditors of the bank under their official responsibilities. In addition, if a director, officer, or auditor of such bank believes that a crime was committed while they were fulfilling their duties, they must take necessary measures to initiate an accusation as regard to the crime. Managers and directors will be personally liable for their failure (if any) to perform their duties as managers or directors.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

For the purpose of overhauling the framework of orderly treatment of assets and liabilities of financial institutions, etc, to stabilise the financial system, where the Prime Minister gives specific approval that the prescribed measures should be taken, acknowledging that otherwise it would bring considerable disruption to the financial market or other financial system, the following three types of resolution measures are prepared under the Deposit Insurance Law of Japan.

Type 1 measure

Financial institutions, subject to the above approval for the Type 1 measure, are able to (but are not obliged to) apply for capital injection from the DICJ. In this process, such a financial institution is required to submit a management reconstruction plan that will be examined and granted by the Prime Minister (the relevant authority is actually delegated to the FSA Commissioner). If the Prime Minister determines that the capital injection should be taken, then the management reconstruction plan will generally be disclosed to the public.

Type 2 measure

Insolvent financial institutions or financial institutions that are unable to repay all of their debts by its own property, subject to the above approval for a Type 2 measure, will be placed under supervision by the government aiming to merge with them or sell them to other financial institutions. Public funds may be provided in the process to enable the merger or the sales.

Type 3 measure

Banks, etc, that fall under insolvent financial institutions and are not able to repay all of their debts by their own property (only if it is impossible for them to avoid the above-mentioned disruption by implementing the Type 2 measure), all shares of such banks, etc, will be sold to the DICJ, the status of their assets and liabilities will be disclosed, the officers may be changed by the DICJ and may be required to submit reports, etc, pursuant to the order of the DICJ, the existing officers must be sued for their responsibility, and such banks, etc, are to be merged with, or sold to, the purchasing financial institution.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The new legal and regulatory capital adequacy requirements applicable to banks in Japan are generally prescribed parallel to the Basel III framework. The capital of a bank is classified into three tiers: common equity Tier 1 capital, other Tier 1 capital, and Tier 2 capital.

The target minimum standard capital adequacy ratio is set at 8 per cent, the minimum ratio for the Tier 1 capital ratio is set at 6 per cent, and common equity Tier 1 capital ratio at 4.5 per cent.

Banks are also required to maintain a capital conservation buffer, in addition to the minimum standard capital adequacy ratio set forth above, for the purpose of absorbing any threatened loss the bank may incur because of the fluctuations of the financial market and the economic conditions, among other capital buffers, starting from 2016, which will gradually be increased to 2.5 per cent in 2019. The countercyclical buffer will be also required to be maintained in the range of zero per cent to 2.5 per cent, which is also gradually implemented, and together with the capital conservation buffer, constitute the minimum consolidated capital buffer. For G-SIBs and D-SIBs, other buffer levels are set by the FSA in line with the Basel III framework.

Common equity Tier 1 capital primarily consists of:

- ordinary shares and warrants of ordinary shares;
- retained earnings; and
- other accumulated comprehensive income and other public reserve.

Other Tier 1 capital primarily consists of preferred shares other than the above, and preferred securities without step-ups (under certain conditions).

Tier 2 capital primarily consists of subordinated bonds and loans, etc (where there are five years or more until the first call date). Banks are not obliged to make contingent capital arrangements in Japan.

17 How are the capital adequacy guidelines enforced?

The capital adequacy requirements are enforced through off-site monitoring of the FSA. The FSA confirms biannually the status of capital enhancement through accounting interviews with the banks. The FSA may further confirm the bank's evaluation system of capital, the bank's analysis on how well its capital is being enhanced and its future capital policies through comprehensive interviews and management interviews.

Further, even before a bank actually becomes undercapitalised, the FSA may take preventive and comprehensive measures in order to further enhance the soundness of the bank. If the FSA finds that an improvement is necessary through the above off-site monitoring and interviews for maintaining the sound operation and appropriate management of the bank, the FSA may request the bank to submit reports and materials on the status of its operation and assets, or improvement

plans, or both. In addition, if the FSA finds that there is a material problem, the FSA may issue a business improvement order.
In case the capital adequacy ratio of a bank actually becomes less than a target minimum standard capital adequacy ratio, then the FSA may take the actions set out in question 19.

18 What happens in the event that a bank becomes undercapitalised?

The level of undercapitalisation of a bank is classified into four categories and the actions to be taken by the FSA are stipulated for each level of undercapitalisation.

For a bank with international operations, the stipulated categories and actions that may be taken by the FSA are as follows:

- capital adequacy ratio of Tier 1 capital from ordinary shares, etc, ranging from 2.25 per cent to less than 4.5 per cent, Tier 1 capital adequacy ratio ranging from 3 per cent to less than 6 per cent, and the total capital adequacy ratio ranging from 4 per cent to less than 8 per cent would fall under category 1, in which case the FSA may order the bank to submit a business improvement plan including the measures for recapitalisation and order the bank to execute such plan;
- capital adequacy ratio of Tier 1 capital from ordinary shares, etc, ranging from 1.13 per cent to less than 2.25 per cent, Tier 1 capital adequacy ratio ranging from 1.5 per cent to less than 3 per cent, and total capital adequacy ratio ranging from 2 per cent to less than 4 per cent would fall under category 2, in which case the FSA may order the following:
  - submission of a reasonable recapitalisation plan and execution of it;
  - prohibiting or limiting the amount of dividend distribution or bonus payments to officers;
  - ordering compression of total assets or ordering suppression of growth of total assets;
  - prohibiting or limiting acceptance of deposits under terms that are less favourable to the bank determined on an arm's-length basis;
  - ordering downsizing of business operations in certain offices;
  - ordering the closure of certain offices except for the head office; or
  - ordering the taking of certain other necessary measures;
- capital adequacy ratio of Tier 1 capital from ordinary shares, etc, ranging from zero to less than 1.13 per cent, Tier 1 capital adequacy ratio ranging from zero to less than 1.5 per cent, and total capital adequacy ratio ranging from zero to less than 2 per cent would fall under category 2-2, in which case, the FSA may order the bank to execute measures for one of the following purposes:
  - strengthening its capital;
  - substantially downsizing its business operations; or
  - merging with another bank or abolishing its banking business; and
- capital adequacy ratio of Tier 1 capital from ordinary shares, etc, less than zero, Tier 1 capital adequacy ratio less than zero, and total capital adequacy ratio less than zero would fall under category 3, in which case the FSA may order the bank to suspend all or part of its business operations.

In addition, even when the bank has cleared the minimum target capital adequacy ratio, if the bank is undercapitalised in terms of capital buffers, then the bank will be required to submit plans for restricting external capital outflow and the execution of it. The level of restriction required in the plan would depend on the level of how much the bank is undercapitalised in terms of the capital buffer. The restriction on external outflow means restriction on, for example, the following activities:

- dividend distribution from surplus;
- acquisition of its own shares;
- acquisition of its own warrants that can be included in the calculation of the Tier 1 capital from ordinary shares;
- distribution of dividend, payment of interest and repurchase or redemption towards the other Tier 1 capital procurement measures;
- payment of bonuses and similar property benefits to the officers and other key employees; and
- other activities similar to the above.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

If the FSA determines that the bank is unable to repay all of its financial debts with its assets or that there is a possibility that the bank may suspend refunding deposits considering the conditions of its business or assets, then the FSA may order the bank to have its business and assets managed by a financial reorganisation administrator who will be appointed by the FSA concurrently with the issuance of order under the Deposit Insurance Law.

The financial reorganisation administrator has the sole power to represent the bank, operate its business and manage and dispose its assets. The DICJ may be appointed as financial reorganisation administrator. In principle, the financial reorganisation administrator is expected to end its duties within one year from the order by transferring the business of the bank to another bank, by merging the bank with another bank or by taking other measures as appropriate. This period may be exceptionally extended by one year with the approval of the FSA if a compelling reason exists.

Upon purchasing of business or merging with the bank, a financial institution that seeks the merger with the bank may apply for financial assistance from the DICJ. Such an application is subject to prior approval of the FSA. The FSA grants the approval only if the merger contributes to depositors' protection, the financial assistance by the DICJ is essential for implementing the merger and the bank's dissolution would be significantly detrimental to the smooth supply of funds and to the benefits of users in the region, or the field, that the bank operates its business. If necessary, the DICJ may decide to establish an acquiring bank to temporarily succeed the business of the bank.

Furthermore, if there is a possibility that failure of a bank causes an extreme adverse effect on the preservation of credit orders in Japan or in the area where the bank operates its business, public money may be injected in order to recapitalise the capital of the bank, provide financial assistance to protect the full amount of deposits as an exceptional treatment to the deposit insurance cap, or have the DICJ acquire all the bank's shares. If the DICJ acquires all the bank's shares, the DICJ must, at the earliest opportunity, merge the bank with another financial institution, transfer its business to another financial institution, or transfer the shares to another financial institution where, as a consequence, the bank will no longer be a subsidiary of the DICJ.

Insolvency procedures such as bankruptcy, civil rehabilitation, corporate reorganisation or special liquidation proceedings are also available.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

The capital adequacy guidelines in Japan have changed in line with Basel III, where the amendments have already been enacted as set out in question 17, and will be fully implemented by 2019.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

In general, both entities and individuals may own a controlling interest in a bank. However, if it is a company established under Japanese law, only a stock corporation with a board of directors, a board or a committee of auditors and an accounting auditor may become a bank holding company, which is one of the categories of controlling a bank's shareholders.

Under the Banking Law, there are two categories of controlling a bank's shareholders: a bank's major shareholder and a bank holding company.

A bank's major shareholder is an entity or an individual that holds 20 per cent (or 15 per cent, if the shareholder is expected to have a material influence on the bank's decisions regarding financial and business policies) or more of the voting rights held by all shareholders of such bank. For the purpose of calculating the holding ratio of such an entity or individual, the number of bank voting rights held by the entity or individual includes the bank voting rights held by certain relevant entities or individuals of the entity or the individual. The relevant entities or individuals include consolidated subsidiaries and affiliates and joint holders (meaning other entities or individuals that hold the

Update and trends

As stated in questions 6 and 8, in the 'Strategic Points and Directions', published in November 2017, the FSA emphasised the importance of creating a sustainable business model and maintaining financial health for regional banks, establishing key performance indicators for their finance intermediary capabilities, assisting in their reinforcement of human resources and valuable know-how, and pursuing a balanced relationship between government and non-governmental financial institutions. Reinforcement of overall governance and risk management capabilities were also stated as important parts of such strategic points.

For mega-banks, the FSA stressed, in its publication, the importance of flexibility and enhancement of their control and governance system in the rapidly changing global economy and to market environments, also by appropriately managing various risks involved in foreign exchanges, share prices, new financial instruments or technologies.

The FSA publication also mentioned the reformation of FSA itself; its reinforcement of global networking among the financial supervisory authorities of various states, and early finalisation of Basel III, as well as the strong need for new and appropriate policies for fintech, cybersecurity and virtual currencies, among others.

In line with the publication, the FSA published the draft 'Supervisory Approaches' in December 2017 and proposed to transform its supervisory approach from a backward-looking and compliance check on formalistic or element-by-element basis to a forward-looking, substantive and holistic analysis and judgement, and to enhance the FSA's own governance level, using feedback from outside the FSA to restructure its internal organisation and infrastructure, and reforming its human resources policy. For this approach, the FSA even proposed to repeal various inspection manual documents that have been heavily used in regular supervisory activities.

voting rights of the bank and have agreed with the entity or individual to jointly acquire or transfer the bank's shares or to jointly exercise their voting rights, etc, as the bank's shareholders).

A bank holding company is a company that holds more than 50 per cent of the bank's voting rights held by all shareholders, and the aggregate amount paid by the company to acquire all of its Japanese subsidiaries, including the bank (or other amounts recorded in its latest balance sheet), exceeds 50 per cent of the total assets of the company (deducting certain amounts such as intercompany loan between the company and its subsidiaries). For the purpose of calculating the company's holding ratio, the number of bank voting rights held by certain relevant entities or individuals of the company is included in the number of voting rights held by the company.

22 Are there any restrictions on foreign ownership of banks?

There is no restriction on foreign ownership of banks under the Banking Law.

23 What are the legal and regulatory implications for entities that control banks?

The Banking Law prescribes the FSA's supervision of major shareholders of banks.

When it is necessary to ensure the sound and appropriate management of a bank's business, the FSA may conduct off-site monitoring (including requesting a bank's major shareholder to submit reports and material concerning the operation and financial conditions of the bank) and an on-site inspection (including interviewing the bank's major shareholder on the operation and financial conditions of the bank as well as the major shareholder and inspecting books, records and other items of the major shareholder) that are helpful for understanding the status of the business or property of the bank.

When and to the extent necessary, the FSA may order the major shareholder to submit (or amend) and execute an improvement plan and to take other necessary measures.

Further, when the major shareholder no longer satisfies any of the requirements set out in question 29, the FSA may order the major shareholder to take necessary measures to satisfy the requirements within a designated time frame.

Similar to bank major shareholders, bank holding companies are also subject to the supervision by the FSA under the Banking Law. Furthermore, the Banking Law limits the activities of bank holding companies to managing and controlling banks and other subsidiaries, which they are authorised to hold under the Banking Law, and activities incidental to it. Bank holding companies are limited to hold, as subsidiaries:

- banks;
- securities companies;
- insurance companies
- companies engaged in certain other financial business;
- certain business related to finance; or
- certain other business relating to businesses and bank operations.

The purpose of this restriction is to ensure the soundness of operations of banks by eliminating risks that may arise from being involved in activities of non-financial industries. A bank holding company will be required to obtain prior authorisation from the FSA before acquiring a new subsidiary company, or when its existing subsidiary company changes its business. In addition, unless the Japanese company becomes the subsidiary of the bank holding company, the bank holding company or any of its subsidiaries may not acquire or hold shares of a Japanese company if their aggregate interests in the company exceed 15 per cent of the voting rights of the company, with certain exceptions.

Bank holding companies are required to satisfy the capital adequacy requirements and maintain adequate capital on a consolidated basis. Such requirements are in line with the capital adequacy requirements for a bank.

Bank holding companies must comply with the rule on a credit limit granted to an individual or entity. The credit limit rule is in line with those applicable to banks. Under this credit limit rule, the grant of credit extended by a bank holding company or any of its subsidiaries, etc, is capped at 25 per cent if the credit is extended to an individual or entity or at 40 per cent if the credit is extended to an individual or entity as well as its parent companies or subsidiaries. The bank holding company is required to establish a proper system for appropriately handling the business-related information and controlling conflicts of interest among its group financial institutions and appropriately monitoring their business operations in order to protect the interests of customers of the banking business and certain other businesses of such institutions. This requirement is in line with those applicable to banks.

Directors and statutory executive officers engaging in the ordinary business of a bank holding company may not engage in the ordinary business of any other company except where it is authorised by the FSA.

Bank holding companies must prepare and submit to the FSA annual and biannual reports that contain consolidated statements on the status of business and property of the bank holding companies and their subsidiaries, and so on.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

For the primary duties and responsibilities of a controlling entity or individual, see question 29, and for the primary filing obligations, see question 30.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

There is no criminal or administrative sanction set out under the Banking Law that would be imposed on an entity or individual that controls a bank in the particular event that it becomes insolvent.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

If and when an entity or individual intends to become a major shareholder of a bank or a company intends to become a bank holding company, the relevant prior authorisation of the FSA must be obtained, except in certain cases such as where shares of such bank are acquired upon enforcement of a security interest or upon payment in kind. The definition of 'control' for this purpose is the same as that defined in question 21.

Documents required upon application for prior FSA authorisation would include, in the case of a bank's major shareholder, a document showing a framework for holding voting rights of the bank, prospective cash inflows, and net present value of cash inflow for the next five years generated from holding those voting rights, a document showing results of stress tests and relationships that the major shareholder plans to have. In the case of a bank holding company, a document would be necessary showing prospective income and expenditure and consolidated capital ratio of the company and the bank for next three fiscal years, among other documents.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The FSA is generally receptive to foreign acquirers, provided that such foreign acquirers satisfy the prescribed requirements for major shareholders of banks or for bank holding companies (for such prescribed requirements, see question 30). The regulatory process for foreign acquirers under the Banking Law is not materially different from that for Japanese acquirers.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

When an application for the authorisation of a major shareholder is filed, the FSA examines the following factors:
- whether there is any risk that the applicant would impair the sound and appropriate management of the bank's business in light of the source of acquisition funds and the purpose of the acquisition and other matters relevant to its holding of voting rights;
- whether there is any risk that the applicant would impair the sound and appropriate management of the bank's business in light of the status of property, income and expenditure of the applicant and its subsidiaries; and
- whether the applicant sufficiently understands the public nature of the banking business, and has a sufficient social reputation.

When an application for the authorisation of a bank holding company is filed, the FSA examines the following factors:
- whether the applicant and its subsidiaries have a prospect of achieving a good balance of income and expenditure;
- whether the applicant and its subsidiaries have the adequate capital in light of the assets owned by them; and
- whether the applicant has sufficient knowledge and experience that will enable it to carry out the management and operation of a subsidiary bank appropriately and fairly in light of its human resources structure, and has a sufficient social reputation.

29 Describe the required filings for an acquisition of control of a bank.

When an entity or individual intends to become a bank's major shareholder, or a company intends to become a bank holding company, an application for authorisation of it must be filed with the FSA.

When it acquires the prior authorisation of the FSA, both a major shareholder and a bank holding company must file a simplified notice with the FSA without delay, stating that it has become a major shareholder or a bank holding company.

In addition, the following events, for example, will trigger filing obligations of a major shareholder or a bank holding company.

In the instance of a major shareholder:
- it has acquired more than 50 per cent of the voting rights of the bank;
- it no longer holds the threshold percentage of becoming a bank's major shareholder (20 per cent or 15 per cent, as applicable);
- it has been dissolved; or
- its majority of voting rights has been acquired by one shareholder.

In the instance of a bank holding company:
- it has ceased to be a holding company;
- it intends to hold a subsidiary;
- its subsidiary is no longer its subsidiary;
- it has been dissolved;
- it intends to change the capital amount; or
- more than 5 per cent of its voting rights has been acquired by one shareholder.

Although not directly connected with the 'control' issue, any entity or individual that has become a holder of more than 5 per cent of the voting rights held by all a bank's shareholders or a bank holding company is required to submit written notice to the FSA within five business days. The extended deadline of one month is applicable for a foreign acquirer. Also, written notice must be submitted if the holding ratio subsequently increases or decreases by 1 per cent or more, or if there is any change in the information included in previously submitted notice.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The ministerial ordinance under the Banking Law provides that the FSA must endeavour to evaluate and determine whether it should grant authorisation for a bank's major shareholder or a bank holding company within one month (or two months for certain banks designated by the FSA) after the formal filing of an application for the authorisation. This timeframe does not include a preliminary evaluation upon request of the applicant (if any) or the time spent for correction, amendment or supplementation of the application or application documents. Despite this provision setting out a standard time frame, the actual period required for such authorisation may differ significantly from case to case.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The Banking Act of the Republic of Korea stipulates that:

> *[T]he purpose of this Act is to contribute to the stability of financial markets and the development of the national economy by pursuing the sound operation of banks, enhancing the efficiency of fund brokerage functions, protecting depositors and maintaining order in credit.*

2 Summarise the primary statutes and regulations that govern the banking industry.

The following statutes governing the banking industry are:

- the Banking Act;
- the Electronic Financial Transactions Act;
- the Foreign Exchange Transactions Act;
- the Financial Investment Services and Capital Markets Act; and
- the Depositor Protection Act.

The Banking Act regulates granting banking licences, limiting the stockholding for bank stocks, the governance structure and scope of the business of the bank, the compliance requirements for management of the bank, supervision and examination of the bank, merger, winding up and dissolution of banks, domestic branches of foreign banks and administrative fines and penalties.

Electronic financial transactions are widespread in Korea, and the Electronic Financial Transactions Act stipulates the rights and obligations of parties to electronic financial transactions, permit issuance for engaging in the electronic financial business, the registration and supervision of electronic financial transactions, and ensuring security for electronic financial transactions.

The Foreign Exchange Transactions Act regulates foreign exchange transactions and governs the entities conducting foreign exchange transactions.

The Financial Investment Services and Capital Markets Act serves as the primary law governing financial investment in the Republic of Korea and applies to financial institutions including banks. The Financial Investment Services and Capital Markets Act regulates the financial investment businesses, issuance and distribution of securities, unfair trade practices and the mutual funds industry.

The Depositor Protection Act stipulates the deposit insurance system and the deposit protection scheme in case of insolvent financial institutions.

Besides the Banking Act, the Act on Structural Improvement of the Financial Industry, the Act on Corporate Governance of Financial Companies and the Financial Holding Company Act regulates the 'governance structure and management' of the bank.

The Act on the Structural Improvement of the Financial Industry (Financial Industry Structural Improvement Act) stipulates ways of dealing with insolvent financial institutions such as merger and conversion, liquidation and bankruptcy of financial institutions.

The Act on Corporate Governance of Financial Companies sets out the basic matters concerning the corporate governance of financial companies such as qualifications for financial company executives, the composition and operation of the board of directors and the internal control system.

The Financial Holding Company Act regulates the establishment of financial holding companies, restrictions on shareholding, business, operation, supervision and incorporation of subsidiaries.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The banks' regulatory oversight bodies are the Financial Services Commission (FSC) and the Financial Supervisory Service (FSS). The FSC deliberates and decides on important matters such as financial supervisory policies and licences for engaging in the financial business, and the FSS implements the decisions made by the FSC or conducts inspections of financial institutions.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

As required under the Depositor Protection Act, the Korea Deposit Insurance Corporation (KDIC) protects up to 50 million won per person, inclusive of the principal and interest, for each financial institution in case the financial institution is unable to pay deposits or interest because of its insolvency. A deposit amount in excess of 50 million won will not be insured.

The government has held shares in Woori Bank, one of the commercial banks, in addition to the specialised banks (Korea Development Bank, Industrial Bank of Korea, Korea Export and Import Bank, etc), but recently the government has been divesting its stakes in Woori Bank.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

The Banking Act, the Act on Corporate Governance of Financial Companies and the Monopoly Regulation and the Fair Trade Act apply to banks and their affiliated companies. If a bank is a subsidiary of a financial holding company, the Financial Holding Company Act shall apply.

The Banking Act provides that the major shareholder of a bank and its related persons (including subsidiaries) are prohibited from the following acts (article 35-4 of the Banking Act):

- requiring banks to provide data or information that is not disclosed to the outside in order to exercise undue influence;
- engaging in unfair influence on the personnel or management of the bank by colluding with other shareholders subject to the provision of interests such as economic benefits;
- influencing the management of the bank, such as demanding premature recovery of credit for the purpose of hindering the business activities of a competitor;
- extending credit from a bank in excess of the credit limit provided under the Banking Act;

- extending credit from a bank by causing another bank to violate the cross-lending prohibition;
- extending credit from a bank by causing the bank to violate the prohibition on extending credit and providing capital to major shareholders;
- causing the bank to extend to the major shareholder the free transfer, sale and exchange of assets, and credit;
- causing the bank to own shares of the major shareholder exceeding the limit set by law; or
- demanding the bank to extend credit to its competitors under unfavourable credit conditions, such as interest rates and collateral, without justifiable reasons.

At this time, the related persons mean the major shareholder and his or her spouse, relatives by blood within six degrees, relatives by marriage within four degrees, and persons and corporations having a certain shareholding relationship.

6 What are the principal regulatory challenges facing the banking industry?

Bank supervision mainly focuses on regulations on safety and soundness and business conduct. According to the Financial Reform Key Tasks announced by the FSC on 12 January 2017, the FSC will focus on the reorganisation of the trust business system, the development of fintech, the enhancement of competitiveness of financial holding companies, and increase in the transparency and trustworthiness of accounting (see question 8 for details).

7 Are banks subject to consumer protection rules?

The Banking Act stipulates that banks may not require customers to deposit money, demand collateral or guarantees and harm unjustly the interests of consumers by using the banks' superior position.

In particular, most of the banking transactions are done under entering into the standard terms and conditions, so consumers are protected by regulation of the standard terms and conditions of banks. In other words, if banks intend to establish or revise the standard terms conditions for financial transactions, banks are required to report such establishment or modification to the FSC in advance. If banks unreasonably limit or exclude the liability of the bank, if banks impose unduly harsh indemnification liability on consumers or limit the rights of consumers, or if banks may determine or amend the standard terms and conditions unilaterally without justifiable reason, the financial supervisory authority may deem such standard terms and conditions as unfair and recommend changes. In addition, banks must clearly display the terms of their products such as interest rate and other benefits and charges, such as savings accounts, when advertising their products in order not to cause any misunderstanding, and must establish and observe their internal control protocol to prevent any wrongdoings. These obligations are subject to supervision by the FSS.

As part of consumer protection, banks are required to conclude deposit insurance contracts with the KDIC under the Depositor Protection Act.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

As mentioned in question 6, the FSC announced the following measures for system improvements in relation to the key tasks for financial reform through its press release of 1 January 2017:

- with regard to the trust business, to enact the Trust Business Act, which deregulates the trust business with the aim that trusts function as a comprehensive wealth management service;
- the establishment of a comprehensive fintech support system to support fintech development, in the course of encouraging the financial regulation test bed, block chains and big data services.
- with regard to financial holding companies, to reduce the restrictions on business entrustment within financial groups and between subsidiaries, to allow customer information sharing and to encourage accountability and stable governance; and
- with regard to accounting, implementing comprehensive measures for the entire process of external audit from the appointment of auditors to supervision and sanctions to eliminate accounting fraud and financial wrongdoings.

In addition, the FSC is working to improve existing conservative financial regulatory practices, such as changing current regulations into ex post regulations, and to reduce administrative guidance and encourage the self-regulating culture for financial institutions.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The bank supervision of the FSS is a compulsory authoritative surveillance that is conducted under the Banking Act and the regulations on financial institution inspection and sanctions in accordance with bank inspection manuals. The FSS conducts regular surveillance of banks' risk levels and levels of control associated with management activities, and conducts periodic inspections of the banking business as a whole. The FSS also carries out inspections for particular sectors of banks if deemed necessary for enforcing the policy of bank supervision.

10 How do the regulatory authorities enforce banking laws and regulations?

If a violation of the Banking Act is detected, the FSC, in keeping with the severity of violation, will take appropriate measures such as:

- administrative sanctions (cancellation of the banking business, suspension of all or part of business, correction order, request or recommendation of disciplinary actions against directors, officers and employees, duty suspension, etc);
- penalties;
- imposition of administrative fines; and
- filing of criminal charges.

In addition to these sanctions, the FSC also uses non-mandatory or non-authoritative supervisory measures such as consultation, guidance and recommendations.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

Bank supervision is mainly conducted from the point of view of entry and exit, soundness supervision, and management evaluation. Regarding the entry and exit of banks, regulatory restrictions on shareholdings of banks are mainly supervised. In terms of soundness, the soundness of business activities is primarily supervised, and in the area of the management evaluation, the adequacy of capital, the soundness of assets, the appropriateness of management, profitability, and risk management are primarily supervised. Banks are paying close attention to these supervisory items in management.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

If the banking licence is revoked, the bank will be dissolved. The Banking Act provides that banking licence may be revoked if:

- the bank has obtained the licence for banking business by false or illegal means;
- the bank has violated a condition or term of the licence;
- the bank has carried on the business during the suspension period of its business;
- the bank failed to comply with the corrective order for violating the Banking Act;
- there is a great likelihood that investors and depositors' interest may be severely harmed because the bank violated the Banking Act or any order or disposition issued under the Banking Act; and
- the bank constitutes a non-performing financial institution under the meaning of the Act on the Structural Improvement of the Financial Industry and meets other requirements stipulated by laws and regulations.

Accordingly, if the bank is dissolved, the court appoints the trustee at the request of the interested party or the FSC or on the authority of the court. The trustee collects on banks' bonds by investigating the assets of the bank after reporting its appointment to the court, makes the payment for its debts to its creditors (the depositors are protected by the Depositor Protection Act) and, after the disposition of the assets, distributes the remaining assets to its remaining rights holders (shareholders). The same is true in the case of bankruptcy as a result of insolvency.

However, because a bank's dissolution such as the foregoing causes serious damage to financial consumers, the FSC may, in accordance with the Act on the Structural Improvement of the Financial Industry, implement such appropriate corrective measures as appointing a manager, reducing its operating divisions, repurchasing or consolidating its outstanding stocks, merger or acquisition of such a bank by a third party and transfer of contracts. In addition, the FSC may designate another financial institution to recommend the merger with the non-performing financial institution, transfer of business or transfer of contract. The FSC may request the government for capital provision. In such case, it is possible to force reduction in the banks' capital with or without compensation without a resolution of the general meeting of shareholders. The shareholders and creditors of the bank who are opposed to such a measure may submit their objections and may request payment on debts or stock purchase.

In 1997, the KDIC injected public funds into some banks such as Kwangju Bank, Kyungnam Bank and Woori Bank (then Hanbit Bank), which were insolvent at the time of provision of the International Monetary Fund bailout package.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

In case of dissolution of a bank as a result of revocation of its banking licence under the Banking Act, the court appoints the trustee, and therefore the officers prior to such decision may not participate in the dissolution procedure. However, if the FSC issued appropriate corrective actions to the insolvent financial institution to avoid dissolution under the Act on the Structural Improvement of the Financial Industry, the FSC may instruct the financial institution or its officers to recommend, request or order implementation of corrective actions or order submission of the plan for such actions, and the financial institution or its officers are required to comply with the foregoing. The FSC may order capital reduction for government bailout. If an officer of a bank fails to comply with such order, the FSC may also order the suspension from duty for such officer, appoint a replacement manager to perform the duties of the officer, or recommend dismissal of the officer at the shareholders' meeting.

14 Are managers or directors personally liable in the case of a bank failure?

As long as the bank failure was not caused by misconduct by an officer or employee, officers and employees are not personally liable for a bank failure. However, if a bank failure occurs because of an unlawful act of an officer or employee, she or he may be held liable for civil indemnification liability to the bank's shareholders or creditors or criminal liability (for example, breach of fiduciary duty, violation of the Banking Act, etc), and may be subject to dismissal, suspension from work, reduction of pay or other disciplinary actions.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

When a bank is dissolved or goes bankrupt, obligations such as providing a rehabilitation plan are not required, other than proceeding with the liquidation procedure as prescribed under applicable laws (see question 12).

If the FSC determines sufficient factual grounds for bankruptcy of a financial institution, the FSC may apply for its bankruptcy, and the Director-General of the FSS or the Korea Deposit Insurance Corporation may propose to the FSC filing for bankruptcy of the financial institution. In such a case, the court should appoint a liquidator or bankruptcy trustee at the request of interested parties or of the FSC, or with the authority of the court, and the liquidator or bankruptcy trustee should conduct all relevant procedures as the court's agent. Therefore, it seems that there is no specific obligation imposed on the bank in the course of its liquidation and dissolution procedure.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Under the Banking Act, banks are required to maintain capital of at least 100 billion won and local banks should maintain capital of at least 25 billion won.

In addition, according to Basel III, the BIS capital adequacy ratio should be maintained at 8 per cent or more, with the ratio of common stock of 4.5 per cent and the ratio of basic capital (Tier 1) to 6 per cent or more, as indicators of capital adequacy. Basel III's Counter Cyclical Buffer system was introduced in Korea, and the FSC set the buffer rate at zero per cent in 2016 and maintained it at zero per cent for the first quarter of 2017. Furthermore, the leverage ratio of capital divided by total assets must be maintained at 3 per cent or more based on its base capital. The short-term liquidity coverage ratio must be more than 100 per cent (60 per cent or more for foreign bank branches).

Banks in Korea do not have obligations for contingent capital arrangements.

17 How are the capital adequacy guidelines enforced?

The Director-General of the FSS must monitor the soundness of the management by analysing management of the bank and evaluate the management practices of the bank through the examination of the bank and reflect the results in its supervision and inspection of the bank. The Director-General of the FSS may request the banks to submit a plan or agreement for improvement or conclude a management improvement agreement with the bank if it is deemed that there is a possibility the bank will be unable to meet the requirement of capital adequacy (see question 16) or that there are unsound business areas.

18 What happens in the event that a bank becomes undercapitalised?

The FSC can issue management improvement recommendations, management improvement demands, and management improvement orders when the capital adequacy indicators are insufficient or the management result evaluation grade is below a certain level. The minimum capital requirement is part of factors considered for issuance of a banking licence, and if the requirement is not met, the banking licence may be revoked or all business operations suspended.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

If the bank is bankrupt, the banking licence will be cancelled, and the related procedure will be the same as the dissolution discussed for question 12.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

Since the capital adequacy ratio has been changed in accordance with Basel III as described for question No. 16, it is necessary to meet the above criteria by 2019 in keeping with the timetable provided.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

The Banking Act has the following restrictions regarding the acquisition of bank stocks.

Under the Banking Act, the same person who is not a non-financial principal (including a person and a person who has a special relationship with the person as determined under the statute) cannot own, in principle, shares exceeding 10 per cent of the total outstanding voting stock of the bank (15 per cent in the case of local banks; see the definition of a local bank below). However, the above requirement may be exempted with the approval of the FSC. In this case, an approval is necessary each time for exceeding 10 per cent (15 per cent for local banks), 25 per cent and 33 per cent.

A non-financial principal cannot hold more than 4 per cent of the total outstanding voting shares of the bank (15 per cent for local banks). However, if the person meets certain requirements on condition that

Update and trends

Korea has been tightening its anti-money laundering regulatory regime in response to the call for strengthening of the international anti-money laundering regime by international organisations such as the Financial Action Task Force (FATF) and overseas regulatory authorities that all countries and financial institutions have a high level of anti-money laundering system. In particular, in preparation for FATF on-site visits to Korea in 2019 for its mutual evaluation programme, Korean financial supervisory authorities have strengthened their anti-money laundering surveillance of financial institutions.

In this regard, the FSC has recently made a public announcement of the scheduled enactment of the amendment to the Enforcement Decree of the Act on the Reporting and Use of Certain Financial Transaction Information, which includes the deletion of provisions exempting the financial institutions from obligations of internal control and the establishment of new criteria for the imposition of fines. The FSS made changes to its organisational structure, such as the creation of an independent department for anti-money laundering, and expanded the scope of its anti-money laundering operation in its effort to revamp its anti-money laundering regulatory framework. Moreover, the FSC has determined the trading of cryptocurrencies as bearing a high risk of money laundering. Accordingly, the FSC made a public announcement on the 'Guidelines to anti-money laundering in regards to cryptocurrencies', which required financial companies to improve their monitoring of financial transactions related to cryptocurrencies and listed the primary types of transactions among cryptocurrency transactions to be carefully monitored for money laundering.

The EU General Data Protection Regulation (GDPR), Regulation (EU) No. 2016/679, enacted in May 2016, will become effective on 25 May 2018. Upon commencement of the enforcement, financial companies with EU subsidiaries or offices and companies that collect or handle the information of EU nationals will be subject to the GDPR. Korean financial companies with EU subsidiaries or offices have a keen interest in the GDPR-related banking regulations, making the GDPR a hot topic in the near future.

he or she does not exercise voting rights, the person may acquire the shares of the bank up to a limit of 10 per cent with the approval of the FSC.

On the other hand, the Banking Act defines a major shareholder who is a bank management person as follows (article 2 (1) (10) of the Banking Act).

A person who falls under any one of:

- *one stockholder of a bank where the same person including such stockholder holds more than 10/100 (15/100 in cases of a bank which does not operate nationwide (hereinafter referred to as 'local bank')) of the total number of voting stocks issued by the bank; or*
- *one stockholder of a bank where the same person, including such stockholder, holds more than 4/100 of the total number of outstanding voting stocks issued by the bank (excluding a local bank) and the same person is the largest stockholder of the bank or exercises de facto influence over the major managerial matters of the bank by appointing or dismissing its executives or by other methods, as prescribed by Presidential Decree.*

As a result, the above-mentioned shareholder holding shares in excess of the limit will constitute the major shareholder. The FSC periodically examines the shareholders holding shares in excess of the limit to determine whether they meet the excess holding requirements and satisfy the conflict prevention measures and if there are signs of unlawful transactions between the major shareholders and the banks, the FSC may conduct frequent examination, which serves as a tool for supervising major shareholders.

22 Are there any restrictions on foreign ownership of banks?

The same share ownership restrictions apply to foreigners as discussed for question 21.

However, the Banking Act stipulates that 'in the case of non-financial principal holding stocks within the shareholding limit for foreigners in accordance with the Foreign Investment Promotion Act', the provisions on 'the same person who is not a non-financial principal' apply. Therefore, such foreigners who are non-financial principals are not subject to restrictions on non-financial principals.

23 What are the legal and regulatory implications for entities that control banks?

The Banking Act limits the credit banks may extend to its major shareholders and restricts the amount of equity securities issued by major shareholders, which may be acquired by banks. In addition, the Banking Act prohibits major shareholders from exercising any undue influence on banks. If the FSC deems that the management soundness of the bank may significantly deteriorate because of the unsound financial condition of the major shareholder, the FSC may request the bank or its major shareholder to submit documentations and may limit the bank's extension of credit to its major shareholder.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

See question 5 for the obligations of major shareholders of a bank under Korean law.

The FSC may require a bank or its major shareholders to submit necessary data when it is found that the bank or its major shareholder is alleged to have violated the above obligations.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

If the bank insolvency was not caused by an unlawful act of a controlling entity or individual, there is no separate criminal or administrative penalty based on the insolvency alone.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

Although the Banking Act does not require separate approval by the FSC as a requirement of becoming a major shareholder, the Banking Act, as discussed for question 21, does require the approval of the FSC for shareholders with shares in excess of the shareholding limit, which serves as a tool for supervision and regulation of major shareholders. Even when the major shareholder is suspected of exercising undue influence, an investigation of such a major shareholder may be undertaken. See question 21 for the definition of a major shareholder who is a person in bank management.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

In the case of a foreign corporation or a foreigner, the Foreign Investment Promotion Act applies. Not much difference in the regulatory process for a foreign acquirer exists from those for domestic persons, except that a different stockholding limit applies to a foreign corporation that is a non-financial principal, and in the case of approval for shareholding in excess of the limit, factors discussed in question 28 are considered. The principle of equal treatment applies to foreign corporations in the regulatory process and enforcement by the authorities.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

Before approving a shareholding exceeding the limit, the FSC considers the risk of:
- harming the soundness of the bank;
- the adequacy of the asset size and financial condition;
- the size of credit extended from the bank;
- the possibility of contributing to efficiency; and
- the soundness of the banking industry.

If the shareholder in excess of the limit is a foreigner, the following factors are additionally considered:

- it must be a company engaging in the financial business in a foreign country or a holding company of a foreign financial company;
- it must be suitable for international business activities in light of the total assets and business scale, and must have a good reputation internationally;
- there must be a confirmation from the financial supervisory body of the country in which the foreigner is a member that its operation has not been suspended for the past three years;
- the BIS capital adequacy ratio must be at least than 8/100 in each of the past three years;
- there must be no history of defaults related to commercial transactions such as financial transactions;
- it must be verified that it is suitable as the controlling shareholder of the bank and contributes to the soundness of the bank and the efficiency of the financial industry; and
- there must be no record of violation of domestic financial laws and regulations or related laws or involvement in insolvent financial institutions at certain levels.

29 Describe the required filings for an acquisition of control of a bank.

The same person must report to the FSC the matters necessary to confirm the status of the shareholding in the bank or the change in the shareholding ratio:

- where he or she holds stocks of a bank (excluding a local bank; hereafter in this paragraph the same shall apply) in excess of 4/100 of the total number of its issued voting stocks;
- where the same person falling under sub-paragraph 1 becomes the largest stockholder of the relevant bank;
- where the ratio of stockholding by the same person under sub-paragraph 1 changes by at least 1/100 of the total number of issued voting stocks of the relevant bank;
- in cases of a private equity fund holding stocks of a bank in excess of 4/100 of the total number of its issued voting stocks, when any change occurs in its partners; or
- in cases of a special purpose company holding stocks of a bank in excess of 4/100 of the total number of its issued voting stocks, when any change occurs in its shareholders or partners.

The report must contain the following:

- matters concerning the same person;
- in the case of a private equity fund participating in management, each of the following:
- shareholder or employee; and
- investment amounts of participating members with limited liability and members in management with unlimited liability of the private equity fund;
- matters relating to status and reasons for stock ownership or change;
- the purpose of the stockholding and matters relating to involvement in the bank's management; and
- other details required by the FSC and publicly announced by the FSC as necessary to identify changes in stock holding status or change in the stock holding ratio.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The FSC must process the application for approval within 60 days from the date of receipt of the approval application (for stock holdings in excess of the limit). However, the period prescribed and announced by the FSC, such as the period during which the application is amended to correct minor errors, is not included in the processing period.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The following governmental and regulatory policies constitute the underlying principles of the banking sector in Lebanon:

- ensuring that banking activities in Lebanon are regulated and supervised by the Banque du Liban (BDL), the Lebanese central bank;
- protecting the banking sector from systemic risks by preserving the solvency of Lebanese banks; the governor (the Governor) and central council (the Central Council) of the BDL, along with the banking control commission (BCC) are vested with the greatest regulatory powers to such effect;
- upholding banking secrecy instituted by the Banking Secrecy Law of 3 September 1956 (the Banking Secrecy Law), which is at the core of the Lebanese banking system and plays a key role in attracting funds to Lebanon;
- applying anti-money laundering (AML) best practices, procedures and regulations;
- encouraging Lebanese banks to broaden their regional and international presence through fiscal incentives and other measures; and
- adhering to various sets of internationally recognised treaties and conventions and maintaining a harmonious balance between the preservation of the banking system and the progressive implementation of international regulations and standards (such as Basel III).

2 Summarise the primary statutes and regulations that govern the banking industry.

The primary laws and regulations governing the banking sector in Lebanon are:

- the Code of Obligations and Contracts enacted on 9 March 1932;
- the Code of Commerce enacted on 24 December 1942, which governs the corporate aspects of banks and prescribes certain formalities applicable to them (the Code of Commerce);
- the Code of Money and Credit enacted on 1 August 1963 (the CMC) which establishes the BDL and sets the general rules governing the banking industry;
- the Banking Secrecy Law, which compels all financial entities regulated by the BDL to absolute secrecy with respect to their clients' personal and account-related information and provides that banking secrecy can only be lifted in very limited circumstances;
- Law No. 318 of 20 April 2001 on Fighting Money Laundering (the AML Law), which provides for increased reporting obligations and the establishment of the Special Investigation Commission (SIC), whose mandate includes investigating suspected money laundering offences and deciding to lift banking secrecy;
- the recent amendment to the AML Law, namely Law No. 44 of 24 November 2015 on Fighting Money Laundering and Terrorist Financing, which expands the sources of illicit funds, broadens the definition and scope of money laundering activities, increases the know-your-customer, monitoring, and reporting duties for banks and financial institutions, and imposes similar duties on legal professionals;
- Law No. 42 of 24 November 2015, which sets reporting obligations with respect to international transfers of funds;
- Law No. 43 of 24 November 2015 on the obligation for banks and financial institutions to exchange tax information, which was enacted in the context of compliance with FATCA regulations;
- other specific laws pertaining to the banking industry, such as Law No. 520 of 6 June 1996 on Developing the Financial Market and the Fiduciary Contracts Regulations, and Law No. 308 of 3 April 2001 on Banks' Shares;
- regulations (in the form of circulars) issued primarily by the BDL, but also by the BCC and the Ministry of Finance;
- international banking rules and standards, namely those resulting from the Basel Committee on Banking Supervision and the Financial Action Task Force (regarding AML) to the extent that such rules are adopted by the BDL and mirrored in the circulars issued by the latter; and
- Basic Circular No. 144 of 28 November 2017 imposed on Lebanese banks and financial institutions to set general policies and adopt technical measures and procedures relating to cybercrime prevention, such as:
  - to allocate the necessary funds and budget in order to set and implement cybersecurity policy, systems, and rules, to prepare insurance contracts that cover cybercrime risks; and
  - to adopt a minimum two-factor authentication technique, particularly to check the right of outside users to access the system of the bank or financial institution and to use an end-to-end, high-grade encryption for crucial data, to avoid loss and tampering of such data.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The BDL is the watchdog of the banking sector and is the entity principally responsible for overseeing banks in Lebanon. Its mission encompasses ensuring the solvency of banks, protecting the stability of the economy and the Lebanese currency, developing the monetary and financial markets, and structuring and organising means of payment.

The BDL's core prerogatives are vested in its governor and central council (which includes the governor, his four deputy-governors, and the general directors of the Ministries of Finance and the Economy).

The Central Council is in charge of defining the monetary and credit policy of the BDL, setting the regulations implementing the provisions of the CMC, determining the discount and interest rates of bank deposits with the BDL and issuing supervisory and regulatory measures applicable to banks' activities. The Central Council is also in charge of issuing banking licences.

The BCC was established by Law No. 28/67 of 16 January 1967 (Law 28/67) as an independent regulatory body not subject to the BDL's supervisory authority. The BCC monitors the regulatory compliance of banks, and may request information from the banks or from the BDL accordingly.

The AML Law established the SIC, which operates under the umbrella of the BDL and is presided over by the governor. The SIC's main mission is to investigate and combat suspicious matters and acts involving money laundering. The SIC may impose sanctions, including imprisonment and hefty fines, on the indicted persons or entities.

Law 28/67 also instituted the higher banking instance (the HBI). The HBI is a judicial body within the BDL hierarchy. It is in charge of delivering administrative sanctions against the banks that do not comply with the applicable laws and regulations, ranging from simple warnings to removal from the BDL's official list of authorised banks.

In addition to the above-mentioned regulatory authorities, the Association of Lebanese Banks (ALB) is a professional association formed of representatives of the banks licensed by the BDL. It is in charge of efficiently coordinating the activities of banks in areas of common interests, optimising the quality of banking activity and, above all, protecting and defending the banks and their interests. The ALB makes decisions relating to the structuring of banking operations and transactions related to the banking business on a microeconomic level. The ALB also supervises the relationship between its members and settles disputes through an arbitral body composed of experts appointed by its board. The ALB may also initiate lawsuits in order to defend the interest of the profession or intervene in ongoing litigations for the same purpose.

Law No. 161, dated 17 August 2011, established a Capital Markets Authority (CMA) to ensure the protection of savings invested in financial instruments, encourage the capital markets in Lebanon, and coordinate between the various concerned sectors. Its functions namely include setting the framework and organising professional activities of the persons who perform operations on financial instruments, while monitoring their compliance with professional ethics, and supervising licensed stock exchanges and the persons who provide deposit, clearing or settlement services. In addition to setting the general regulatory framework for listing financial instruments and approving their trading on stock markets, the CMA is empowered with a sanctioning power with regard to violations of the provisions of the law on capital markets.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The BDL is a public entity that has administrative and financial independence. Its initial capital was allocated by the Lebanese state. The capital can be increased through allocations by the state or by adding reserves to the capital by virtue of a decree of the council of ministers taken upon the request of the BDL and proposal by the Minister of Finance.

The national institute for the guarantee of deposits (NIGD), established by virtue of Law 28/67, acts as the insurer of deposits. Its capital is composed of nominal shares owned by the Lebanese state and all Lebanese banks. All banks are required to contribute to the NIGD by paying an annual fee and the state contributes an annual fee equivalent to the sum of the fees paid by the banks. The NIGD indemnifies depositors for up to 5 million Lebanese pounds per depositor. The NIGD is managed by a board of seven members designated by decree.

The Lebanese state owns 20 per cent of the shareholding of the Housing Bank, which was established by virtue of Law No. 14 of 17 January 1977, as amended, by Law No. 283 of 30 December 1993. The private sector owns the remaining 80 per cent of the bank's shareholding. The main purpose of the Housing Bank is to grant loans to Lebanese citizens wanting to purchase, construct, renovate, complete, or revamp real estate property in Lebanon.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

There is no unified legal definition of an 'affiliate' in the Lebanese banking laws and regulations. The meaning of 'affiliate' is addressed differently in various circulars depending on the purpose of the circular in question.

For example, BDL Circular 34 of 24 April 1997 distinguishes between three types of control exercised by banks over their affiliates and provides for a different accounting treatment for each type, as follows:

- exclusive control: effective control by the parent company of the financial and operational policy of the affiliate (when the parent company directly or indirectly holds the majority of the voting rights in the affiliate and is entitled to appoint or revoke the majority of the affiliate's board members);
- joint control: joint control of the affiliate by the parent company and other partners by virtue of a joint venture agreement related to the management of the company, without any partner having any majority stake in the affiliate; and
- participation interest: the parent company directly or indirectly holds at least 20 per cent of the voting rights in the affiliate.

Moreover, BDL Circular 141 of 16 August 2007 governs the relationship between Lebanese banks and their affiliates abroad and provides for a set of reporting obligations applicable in relation to banks and financial institutions established abroad in which the parent company holds, directly or indirectly, at least 40 per cent of the voting rights or whose management is effectively controlled by the parent company regardless of the latter's equity stake.

There are no limitations applicable to transactions between a bank and its affiliates other than the usual conflict-of-interest limitations set out in the CMC and the Code of Commerce, namely that granting loans to, or conducting other transactions with, board members, major shareholders or their family members is subject to the prior approval of the bank's general assembly and to the provision of sufficient collateral if applicable.

Legislative Decree 50/83 of 15 July 1983 established a summa division between commercial banks and specialised banks (investment banks). On 11 February 2004, Law No. 575 introduced Islamic banks in Lebanon as a new category.

Article 121 of the CMC defines a bank as 'an institution whose main purpose is the usage of funds it receives from the public for its own account in lending operations'. This definition applies to commercial banks, often described as 'conventional banks'. Generally speaking, commercial banks are entitled to carry out the broadest set of activities related to commercial banking.

Legislative Decree No. 50/83 of 15 July 1983 establishes 'specialised banks', more commonly known as investment banks. The purpose of specialised banks is limited to using their resources in medium- and long-term loans, direct investment, participations, purchase and sale of financial instruments for their account or for the account of third parties and the issuance of guarantees for medium or long-term operations against adequate collateral. Specialised banks are in principle prohibited from receiving deposits from the public for a term shorter than six months. Investment banks may also manage collective investment funds and carry out fiduciary activities in accordance with applicable laws.

Intermediate Circular No. 437 of 8 November 2016 stipulates that all bank accounts opened with commercial and investment banks and relating to the following should be subject to the supervision of the CMA:

- issuance, purchase, sale or promotion of financial instruments directly offered for public subscription or purchased or sold to public accounts; and
- trades in financial instruments and financial rights listed or traded in regulated financial markets and licensed by the CMA.

In addition, the circular provided that only financial intermediary institutions and specialised banks (ie, investment banks) have the right to carry-out operations on financial instruments and products.

Law No. 575 institutes Islamic banks, which are defined as 'banks whose articles of association comprise an undertaking not to contravene, in the operations they carry out, the provisions of Islamic law (shariah), particularly with the prohibition to pay or receive interest'. It is worth noting that shariah law prohibits fixed or floating payment or acceptance of specific interest or fees (known as *riba*, or usury) for loans. Unless otherwise specified in Law No. 575, Islamic banks are governed by all legal and regulatory provisions in force in Lebanon, particularly those related to banks, including without limitation, the CMC, the Code of Commerce and the Banking Secrecy Law. Islamic banks are specialised in shariah-compliant operations such as *mudarabah*, *musharakah*, *ijara* and so on, which are tailor-made financial operations structured to be shariah-compliant. A shariah board often issues a scholarly opinion to evidence compliance of a particular instrument or product with shariah precepts.

6 What are the principal regulatory challenges facing the banking industry?

The principal regulatory challenges facing the banking industry are twofold:

- regulating an increasingly complex banking industry, taking into account growing supranational regulations focused on AML or otherwise (Basel, FATCA, etc), while preserving the specificities of the Lebanese banking sector (including, without limitation, banking secrecy, which is a principle inherent to the country's history); and
- safeguarding the immunity of the Lebanese banking system from the risks of overspill from the conflict in neighbouring Syria and domestic security challenges.

7 Are banks subject to consumer protection rules?

Consumer Protection Law No. 659, dated 4 February 2005, includes banks within its scope of application. However, the provisions of the Consumer Protection Law on the treatment of contracts concluded between banks and consumers are enforced without any prejudice to the provisions of the specific laws and regulations applicable to the banking sector, especially circulars issued by the BDL.

It is in that sense that the BDL remains the most important safeguard for consumer rights in the banking sector. Over the past few years, the BDL issued several consumer-oriented circulars, the latest of which is Circular 134, dated 12 February 2015, which sets communication guidelines for products and services offered by banks and financial institutions to their clients and imposes information obligations to raise the awareness of clients and clarify their rights regarding the products and services in which they are interested.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

In light of the severe volatility in global financial markets, the policies and guidelines that have secured the resilience of the Lebanese banking sector to the global financial turmoil of 2008 are likely to be pursued by the BDL, in order to ensure the limitation of systemic risk, the increase of the Lebanese banking system's competitiveness, and the progressive implementation of international banking standards.

The existing framework is being continuously strengthened to give supervising authorities new powers to monitor banks and impose extensive reporting duties; namely in an effort to comply with international AML standards while preserving the principle of banking secrecy, so that the required actions, decisions and sanctions are taken in a timely fashion and that banks abide by their regulatory obligations.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Pursuant to Law 28/67, the BCC plays a major role in overseeing banks in Lebanon and assists the BDL in its mission of overseeing the banking sector. The BCC is vested with the authority to conduct investigations ex officio and to require any information directly from the banks or from the BDL.

The BDL and the BCC are vested with the necessary authority to:

- control the monetary and financial policies of the banks;
- control the compliance of the banks with the applicable rules and regulations;
- require any information, including but not limited to the financial statements of banks; and
- carry out off-site and on-site monitoring.

The BCC is entrusted with the task of monitoring banks on a recurring basis and has extensive powers when performing its tasks. Such powers may even go beyond the monitoring powers granted to the BDL under the CMC and which include, without limitation, reviewing documentation, requesting information and clarifications, the performance of an audit, etc.

In practice, the BCC's controllers carry out off-site and on-site monitoring and communicate to the banks any corrective actions that should be implemented. The BCC often solicits the governor's opinion and intervention as may be required.

10 How do the regulatory authorities enforce banking laws and regulations?

The BDL uses the broad powers granted to it by the CMC to ensure compliance by the banks with banking laws and regulations.

The BDL issues instructions, notes and circulars destined to clarify the requirements imposed on banks. Following off-site monitoring and on-site inspections, the BDL regularly sends follow-up letters to banks, outlining the main flaws and discrepancies and the corrective actions that should be taken. The BDL may opt for any of the following actions:

- sending a cautionary notice to the bank's management requiring an explanation for the failure to observe an applicable regulation;
- providing the bank with a recommendation as to the necessary measures that must be taken to ensure compliance with the applicable rules and regulations; and
- issuing an order to the bank requiring that certain measures be taken within a designated time frame.

The BDL is entitled to impose a wide range of sanctions on banks. These sanctions range from a simple warning or a prohibition to engage in certain operations or activities, to the removal of the infringing bank from the list of authorised banks and its subsequent liquidation.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The most common enforcement issues relate to transparency in business dealings, suitability and efficiency of information systems and compliance of the banks with the BDL's circulars, especially those related to the limitation of systemic risk, AML or CFT procedures and corporate governance practices.

The BDL and the BCC ensure that adequate measures are taken in a timely manner to sanction violations and to ensure compliance with the regulatory framework and best practices.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Law No. 2/67 of 16 January 1967, Law No. 1,663 of 17 January 1979 and Law No. 110 of 7 November 1991 address different aspects of the regime applicable to insolvent banks.

Pursuant to the CMC and the laws referred to above, a bank may be seized and thereafter liquidated if it ceases to pay its debts as they fall due.

The introduction of these measures was triggered by the financial difficulties faced by Bank Intra in the 1960s. Since then, the effective application of Law 2/67 to a bank facing difficulties has occurred only once (Al Madina Bank in 2004). This is partly because of the stringent preventive control exercised by the BDL and its tendency to encourage alternative solutions, such as merger with, or absorption by, another bank in case a bank suffers difficulties, with the ultimate aim of preserving the reputation of the Lebanese banking sector.

Law No. 110 of 7 November 1991 entitled 'Reform of the banking sector' instituted a special banking court whose competence extends to all cases of bank insolvency. In the event a bank is officially declared insolvent, it is deemed 'seized' and all its assets and rights are automatically transferred to the NIGD.

The bank's employees enjoy the first privilege on the bank's assets and take precedence over, respectively, the creditors and the shareholders.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

Before the bank is seized, the court appoints a management committee (see question 19), which is vested with the powers of the board of directors and, if need be, those of the general assembly.

After the bank is seized, the NIGD will be in charge of establishing the liquidation's final inventory. At the end of this process, the NIGD will transfer the ownership of any remaining assets to the BDL.

Basic Circular No. 141 of 18 September 2017 imposed on Lebanese banks the obligation to prepare a recovery plan to be approved by their respective board of directors in order to restore stability to their financial situation and to cope with any future difficulties in times of crisis. This plan must be written and adapted to the bank's size, its level of expansion abroad, and the degree of complexity of its activities and operations. The plan should also be updated annually. Furthermore, Lebanese banks and the branches of foreign banks operating in Lebanon should submit their recovery plan to the BCC for its review and assessment.

14 Are managers or directors personally liable in the case of a bank failure?

The assets of the chairman or general manager, board members, auditors and all persons having signatory authority on behalf of the bank during the 18 months before the bank's failure shall, de jure, be put under precautionary seizure until their respective liability is determined by virtue of a final judicial order.

The managers and directors are hence personally and civilly liable. They are also prohibited from partaking in boards or in any other positions in banks in the future. Their criminal liability may also be invoked in the event they have committed fraudulent or collusive acts.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

The Recovery Plan referred to above must contain the following key elements:

- the Recovery Plan internal governance, which includes:
  - the parties responsible for preparing, managing, and implementing the Recovery Plan, and those responsible for monitoring the indicators that necessitate the Recovery Plan's activation; and
  - the mechanism of communication between the Recovery Plan's various stakeholders; and
- the Recovery Plan indicators, which signal any deviation from the bank's business plan, and which may include indicators of quantitative and qualitative nature, provided the following minimal conditions are met:
  - to take into account the bank's various financial soundness indicators, including liquidity indicators, capital indicators, asset quality indicators, and profitability indicators, in addition to market-based indicators and macroeconomic indicators;
  - to determine the set of early warning indicators that the bank will adopt to identify emerging risks;
  - to use progressive metrics in relation to the Recovery Plan indicators, until they reach a threshold that triggers the mandatory activation of the Plan; and
  - to consider forward-looking prospects when determining the calibration of the Recovery Plan indicators; and
- the stress tests adopted to determine the recovery options, and which should contain:
  - systemic scenarios, scenarios specific to each bank (idiosyncratic), and both together; and
  - stringent assumptions that prompt the activation of the Recovery Plan.

Moreover, the Recovery Plan shall be prepared and applied at two different levels:

- the Lebanese bank; and
- each main subsidiary of the Lebanese bank abroad, including its branches overseas.

Also, Lebanese banks must promptly provide the BCC with their adopted Recovery Plan, and any amendment to it. In this respect, Circular 294 of 28/12/2017 issued by the BCCL details the required sections that should be included in the Recovery Plan, as follows:

- business plan;
- governance;
- Recovery Plan indicators;
- stress tests; and
- recovery options and impact assessment.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Given the importance of maintaining a highly solvent and well-capitalised banking sector, the BDL has adopted several regulatory measures to ensure that banks preserve a sound capital adequacy level.

BDL Circular 6,939 of 25 March 1998 defines the total capital ratio as the aggregate of Tier 1 capital (composed of common equity Tier 1 and additional Tier 1 capital) and Tier 2 capital.

On 30 September 2016, the BDL amended Circular 6,939 by issuing Intermediate Circular 436 pertaining to the increase of the minimum capital adequacy ratios for banks in Lebanon to 15 per cent, from the previous 12 per cent, and capital conservation buffers from 2.5 per cent to 4.5 per cent so as to comply with the new capital requirements under Basel III and the new IFRS9 accounting standard, which will come into effect in 2018. The increase in minimum capital adequacy ratios will be gradual, as banks have to meet a minimum capital adequacy ratio of 14 per cent by the end of 2016, 14.5 per cent by the end of 2017, and 15 per cent by the end of 2018.

In detail, Intermediate Circular 436 requires banks to comply with a minimum common equity Tier 1 ratio of 8.5 per cent at the end of 2016, 9 per cent at the end of 2017 and 10 per cent at the end of 2018, compared with a ratio of 8 per cent prior to these amendments. The Circular also requires banks to comply with a minimum Tier 1 ratio of 11 per cent at the end of 2016, 12 per cent at the end of 2017 and 13 per cent at the end of 2018, compared with a ratio of 10 per cent prior to these amendments.

17 How are the capital adequacy guidelines enforced?

Pursuant to the BDL Circular 43 of 25 March 1998, banks operating in Lebanon are required at the end of June and December to report their solvency ratios to the BCC and to the Statistic and Economic Research Department at the BDL.

BDL Circular 104 of 1 April 2006, the purpose of which is the implementation of the Basel II Capital Adequacy Accord, provides that all banks operating in Lebanon must, inter alia:

- implement the Basel II Accord in a diligent and progressive manner, in order to compute the solvency ratio on an individual or consolidated basis, starting 1 January 2008;
- implement the standardised approach to compute credit risks and the basic indicator approach to compute operational risks;
- compute market risks, as of 31 August 2007, and include in the solvency-ratio calculation capital requirements to cover market risks, as of 1 January 2008;
- obtain the approval of the BDL to switch from the implementation of both aforementioned approaches to more advanced approaches; and
- prepare an action plan for the implementation of the foregoing to be discussed with and approved by the BCC.

The BCC requires banks operating in Lebanon to initiate an internal capital adequacy assessment process in accordance with the second pillar of Basel II. Lebanese branches of foreign banks registered in countries that implement the Basel II Accord must submit to the BCC the annual reports issued by their foreign head office on capital adequacy, irrespective of the approach applied by the head office to the said branches in Lebanon.

BDL Circular 118 of 21 July 2008 provides that the BCC shall periodically ascertain the banks' capital adequacy and shall review and evaluate the qualitative and quantitative components of the capital adequacy assessment process, in accordance with the requirements specified in such Circular and the regulations and implementation rules issued, or to be issued by the BCC and the BDL.

The qualitative components include the review of and assessment of the banking governance system, the risk-management system and the internal audit and control systems, while the quantitative elements include the calculation of required capital level.

18 What happens in the event that a bank becomes undercapitalised?

Pursuant to BDL Circular 118 of 21 July 2008, the BCC may request the bank to increase its own funds, in case it detects weaknesses or

Update and trends

Basic Circular No. 135 of 26 October 2015, related to debt restructuring, as amended by Intermediate Circular No. 479 of 21 December 2017, states that in case of a restructuring of a client's debt, the bank has the right in order to settle or reduce the restructured debt, to acquire real estate, participations and shares acquired by the client and to constitute a 'real estate reserve for liquidation' or 'reserve for shares and participations for liquidation', which will be provisioned by the bank for 20 years at an annual rate of 20/1 of the debt's value. Said rate will be against the non-liquidated real state's properties, participations and shares acquired by the bank as a recovery of the restructured debt.

The Circular sets a systematic, accurate and clear restructuring mechanism aimed at preserving viable businesses that are financially distressed. In parallel, it aims to increase the creditors' recovery rate through direct negotiations between the debtor's creditors and the debtor in order to reach a voluntary, consensual agreement without resorting to court to readjust the outstanding debt obligations of the debtor, through the operational restructuring of business or financial restructuring of liabilities.

Moreover, Circular 284 of 15/02/2016 issued by the BCC details the restructuring process by determining its scope, its launching mechanism, and all required steps to follow throughout the restructuring process.

deficiencies in the qualitative or quantitative components. However, such increase does not relieve the bank from the obligation to address these weaknesses.

Pursuant to article 134 of the CMC, Lebanese banks must ensure that their assets exceed their total liabilities by at least the value of their capital. If a bank suffers a loss, it must recapitalise within a period of one year. This time frame may be extended by the BDL for additional periods not exceeding one year on aggregate, provided the bank offers sufficient guarantees as to its ability to reconstitute its capital.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

Law 2/67 provides for specific provisions applicable to defaulting banks operating in Lebanon.

In the case a bank ceases to pay its debts as they fall due, the governor shall promptly request the competent court to start applying the provisions of Law 2/67 and inform the Minister of Justice and the Minister of Finance of the insolvency. Defaulting banks as well as their creditors may also request the application of the provisions of Law 2/67 by the court.

Within 48 hours of the date of the request, the court must temporarily appoint a director having banking and financial expertise to manage the ordinary operations of the bank, and whose role ends upon the appointment of a managing committee, composed of six to 10 members and a president (the management committee).

Following deliberation and after consulting with the governor and hearing the defaulting bank's representative, the court delivers its decision confirming the payment cessation. As a result of such decision, the board members of the defaulting banks are dismissed. The same applies to the local management of defaulting foreign banks operating in Lebanon.

As long as the bank is not seized, the management committee represents the creditors of the defaulting bank and takes the necessary measure to safeguard the interests of the right holders.

The role of the management committee encompasses the management of the bank's branches in Lebanon and abroad. Within six months, if the management committee deems that the bank is able to continue its activities, it notifies the competent court, which delivers a decision to convene the general assembly of the shareholders to elect a new board of directors thus ending the role of the management committee. If on the contrary, it appears that the bank is unable to resume its activities, the court may decide, upon the request of the management committee, to liquidate the bank.

Law 1,663 of 17 January 1979 considerably enhanced the prerogatives vested in the NIGD after a bank is seized. Such prerogatives comprise the automatic transfer of the banks' seized assets and rights to the NIGD.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

As indicated in question 16, the BDL is aiming at strengthening the banks' capital funds in order to attain a capital adequacy ratio of 15 per cent by 2018. The BDL is attempting to increase this ratio as a prudential measure to exercise better control and protect the banking sector through positive signals to the international community.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

The set of documents to be presented to the BDL as part of the application for a new bank licence comprise signed declarations by the founders which include their curriculum vitaes (degrees, experience and other relevant information), as well as an overview of their financial standing.

Law 308 of 3 April 2001 grants the Central Council the authority to ascertain the financial and moral aptitude of the bank's founders, as well as the subscribers to the bank's shares and is entitled to object to any transfer of a Lebanese bank's shares that may cause, directly or indirectly, the loss of effective control by any shareholder or economic group over the management of the bank or the voting rights. The Central Council enjoys broad discretionary powers in this regard, for the purpose of upholding the public interest.

There is no legal definition of 'control' per se. BDL Circular 47 of 4 June 1998 provides for specific obligations on 'holding companies', defined as companies that own more than 5 per cent of the shares of a bank. Pursuant to Law 308 of 3 April 2001, subscribing to and trading in the shares of Lebanese banks is subject to the prior authorisation of the Central Council (see question 26).

22 Are there any restrictions on foreign ownership of banks?

There are no restrictions on foreign ownership of banks in Lebanon. Law 308 of 3 April 2001 abolishes previous restrictions regarding the ceiling on the ownership of shares by foreign nationals. However, the Lebanese Code of Commerce requires the majority of the board of directors of joint-stock companies (which is the form under which all banks in Lebanon are incorporated) to be Lebanese nationals and said requirement should hence be reflected in the composition of a bank's board of directors. All the bank's shares must be in the nominative form.

23 What are the legal and regulatory implications for entities that control banks?

A direct implication for such entities is an increased exposure to the scrutiny of the regulatory authorities overseeing the banking sector and the obligation to abide by certain duties and responsibilities as detailed in question 24.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

BDL Circular 47 requires holding companies registered in Lebanon to comply with the following obligations:

- preparing non-consolidated detailed annual financial statements according to the forms issued by the BDL and organised in accordance with International Accounting Standards (IAS) that do not contradict the regulations in force in Lebanon;
- preparing annual consolidated financial statements of the companies within its group (including banks and financial and non-financial institutions related to it and registered in Lebanon or abroad), in accordance with the consolidation guidelines set by the BDL;
- using the templates for the balance sheet and the profit and loss accounts adopted by the BDL for the preparation of annual consolidated financial statements;
- organising its internal accounting in compliance with IAS regulations that do not contradict the regulations in force in Lebanon;
- establishing an internal control unit that operates in accordance with the regulations applicable to Lebanese banks;
- providing the BDL and the BCC on annual basis and within the timetables applicable to Lebanese banks, with the detailed personal and consolidated financial statements, yearly bulletin, auditors'

report, and the yearly minutes of meetings of the general assembly and the board of directors;
- using IAS 14 as a guideline for the disclosure of financial and non-financial information related to the group companies;
- publishing consolidated and non-consolidated financial statements on a yearly basis (in accordance with the rules applicable to Lebanese banks) and provide the BDL and the BCC with evidence of such publication;
- appointing the same auditors as for its related banks and financial institutions; and
- providing the BCC, before the end of July and December of each year with a detailed statement of all its shareholders, identifying their nationalities, share proportions and the class of shares they own (if existing), along with information regarding the companies participating in the holding companies and any amendment to such statement and a detailed statement of about the shares held by the holding companies in companies located in Lebanon and abroad.

All the shares of the holding companies registered in Lebanon must be in the nominative form.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

Laws 2/67 and 110/91 do not expressly refer to the controlling entities or individuals. However, it is common in Lebanon that board members are themselves owners of equity stakes in the capital of the bank (controlling or non-controlling), and therefore suffer the same consequences referred to above applicable to board members of an insolvent bank.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

There is no legal definition of 'control' per se.

Pursuant to Law 308 of 3 April 2001, subscribing to and trading in the shares of Lebanese banks is unrestricted in principle, subject to the prior authorisation of the Central Council:
- if the subscriber or the transferee acquires directly or indirectly more than 5 per cent of the shares or the voting rights of the bank, whichever is higher;
- if at the time of the transfer of shares, the transferor holds 5 per cent or more of the shares or the voting rights of the bank, whichever is higher; and
- if the transferor or the transferee is a board member of the bank, irrespective of the number of shares held or transferred.

Any legal action that aims at enabling an assignee to acquire shares of a Lebanese bank in violation of Law 308 of 3 April 2001, as amended, shall be null and void.

The governor has the authority to suspend the trading in such shares and the exercise of the voting rights related to it. His decision shall be notified to Midclear, the central custodian and clearing centre of the banks' shares, with a request to sell the said shares, by auction or through the organised financial market.

Specific requirements apply to the transfer of the shares of a bank listed on the financial market, namely, the prior authorisation of the BDL should be sought in case the purchaser or the seller is an employee who is part of the 'upper management' as such term shall be defined in the circulars issued by the BDL, or already has or acquires in aggregate more than 1 per cent of the bank's total shares.

The content of the BDL authorisation and the details of the contemplated operations should be immediately communicated to the body overseeing the financial market.

More generally, Law 308 provides that the Central Council may object to any transfer of shares of a Lebanese bank which may directly or indirectly lead to the loss by a shareholder or an economic group of 'effective control' (even if such loss of control is relative), with respect to the administration of the bank or the voting rights related it. Control is not defined in this particular context and its determination is left to the discretion of the Central Council on a case-by-case basis.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The regulatory authorities are generally receptive to foreign acquirers. The regulatory process for a foreign acquirer is not substantively different but may take longer in instances where the approval of the Central Council is required considering the assessment to be made by the latter of the prospective foreign acquirer. It remains that Law 308 did not comprise restrictive or specific provisions applicable to foreign acquirers.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

Law 308 provides that, in all cases where the approval of BDL is required, the Central Council shall ascertain the financial and moral aptitude of the founders, subscribers and transferees of a bank's shares.

The Central Council will take into account other informal criteria in order to ascertain that the relevant persons possess the necessary experience and track record in the banking industry, as well as sufficient financial capabilities to take part in the bank's activities.

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29 Describe the required filings for an acquisition of control of a bank.

An application should be filed before the Central Council describing in detail all elements of the acquisition operation for which the approval of the Central Council is sought. This application must comprise the contractual documents corresponding to the proposed share transfer. The Central Council may request clarifications, additional information or amendments.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The length of the process depends on the level of scrutiny required to give comfort to the Central Council and approval of applications by foreign acquirers are likely to take a longer time frame.

In practice, informal preliminary discussions are held with the BDL to evaluate the feasibility of the transaction prior to filing an application. The effective filing usually takes place after an informal favourable opinion is granted, which explains why rejected applications are rare and result mostly from adverse developments originating after the filing.

Monaco

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The Monegasque banking sector is governed by three main sources of policies.

According to an agreement in the form of an exchange of letters between France and Monaco dated 20 October 2010, Monegasque credit institutions are submitted to a limited number of French legislations and related general regulations (provided primarily in the French Monetary and Finance Code) (MFC). Consequently, Monegasque credit institutions shall be authorised by the French banking regulator before carrying out a banking activity within the jurisdiction of Monaco.

In addition, Monaco and the European Union have entered into a Monetary Agreement in 2011 whereby some EU policies and regulations are applicable to Monegasque banks when falling within the scope of application defined in article 11 of this Agreement (see question 2).

Furthermore, several local rules regulate the banking sector. Each Monegasque bank must comply with the Monegasque anti-money laundering (AML) regulation (Law No. 1.362 of 3 August 2009 (as amended)) and the Monegasque regulations relating to the performance of financial activities in Monaco (Law No. 1.338 of 7 September 2007 (as amended)). The proper performance of these regulations is respectively overseen by the Financial Circuits Information and Control Department (SICCFIN) (for the AML requirement) and the Monegasque Supervisory Committee for Financial Activities (CCAF) (for the financial activities). These two regulators produced each year an annual report describing the main regulatory policies and guidelines for the implementation of these regulations.

2 Summarise the primary statutes and regulations that govern the banking industry.

The primary statutes and regulations framework that govern the banking industry in Monaco is rather complex since they come from different sources:

- European Union rules: the Monaco and the European Union have concluded on 29 November 2011 a revised Monetary Agreement (the former one had been concluded in 2001). This agreement is composed of a core agreement and two appendixes (Appendix A and Appendix B). Under this agreement, Monaco must apply the measures taken by France to transpose the directives listed in Appendix A of the Monetary Agreement when relating to the activity, the control of credit institutions or the prevention of systemic risk in payment and settlement systems. The Monetary Agreement also established a list of directives and EU regulations in Appendix B for which Monaco is compelled to take equivalent effects measures (for instance, the Fourth EU Directive relating to anti money laundering of 20 May 2015);
- French legislation: the treaty between Monaco and France on exchange control dated 14 April 1945 established the principle of the application in Monaco of French banking regulations. Subsequent agreements in the form of exchange of letters have amended and defined the practical details of such application. The latest one was signed in 2010. In a nutshell, under these exchange of letters, the general French banking regulations are applicable to Monegasque banks when regarding the internal organisation of the bank. Therefore, French banking law is partially governing the Monegasque banks' activities;
- Monegasque legislation: the ordinance on the banking activity dated 4 August 1899 requires an authorisation of the Monegasque government for the performance of banking activity in Monaco. Local law also provides some rules governing the relation between a Monegasque bank and its clients (mainly governed by the Civil Code and Commercial Code provisions). Moreover, Monegasque laws govern any financial activities carried out by a Monegasque bank. These financial activities are listed in article 1 of Law No. 1.338 dated 7 September 2007 and encompass: discretionary asset management, portfolios management, management of local or foreign funds and assistance and advice in relation with the aforementioned activities. Finally, Monaco provides its own local AML regulation (Law No. 1.362 of 3 August 2009), which is substantially similar to EU AML requirements.

3 Which regulatory authorities are primarily responsible for overseeing banks?

Credit institutions in Monaco are licensed by the French Prudential Control and Resolution Authority (ACPR) for the banking services they render and by the CCAF regarding their financial activities including discretionary asset management, management of foreign and Monegasque funds, reception and transmission of orders, advice and assistance in these matters.

Monegasque banks are also supervised and controlled by two local entities: SICCFIN, for the compliance by the banks to their AML obligations and the Supervisory Commission on Personal Data for data protection obligations.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The Monegasque government has no duty to insure deposits and has no ownership in the banking sector.

Monegasque credit institutions are affiliated to the French Deposit Guarantee and Resolution Fund (FGDR) created by the French law dated 25 June 1999. The FGDR is a private-law legal entity that aims at indemnifying depositors and investors in the event of an unavailability of their deposits or other repayable funds. The FGDR's intervention is triggered when a bank is no longer able, immediately or in the near future, to return the funds it has received from the public. Besides, the FGDR might intervene as soon as it is expected that the repayable funds held by a bank may not be available when due.

The FGDR compensates depositors under the conditions set out by the regulations (eg, some depositors cannot benefit from this guarantee) and up to a maximum limit of €100,000 per depositor. Securities are also guaranteed under several conditions set out by the regulations and up to a maximum limit of €70,000 per investor.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Under Monegasque law, there are no specific limitations that apply to transaction between a bank and its affiliates other than the general corporate law rules applicable to Monegasque corporations.

According to the Comité de la Réglementation Regulation No. 96-21, dated 24 November 1986, banks are authorised to carry out ancillary activities to the banking activity. These ancillary activities are described in article 2 of this regulation and encompass, activities of representation, commissioning and brokerage for subsidiaries and any activities of real estate management or service providing (if linked to its banking activities). However, the performance of these activities shall not be in contradiction with its banking activities or harm the reputation of the bank. Furthermore, their incomes generated from these ancillary activities cannot exceed 10 per cent of the net banking income of the bank.

6 What are the principal regulatory challenges facing the banking industry?

The principal regulatory challenges facing the banking industry in Monaco are the implementation of recovery plans required by the article 613-35-IV to VII MFC, strengthening of cybersecurity and the adoption of a new anti-money laundering regulation. In that regard, a proposed bill to amend the existing AML requirements is currently under discussion in the Monegasque parliament. The coming amending AML regulation would be based on the Fourth EU Directive, dated 20 May 2015, on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing. Indeed, this Directive is listed in Appendix B of the Monetary Agreement and as such, the Monegasque government is constrained to adopt equivalent effect measures (see question 2). Monegasque banks will have to implement in the near future the new Monegasque AML regulation, which is due to enter into force during 2018.

7 Are banks subject to consumer protection rules?

There are no specific consumer protection rules provided by Monegasque body of laws other than the general rules provided by the Monegasque Civil Code.

Nevertheless, one should note that Monegasque case law imposes on credit institutions a stronger obligation of information and a duty of advice in the presence of an unadvised customer.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

Since 18 March 2015, Monaco and the European Union have entered into negotiation to implement an association agreement to further integrate Monaco into the European Union market. We consider that the conclusion of this agreement will have important consequences on the domestic legal framework.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Monegasque banks are supervised and controlled by the ACPR for their banking activities and by the CCAF for their financial activities.

The CCAF is empowered to supervise and control on an ongoing basis Monegasque banks carrying out financial activities. As such, the CCAF operates a permanent control based on the annual report communicated by the banks on their financial activities in Monaco (this report is communicated quarterly for banks monitoring Monegasque funds). These reports are examined by the CCAF and the latter can request written explanations or conduct deeper investigations. Besides, authorised Monegasque companies are subject to periodic control of the CCAF, which is likely to take place every three to five years. The CCAF is also vested with a general power to obtain the communication of any relevant documents, to summon any directors of the banks and to get access to any bank's premises to investigate.

The ACPR has responsibility for supervising the banks that it has authorised to conduct business in Monaco. Its mission includes the supervision of the financial situation, the operational arrangements of the banks and their solvency and liquidity. The powers of the ACPR relating to the supervision of the rules protecting the clients are not applicable to Monegasque banks. Monegasque banks are subject to onsite and offsite document inspections. To enable offsite document inspections, Monegasque banks are also compelled to transmit information and documents to the ACPR on a periodic basis. According to the exchange of letters dated 20 October 2010 the conclusions of these inspections are disclosed by the ACPR to the Monegasque authorities.

In addition, the SICCFIN supervises the proper performance of AML obligations by, among other entities, Monegasque banks. As such, the SICCFIN can carry out onsite and offsite controls. The purpose of these controls is to ensure the follow up and the proper implementation of AML requirements by Monegasque banks.

10 How do the regulatory authorities enforce banking laws and regulations?

The enforcement of French banking laws and regulations applicable to Monegasque banks under the exchange of letters dated 20 October 2010 is ensured by the powers of sanction of the ACPR. Indeed, the latter may impose an injunction in the event a Monegasque bank does not comply with its obligations to notice, to declare or to transmit information and documents (article 612-25 of the MFC). The ACPR can also resort to administrative police measures provided by article L 612-30 and following of the MFC. For instance, under article L 612-31 of the MFC, the ACPR may order any Monegasque banks to adopt measures to achieve compliance with its obligations. Ultimately, the ACPR may contemplate to initiate disciplinary proceedings on the basis of its general power of supervision or the report following an on-site document inspection. The list of sanctions that can be taken against a credit institution is set out in article L 612-39 of the MFC. However, under article 2 of the exchange of letters dated 20 October 2010, the ACPR has no power to execute such sanctions. The enforceability of ACPR's decisions is solely ensured by the Monegasque government.

The CCAF is also vested with a range of tools to ensure that the obligations relating to the performance of financial activities in Monaco are enforced. These sanctions are provided by Law No. 1.338. dated 7 September 2007, and can be:

- a reprimand or a warning;
- a temporary suspension of the approval; or
- a withdrawal of the approval.

Besides, in case of emergency, a temporary and motivated suspension of the approval for a maximum of three months can be decided by the Commission in case of non-compliance with one or several obligations set out by Law No. 1.338. The administrative sanctions decided by the Commission do not exclude possible additional criminal sanctions by the Monegasque criminal jurisdictions.

The SICCFIN contols the AML compliance of Monegasque banks. To enable the enforcement of the provisions of Law No. 1.362 on AML requirements, the SICCFIN regularly controls Monegasque banks' AML obligations. In case of a violation, the SICCFIN is entitled to deliver a warning or, if serious misconduct is detected, to refer to the Minister of State of Monaco. This referral can lead to several penalties decided by the Minister of State (eg, warning, financial penalties or withdrawal of its authorisation to carry a commercial activity in Monaco). Such violations can also result in criminal prosecution.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The most common issue for banks in Monaco remains the applicability or not of some EU directives and regulations. The legal architecture of banking laws in Monaco can convey Monegasque banks with uncertainty on the application and enforceability of some EU regulations and directives. While listing in Appendix A of the Monetary Agreement, it appears that some of the EU directive and regulation might not fall within the scope of application of this agreement. As a result, it can be sometimes difficult to consider the applicability of some EU bodies of law in Monaco.

Resolution

12 In what circumstances, may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

In accordance with the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD) of 15 May 2014, transposed into French law by the Ordinance of 20 August 2015 and the Decree of 17 September 2015, the ACPR has sole power to launch and supervise the resolution procedure against a credit institution based in Monaco. As EU Regulation (EU) No. 906/2014 is not binding under Monegasque law, the single resolution mechanism does not apply in Monaco.

Alongside the power of the ACPR to require any entity subject to its supervision to submit to its approval a preventive recovery programme (see question 13), the ACPR must establish a preventive resolution plan for credit institutions subject to its supervision. In this regard, the ACPR was committed to drafting a preventive resolution plans for credit institutions under its supervision as a priority in 2017.

Once the ACPR has been seized (either by the Governor of the Banque de France or by the General Directorate of the Treasury or by the European Central Bank or by the directors of the defaulting bank), the Resolution Commission must determine whether the entity, taken individually or within its group, is defaulting and whether there is any perspective of this default being avoided within a reasonable time frame without implementing any resolution measures. If these conditions are fulfilled the Resolution Committee is entitled to take resolution measures that can affect the administration of the bank, the activity and the capital structure of the bank (bridge institution, sale of assets, split of activities, etc) and the shareholders and creditors' interests (bail-in measures).

When implementing resolution measures, the ACPR shall observe the following guidelines:

- ensure the business operation's flow;
- avoid any negative impacts on financial stability and;
- above all, safeguard state resources and clients' assets.

The resolution measures must be taken in a way that first affect the shareholders' rights and then the creditors' rights in accordance with the order of priority of their receivables. The core objective of the implementation of resolution measures is to protect customers' deposits and, if need be, the FGDR would intervene to indemnify the depositors in the conditions set out in question 4. To date, the implementation of resolution measures has never been adopted for a Monegasque bank.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

The bank's management and directors have the obligation to draft a preventive recovery plan, ie, a living will, covering a large range of measures enabling the bank to face any significant deterioration of its financial situation. The content of the preventive recovery plan is detailed in the regulation dated 11 September 2015. This plan must be updated every year.

As soon as a quick degradation of the financial situation of the bank comes up, some early intervention measures may be taken, among which is the removal of the management and directors. Once a proven or predictable failure has materialised, the management is required to refer to the ACPR that may decide to adopt resolution measures.

By principle, the implementation of resolution measures leads up to the replacement of the management and directors. However, their retention can be decided by the ACPR if it is necessary to achieve the resolution of the failed bank.

14 Are managers or directors personally liable in the case of a bank failure?

Resolution measures shall be implemented, in spite of the ordinary legal rules, as regard civil, commercial and criminal liability of natural and legal persons.

Moreover, managers or directors of failing banks can be liable under the general Monegasque bankruptcy law, especially in case of:

- a shortfall of assets (unless due activity and diligence is proved by the managers;
- mismanagement; or
- abusive continuation of operation at deficit, which could lead to the default.

In addition, managers and directors of failing banks are subject to ACPR's disciplinary power. As such, and in accordance with article L 612-39 etc, severe penalties can be taken against managers and directors of bank.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

Monegasque credit institutions are required to adopt a preventive recovery plan to face any significant deterioration of their financial situation (see question 13). The ACPR reiterated its expectations regarding this recovery plan in 2017. A large panel of preventive measures has to be taken with a necessary coordination and consistency with the measures taken at the group level. The preventive recovery plan shall also provide for specific procedures enabling a swift implementation of the plan. In addition, several crisis scenarios shall be contemplated in the plan.

The ACPR has raised the preparation of the preventive recovery plan as a priority for Monegasque credit institutions for 2017.

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Concerning initial capital requirements French banking regulations apply to credit institutions based in Monaco. Therefore, the latter must have an initial paid-up capital or an endowment of at least €5 million in accordance with article 1 of CRBF Regulation N. 92-14, dated 23 December 1992.

Furthermore, under the revised Monetary Agreement between the European Union and Monaco, the Capital Requirements Regulation (Regulation (EU) No. 575/2013) (CRR) and CRD IV (Directive 2013/36/EU), except provisions related to freedom of establishment and freedom to provide services, are applicable in Monaco, through French transposition acts.

Therefore, credit institutions are required to comply with management standards to ensure their liquidity and solvency in respect of depositors and, more broadly, third parties, and the balance of their financial structure. To this end, credit institutions must comply with prudential ratios to guarantee their liquidity and solvency, in accordance with article L511-41 of the MFC, which transposes CRD IV. The main requirement is that credit institution need to be permanently solvent. To that extent, a solvency ratio must be observed, which consists of a minimal level of equity capital requirement to cover the total risk exposure faced by credit institutions. Under article L 511-41-1-A of the MFV, credit institutions must always maintain a total capital ratio of 8 per cent, a common equity Tier 1 capital ratio of 4.5 per cent and a Tier 1 capital ratio of 6 per cent. Besides, as contingent capital arrangement, article L 511-41-A of the MFC require credit institutions to be able to justify of a capital conservation buffer of Common Equity Tier 1 capital equal to 2.5 per cent of their total risk exposure calculated in accordance with article 92(3) of the CRR. In addition, depending on the type of credit institutions, four additional capital buffers can be requested:

- the countercyclical buffer;
- the systemic risk buffer;
- the global systemic institutions buffer; and
- the other systemic institutions buffer.

Capital requirements

17 How are the capital adequacy guidelines enforced?

According to article L 511-41-1 B of the MFC, every bank must implement strategies and processes subject to a constant evaluation of the internal control in order to identify, quantify and monitor the risk connected to its banking activities.

Credit institutions based in Monaco are also submitted to ACPR's supervision and control.

As a consequence, the ACPR receives monthly, quarterly and bi-annually accounting and prudential reports, allowing for the periodic assessment of compliance with capital adequacy guidelines. Every bank must ensure at all times that its assets exceed the minimum share capital amount. To ensure such compliance, credit institutions are annually subject to stress tests to examine their capital adequacy's strength.

Specifically, for capital adequacy requirements, the ACPR is vested with several powers aiming at adopting preventive measures to restore the compliance with capital requirements (articles L 511-41-3, L 511-41-4 and L 541-41-5 of the MFC). Furthermore, a wide range of administrative remedies or sanctions are granted to the ACPR to ensure that the capital adequacy guidelines are fully observed and that Monegasque banks implement an effective internal control system. Sanctions range from simple warnings to the withdrawal of the banking licence (article L 612-39 of the MFC).

The Monegasque law regulating financial activities also provides capital adequacy requirements. However, these capital requirements are not applicable to Monegasque banks (as they are subject to stronger capital requirements adequacy under ACPR's supervision).

18 What happens in the event that a bank becomes undercapitalised?

Monegasque banks that become undercapitalised ought to be treated similarly to French banks.

Therefore, in accordance with article L 511-41-3 of the MFC, the ACPR may require the necessary measures to re-establish its liquidity or its financial situation. These measures can also aim at improving its management methodology and insuring the adequacy of its organisation to the activities performed.

If the measures taken by the bank are considered not sufficient to restore the liquidity or the financial situation, the ACPR is entitled to use its administrative police powers provided by article L 612-30 et seq of the MFC to ensure that the bank overcomes a lack of capitalisation.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

If a bank is defaulting, pursuant to article L 613-48 of the MFC, the resolution procedures should apply (see question 12). More broadly, general Monegasque bankruptcy law may apply. However, article L 613-24 et seq of the MFC provide for specific rules to coordinate any resolution procedure with the ordinary rules applicable to insolvency proceedings:

- a slightly different definition of 'insolvency' for credit institutions to enable the implementation of resolution measures before any opening of standard insolvency proceedings;
- the ACPR may appoint a liquidator that can transfer all powers of administration, management and representation of the corporation; and
- some insolvency proceedings cannot be opened against a credit institution without prior notice and approval of the ACPR.

Moreover, on the basis of the revised Monetary Agreement between the European Union and Monaco, Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding-up of credit institutions is applicable under Monegasque law through French transposition acts. The regulation provides, inter alia, for a single bankruptcy proceeding when a bank with branches in several EU member states becomes insolvent.

Finally, the FGDR Funds may intervene upon ACPR's request in order to compensate depositors subject to the questions set forth in question 4.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

It is not expected that capital adequacy guidelines will change in the near future. However, negotiations are currently in progress at EU level to build up a new generation of CRD and regulation. Indeed, on 23 November 2016, the European Commission published a set of legislative proposals, including amendments of the existing CRD and the CRR.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

There is no specific definition of 'control' under Monegasque law. Also, there is no formal restriction regarding the types of entities and individuals that can control bank. The only limit remains on ACPR's veto power for the acquisition and control of a bank. Indeed, in accordance with article L 511-12-1 MFC, any project to acquire at least 10 per cent of a Monegasque bank shall be first notice to the ACPR. The ACPR will then evaluate among other criteria the conditions of the operations and the respectability of the acquirer (article R 511-3-2 of the MFC). If it appears that the intended acquisition would not comply with the conditions set out in the aforementioned articles, the ACPR might decide not to authorise this acquisition. Besides, from a Monegasque perspective, under article 8 of Law No. 1.338, dated 7 September 2007, the modification of the share capital would also require notifying the CCAF that is entitled to request the bank to submit for a new authorisation application.

22 Are there any restrictions on foreign ownership of banks?

There are no formal restrictions concerning foreign ownership of banks. However, it should be noted that any acquisition of banks shall be de facto authorised by the ACPR (see question 20).

23 What are the legal and regulatory implications for entities that control banks?

There are no specific implications for entities that control banks. The only indirect obstacle for the controlling entity is the formalism applicable to the sale of its shares. Indeed, the selling process would require a prior notice of the ACPR that can veto such selling if the conditions set out in article R 511-3-2 of the MFC are not reached. Consequently, the liquidity of the shares would be affected. Moreover, as part as the process of the supervisions of a bank, controlling entities might have to disclose information concerning their activity and governance.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

Under Monaco laws, the main responsibilities of an entity or an individual remains on the event of default and the implementation of resolution measures. In such a case, the shareholders might be solicited by the ACPR to financially support the defaulting bank as set out in article L 511-42 of the MFC.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

It should be noted that some resolution measures can affect the rights of the shareholders on the insolvent credit institutions (right of disposal of shares, designation of a mandatory in charge of the management of the bank, forced sale of shares, etc) (see question 23).

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

Under Monegasque law, there is no definition of 'control'. In our opinion, this concept shall be understood as any person who held more than 50 per cent of the bank's share capital. The acquisition of a Monegasque bank would require several types of approvals. First, the modification of the share capital would require notifying the CCAF, which could ask for a new application to be authorised to carry out financial activities in Monaco. Besides, in accordance with article L 511-12-1 of the MFC, any intention to acquire more than 10 per cent of the equity capital of a Monegasque bank, the ACPR shall be given prior notice. In this regard, the ACPR benefits from the right to veto, under certain circumstances, the acquisition's project (see question 20).

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

Regulatory authorities in Monaco are quite receptive to foreign acquirers. The acquisitions process for a foreign investor is similar to the one applicable to national investors.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The ACPR is cautious with the following criteria in case of an acquisition of the control of a bank (credit institution):
- the reputation of the proposed acquirer;
- the reputation and the experience and skills of any person who, as a result of the proposed acquisition, perform the effective direction of the credit institution's activities;
- the reputation and the experience and skills of key functions such as internal control or compliance of the credit institution;
- the financial soundness of the proposed acquirer;
- the ability of the proposed acquirer to comply with the prudential requirements (eg, if the credit institution's group has a structure that enables an effective supervision and the exchange of information between the competent authorities); and
- the existence or not of reasonable grounds to suspect the existence of money laundering or terrorist financing in connection with the proposed acquisition.

The CCAF will also be mindful of the acquirer's background, its reputation, skills and experience of financial activities. However, it should be noted that, for a bank, it is likely that the CCAF will follow the ACPR's position.

29 Describe the required filings for an acquisition of control of a bank.

For an acquisition of control of a bank, the proposed acquirer must receive authorisation from the ACPR. The acquirer must fill an application available on the ACPR's website (www.acpr.banque-france.fr). This application includes, inter alia, information regarding the target, the acquirer, the shareholders agreement, the ability to comply with the prudential requirements, etc.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The regulatory approvals from the ACPR and CCAF alike take at least six months from the date of application submission. Foreign acquirers should anticipate a similar time frame.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The banking sector in Norway is regulated by the Financial Supervisory Authority of Norway (FSAN), the Central Bank of Norway and the Ministry of Finance. FSAN is the regulatory authority with responsibility for both prudential supervision of the institutions and market conduct supervision. The Financial Stability Department (FSD) within The Central Bank of Norway has the chief responsibility for the macro prudential oversight. Legislatively, the regulatory framework is within the responsibility of the Norwegian Ministry of Finance.

The FSAN is an independent governmental agency established under the Financial Supervisory Authority Act of 1956. Its primary objective is to promote financial stability and well-functioning financial markets. Its intermediate objectives are to promote financially sound and liquid financial institutions and robust infrastructure ensuring satisfactory payments, trade and settlement, enhance investor protection and consumer protection through good information and advice, and facilitate efficient crisis management. FSAN also supervises insurance and pension funds, securities firms and markets, debt collection, accounting and revision activities, and real estate brokerage. The FSAN also contributes in the development of the regulatory framework.

The FSD is part of the Central Bank of Norway, which is governed by the Central Bank Act of 1985. The FSD's objective is to promote a robust financial system by monitoring financial stability and advising on measures to prevent systemic risk. The department also contributes to the development of the regulatory framework and acts as the licensing authority for interbank systems and monitoring payment systems.

Norway is not part of the European Union. EU legislative acts will therefore not apply to Norway directly. However, Norway is a part of the European internal market through the European Economic Area (EEA) agreement together with the two other European Free Trade Association states: Iceland and Liechtenstein. The EEA agreement commits Norway to implement all EU acts considered EEA relevant.

The FSAN has a permanent observer role to the European Supervisory Authorities (the European Banking Authority) (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)). Norway also participates as an observer to the European Systemic Risk Board (ESRB) on an ad hoc basis and is part of the Financial Stability Boards (FSB) regional consultative group for Europe.

2 Summarise the primary statutes and regulations that govern the banking industry.

The two primary statutes governing the banking sector in Norway are the Financial Enterprises Act of 2015 and the Financial Contracts Act of 1999. Other important banking sector statutes include the Financial Supervisory Authority Act of 1956, the Anti-Money Laundering and Counter Terrorist Financing Act of 2009, the Central Bank Act of 1985 and the Securities Trading Act of 2007. The statutes are all complemented by regulations.

The Financial Enterprises Act consolidates the previous Savings Bank Act, the Commercial Bank Act, the Financial Services Act and Guarantee Schemes Act (plus large parts of the Insurance Services Act) and applies to all financial enterprises as defined in the statute.

The new Financial Enterprises Act has introduced a number of amendments and consists of more than 280 sections (which is a lot by Norwegian legislative standards) and comprehensive secondary law regulations. That said, the Act does not imply larger material changes of the former legislation.

The substantial changes compared with the former legislation relate to, inter alia, new capital requirements for insurance companies incorporating:

- Basel III and CRD IV;
- new regulations on cooperation agreements out of group relations;
- regulations on holding companies as parent companies in financial groups;
- exchange of customer information between group entities;
- removal of banks' obligation to have control committees and boards of representatives;
- abandoning of regulations on securitisation; and
- changes in banks' cash-handling requirements.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The FSAN is the regulator primarily responsible for overseeing banks.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The governmental Norwegian Banks' Guarantee Fund guarantees deposits of up to 2 million Norwegian kroner per, depositor per bank. The guaranteed amount is more than twice as much as the €100,000 deposit guarantee applicable in the EU, given current exchange rates.

All banks headquartered in Norway are required to maintain membership in the Banks' Guarantee Fund. Branches of non-Norwegian banks operating in Norway have the right, but are not required, to seek membership. The right to be admitted as a member is conditional and subject to approval by the FSAN. Currently admitted branches of non-Norwegian banks are the Norwegian branches of Danske Bank, Nordea, Swedbank, Nordnet Bank, Handelsbanken, Bluestep Bank, and Skandinaviska Enskilda Banken.

It is uncertain if Norway can uphold its higher level of guaranteed deposits compared to the EU in the future. The Deposit Guarantee Scheme's Directive (Directive 2014/49/EU) (DGSD) implements a fully harmonised level of €100,000 deposit guarantee across the EU, and the directive is considered EEA relevant. According to the DGSD, any member state with higher levels of deposit guarantees must adapt to the fully harmonised level by 31 December 2018. However, the directive has not yet been adopted in the EEA agreement, and the matter is subject to ongoing political negotiations. Statutes adopting the remaining parts of DGSD in Norway have been proposed to parliament by the Ministry of Finance on 21 June 2017 and are scheduled to be decided by parliament in March 2018.

The Norwegian state owns 34 per cent of the shares of DNB ASA, which controls DNB Bank ASA, Norway's largest bank. The objective of this ownership is to ensure that DNB stays headquartered in Norway, which is secured by the state's negative control. The government intends to maintain this interest but has, on the other hand, not expressed any intention to increase its ownership in the banking sector.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Transactions between a bank and its affiliates shall be carried out on an arm's-length basis. For this purpose, 'affiliates' means financial enterprises within the same group, a financial institution and a subsidiary or other affiliated enterprise with a capital interest in, or shared management with, the financial institution, and a financial institution and its parent company or other affiliated enterprise with a capital interest in or shared management with the financial institution. A financial group is obliged to ensure that revenues, costs, losses and profits are distributed as accurately as possible between the enterprises and areas of operations of the group.

Group contributions and dividend combined may not exceed the threshold 'justifiable dividend' based on the operations of the relevant year, unless the Ministry of Finance, to secure the solvency of the group or an enterprise of the group, allows larger distributions. A subsidiary of the group may not provide group contributions to another subsidiary. Furthermore, a group enterprise may not provide loans or guarantees for another group enterprise that are not justifiable based on the capital and risk exposure of the enterprise providing such loans and guarantees. An enterprise providing loans or guarantees exceeding 5 per cent of that enterprise's liable capital shall be required to notify the FSAN.

6 What are the principal regulatory challenges facing the banking industry?

The regulatory challenges facing the Norwegian banking sector are principally issues familiar to international banking regulators and participants. These involve regulations becoming more stringent, complex and frequent, as a result of the European Union's ambitions to establish an internal market with common regulations and harmonised supervision. Further from the abovementioned, Norwegian authorities worry about a potential housing bubble in Norway and have suggested countercyclical measures for local banks.

7 Are banks subject to consumer protection rules?

Norwegian Banks are subject to consumer protection rules. The Financial Contracts Act, which, inter alia, implements EU Directive 2008/48/EC on credit agreements for consumers, is invariable in consumer relations and contains a number of mandatory consumer protection provisions applicable to financial contracts between banks and consumers. The provisions therein set out the banks' disclosure duties and other obligations in relation to agreements on deposits and payment services, credit, guarantees and security.

The FSAN is responsible for maintaining the consumer protection rules through inspections and supervision. Furthermore, the FSAN regularly publishes circular letters and guidelines regarding consumer protection, including guidelines provided by the European Banking Authority.

As allowed for in the Financial Contracts Act, an extrajudicial complaints committee for consumers is established for the purposes of resolution of disputes relating to financial contracts. Most Norwegian banks are affiliated members of the complaints committee through interest groups. Interest groups of consumers, insurance companies and securities funds are also represented. The complaints committee regularly handles disputes regarding financial contracts brought to them by consumers. The committee's decisions are precatory, but most banks (and other non-consumer parties) choose to comply with its decisions.

Disputes regarding financial contracts may also be brought before the court. In recent years, particularly cases relating to leveraged investments (often in complex structured financial products) marketed and arranged by banks for consumers, have received a great deal of attention.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

The Norwegian regulatory policy is, to a large extent, harmonised with that of the European Union. The direct consequences for Norway of the European Union's ambitions will be the continuous need for evaluation and harmonisation of relevant EU regulations in Norway through the EEA Agreement, which will probably require larger and more dominant regulatory bodies, even more coordinated with the equivalent EU bodies. In the third quarter of 2016, the first 'package of acts' on European Financial Supervisory Authorities was incorporated into the EEA Agreement.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Banks are supervised by the FSAN. Supervision is conducted in the following ways:

- on-site inspections (based on international supervisory standards) involving the banks' management team and board of directors;
- off-site supervision on the basis of reporting to the FSAN (ie, regular reporting regulated by law and ad hoc reporting pursuant to the FSAN's instructions);
- risk-based supervision (see Pillar II of the Capital Requirements Directive);
- all banks are required to conduct the annual Internal Capital Adequacy Assessment Process (ICAAP) to determine their actual need for capital;
- the FSAN evaluating the respective bank's ICAAP through the Supervisory Review Evaluation Process; and
- supervisory collaboration: Norway has signed the European Union's Memorandum of Understanding (MoU) on Cooperation between the financial supervisory authorities, central banks and finance ministries of the European Union on cross-border financial stability, and a similar MoU between the Nordic and Baltic countries.

The supervision of banks is already comprehensive and coordinated with EU supervision, but as indicated in question 8, the strengthening of the cooperation between the supervisory bodies of the European Union and EEA will presumably cause more frequent and coordinated supervision.

According to the FSAN's public register, there are 25 commercial banks, 100 savings banks and 38 Norwegian branches of foreign credit institutions operating as licensed banks in Norway. Banks of all these categories are regularly subject to on-site inspections. The FSAN prioritised on-site inspections of Norway's largest banks for supervisory review of capital and risk assessments after the 2007 to 2010 financial crisis, as a preventive measure. In general, supervision with a focus on capital adequacy and (systemic) risk prevention has increased significantly in response to the financial crisis. The FSAN also carries out on-site inspections based on specific suspicion. Such inspections may be limited to a certain area of the bank's operations or cover larger parts of the bank's business. The FSAN also initiates inspections with the purposes of controlling the banks' compliance with new legislation or regulations.

10 How do the regulatory authorities enforce banking laws and regulations?

The FSAN has all regulatory powers to enforce banking laws and regulations, including issuing injunctions and orders (including orders to cease operations) and fining.

Representatives of banks wilfully or negligently violating the Financial Supervisory Authority Act or an order issued by the FSAN may be subject to fines or prison of up to three years.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The FSAN rarely issues fines against banks operating in Norway. The most common misconduct issues involving Norwegian banks relate to misleading investment advice and selling, or mis-selling, unsuitable complex financial products to consumers, management and control failures in relation to anti-money laundering procedures and bank system deficiencies.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Government authorities may intervene in and take control over a bank's operations, public administration, pursuant to the rules in the Financial Enterprises Act. Public administration is triggered by the FSAN's assessment of a bank's deteriorating capital and liquidity situation. The criterions to be assessed are:

- a bank is unable to meet its liabilities as they fall due;
- a bank is unable to meet the existing capital adequacy requirements in accordance with a directive from the FSAN; or
- a bank's assets and incomes combined are not sufficient to meet the bank's liabilities in full.

If the FSAN has reason to believe one of the conditions will occur, the FSAN shall notify the Central Bank of Norway and the Banks' Guarantee Fund.

Subsequently, a second assessment on whether the bank may be secured a sufficient financial basis for continued satisfactory operations will be made. If the FSAN concludes that such sufficient financial basis may not be secured, the Ministry of Finance will be notified. The notification shall include the FSAN's assessment on whether the bank should be subject to public administration. Based on the notification, the Ministry of Finance will make the final decision to issue an order putting the bank under public administration.

Once a public administration order has been issued, the banks governing bodies become inoperative, and an administration board, appointed by the FSAN, assumes control of the authority vested in these bodies. The operations of the bank will at this point be severely restricted; the bank will be unable to receive deposits, assume any new financial obligation or expand existing financial obligations, or pay depositors and other creditors without the FSAN's approval.

After assuming control of the bank, the administration board shall as soon as possible determine whether the bank may be able to continue its operations, should be subjected to merger or takeover, or should be wound-up. Depending on the administration board's decision, the position of shareholders, creditors and employees will vary substantially. In any event, creditors holding claims against the bank established prior to the administration order will be unable to distrain on, or by other means secure payment by recourse to, assets belonging to the bank.

Public administration orders in Norway are almost unheard of, with the administration of Norion Bank in 1989 being the sole example. Other public measures have, however, been implemented. During the financial crisis in Norway in 1991–92, the Norwegian state became the owner of 100 per cent of the shares in three of the largest Norwegian commercial banks (Kredittkassen, Fokus Bank and DNB), through forced write-offs of the banks' share capital as a requirement from the state to re-fund the banks. During the financial crisis of 2007 to 2010, no Norwegian banks were set under public administration, but an administration order was passed in relation to Kaupthing Bank Hf's branch in Norway in 2008. Two other collapsed Icelandic banks, Glitnir and Landsbanki, were administered without involvement from the Norwegian government.

It should be noted that the Ministry of Finance has proposed amendments to the Financial Enterprises Act that will implement Directive 2014/59/EU (the Bank Recovery and Resolution Directive) (BRRD). The BRRD was included in the EEA agreement on 9 February 2018. The Ministry's proposal is scheduled to be decided by parliament in March 2018, which means a new set of rules will probably be in force in a reasonably short period of time. If adopted, the rules will apply with regards to resolution and public administration of banks prior to the above-mentioned (see question 19 for the new rules).

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

If a bank is taken under public administration the bank's ordinary governing bodies become inoperative once the public administration order is effective and replaced by an administration board. Until the administration board is ready to assume control, however, matters that cannot be deferred shall be decided by the last serving board of directors. When the administration board assumes control the board of directors, together with the auditor, are responsible for informing the administration board on the bank's current status and activities (see question 15 for resolution plans).

14 Are managers or directors personally liable in the case of a bank failure?

The CEO and the directors may be held personally liable in the case of a bank failure if such failure has been caused by their negligence or wilful misconduct.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

Norwegian banks are currently not required by law to have recovery or resolution plans. However, the proposed implementation of the BRRD, as discussed above, will introduce a requirement for banks to draw and maintain recovery plans. The recovery plans shall describe measures to be taken if the bank's financial situation significantly deteriorates. It must include capital and liquidity measures to restore the institution to financial soundness. Most notably, the plan shall not assume or rely on any public financial support. The plan must be updated annually or whenever the bank has substantially changed its business.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The Norwegian capital adequacy requirements for banks are established in accordance with the EU Capital Requirements Directive (2013/36) (CRD IV) and the Capital Requirements Regulation (575/2013) (CRR). Neither CRD IV nor the CRR has been implemented in the EEA agreement yet, but Norwegian legislation has been adapted to comply with most of these requirements.

CRD IV is the legal framework for the supervision of credit institutions, investment firms and their parent companies in all member states of the European Union and the EEA and will be the basis of the single supervisory framework throughout the EU and the EEA when that will be formally introduced.

CRD IV partly builds on several standards issued by the Basel Committee on Banking Supervision, most notably Basel III regarding capital buffer and its buffer components, which include the capital conservation buffer, the countercyclical buffer, the global systemically important institutions buffer, the other systemically important institutions buffer, and the systemic risk buffer components. CRD IV also includes several more general provisions, concerning competence of the regulatory authorities, market entry, sanctions in case of breach of the CRD and CRR, governance and remuneration, among others. On 23 November 2016, the EU Commission published its proposal for amendments to the CRD IV and the CRR.

17 How are the capital adequacy guidelines enforced?

The capital adequacy guidelines are enforced through period reporting from the banks and a combination of theme-based inspections and on-site inspections from the FSAN.

18 What happens in the event that a bank becomes undercapitalised?

If a bank becomes undercapitalised, the CEO and the board of directors of the bank are, independently of each other, required to notify the FSAN. Together with the bank itself, the FSAN will consider what measures are required. The FSAN has wide powers to ensure that appropriate measures are taken, for example, to call for a general meeting or to replace the board of directors.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

If a bank becomes insolvent, the FSAN shall notify the Central Bank and the Banks' Guarantee Fund. If it must be assumed that the bank cannot pay its dues on time, and that further funding of the ongoing operations is not available, the Ministry of Finance can decide to put the bank under public administration. However, adopting the new set of rules and implementing the BRRD, as mentioned in question 12, the regulatory approach and process will change. In the Ministry of Finance's proposal the rules will be set out in a new Chapter 20 to the Financial Enterprises Act. The FSAN is set to be appointed the resolution authority according to the BRRD, however, with certain decisions, including decisions of major significance, conferred on the Ministry of Finance.

Prior to insolvency, if the institution infringes or is likely in the near future to infringe capital adequacy requirements, including solvency issues, the bank shall notify the FSAN. The FSAN will have powers to initiate early intervention measures, including orders to implement steps drawn up in the recovery plan, orders to call a general meeting of shareholders and orders to draw up a plan for negotiation on restructuring of the bank's debt. If the bank's financial situation continues to deteriorate regardless of the steps taken, the FSAN may require further steps, including a change of the management of the bank or appoint a temporary administrator of the bank for up to one year.

If the bank is failing, or is likely to fail, it has a duty to notify the FSAN. Thresholds for when an institution is failing, or likely to fail, are detailed further in the new rules. The assessment includes, inter alia, whether the bank will be unable to pay its debts or other liabilities as they fall due. If the FSAN determines that the bank is failing, or is likely to fail – either following a notification or by its own accord – and there is no reasonable prospect that any alternative private sector measures will prevent the failure of the institution within a reasonable time frame, the FSAN shall notify to the Ministry of Finance. The notification shall include an assessment of whether a resolution action is necessary in the public interest or if the institution should be wound up.

Following a notification from the FSAN, the Ministry of Finance will decide whether or not the bank is to be set under public administration. If the bank is set under public administration the FSAN shall appoint an administration board assuming control of the bank. A set of resolution tools become available for the administration board and the FSAN, including powers to sell whole or parts of the business, transfer whole or parts of the business to a bridge bank, transfer whole or parts of the business to an asset management vehicle and recapitalise the institution using a bail-in tool.

The proposal also entails that the rules set out under question 12 no longer will apply to banks. Accordingly, if the Ministry of Finance decides not to put the bank under public administration pursuant to the new rules, ordinary insolvency proceedings will apply.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

See question 16.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

The legal framework on ownership in banks is based on ownership control rather than ownership restrictions. Accordingly, there are no express statutory limitations to which types of entities and individuals may own a controlling interest in a Norwegian bank. However, any entity or individual who acquires a controlling interest are subject to the Ministry of Finance's approval, or the FSAN in cases not considered important. The approval is granted on the basis of a fit and proper testing of the entity where the Ministry of Finance of the FSAN will consider the acquirer's qualification as owner in relation to the bank's activities. The factors considered by the Ministry of Finance or the FSAN in such approval are explained under question 25.

A 'controlling' interest for the purposes of the ownership regulations constitutes more than 10 per cent of the capital or voting rights, or other interest that provides material influence, in the bank. Such interest is referred to as a 'qualified interest'.

In relation to the institution's application for authorisation to carry out banking activities it should be noted that three-quarters or more of the share capital must be dispersed through a capital increase or sale effected without any preferential or pre-emption right for shareholders or others, known as a 'dispersion sale'.

Ownership is further subject to regulatory practice set out by the Ministry of Finance. According to regulatory practice, no single entity may hold more than 25 per cent of the shares in a bank, unless the owner is a financial institution itself. The purpose of the limit is to ensure the independence of the institutions and to prevent private banker activities. Under special circumstances there may be made exceptions to this limitation, and such exceptions have been granted on a few occasions.

A recent judgment by the EFTA Court challenges the above-mentioned dispersion sale rule and the regulatory practice setting out the 25 per cent limitation rule, on the basis that they unjustifiably infringe on the internal markets' freedom of establishment. In its judgment, the EFTA Court first concludes that the dispersion sale rule is not suitable to achieve its otherwise legitimate objective, and therefore is not compatible with EEA law. Second, the EFTA Court found that the limitation rule was suitable to achieve the legitimate objective to the extent that it applies to applications for authorisation as a bank but not, however, to secondary acquisitions after the granting of authorisation. The case for Oslo District Court has not yet been decided and it is at this point unclear if the dispersion sale rule and 25 per cent limitation will be ruled lawful or not by the District Court.

22 Are there any restrictions on foreign ownership of banks?

There are no additional regulatory restrictions on foreign ownership of banks in Norway, apart from the general rules outlined in this section.

23 What are the legal and regulatory implications for entities that control banks?

An entity that owns a 'qualified interest' in a bank is responsible for complying with the terms of the approval given by the Ministry of Finance for such ownership. The Ministry of Finance may revoke the approval at any time if the terms of the approval are no longer met. Special regulatory requirements relevant for the shareholders apply upon the occurrence of insolvency or capital inadequacy of the bank (see question 25).

Further, any owner with a 20 per cent or higher shareholding may be subject to capital requirements on a consolidated basis.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

In addition to being responsible for complying with the terms of the ownership authorisation issued by the Ministry of Finance or the FSAN, an entity with a qualified interest in a bank is required to notify the FSAN of changes to the entity's board of directors, management and shareholders. The FSAN may require additional information if it considers it necessary for their ownership control.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

Upon the occurrence of insolvency or capital inadequacy, the board of directors and the managing director of the bank are required to notify the FSAN. The FSAN will subsequently consider alternative measures together with the bank, and the Central Bank of Norway will be notified. The FSAN will also be authorised to call for a general meeting to be held, involving all shareholders of the bank. If the assessment of the bank's solidity implies that a significant share of the bank's equity capital is lost, the board is required to call for a general meeting immediately. This requirement also applies if 25 per cent of the bank's share capital, or 25 per cent of the bank's primary capital and basic capital combined if the bank is not organised as a private or public limited company, is lost. In these events, the general meeting must resolve, inter alia, whether the bank has sufficient capital to adequately continue its operations. The general meeting's resolution is subject to approval by the FSAN. The general meeting may also resolve to transfer the bank's operations to other financial institutions or resolve winding-up.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

Any entity or individual who acquires a 'qualified interest' in a bank is required to notify the FSAN of the acquisition. As noted above, a 'qualified interest' is defined as controlling more than 10 per cent of the capital or voting rights in the bank, or any other interest which provides material influence of the bank. Similar notifications shall also be filed for any acquisition resulting in the entity exceeding 20, 30 or 50 per cent or when controlling influence is achieved and shall contain specific information according to the Financial Services Act and appurtenant regulations.

The acquisition is then subject to regulatory approval by the Ministry of Finance or the FSAN, which will consider the acquirer's qualification as owner, and if the acquisition is financially adequate in relation to the bank's activities. Pursuant to the Financial Enterprises Act, the Ministry of Finance or the FSAN shall consider, inter alia:

- the acquirer's general reputation, professional competence, experience and previous conduct in business relationships;
- the general reputation, professional competence, experience and previous conduct in business relationships of persons who will form part of the board of directors or management of the bank's activities;
- whether the acquirer will be able to use the influence conferred by the acquisition to obtain advantages for its own or associated activities, or indirectly exert influence on other business activity, and to whether the acquisition could result in impairment of the bank's independence in relation to other business interests;
- whether the acquirer's financial situation and available financial resources are adequate, especially in relation to the types of activities in which the institution is will be engaged, and whether the acquirer and its activities are subject to financial supervision;
- whether the bank is and will continue to be in a position to meet the solvency and prudential requirements and other supervisory requirements that follow from the financial legislation;
- whether the ownership structure of the bank after the acquisition or particular ties between the acquirer and a third party will impede effective supervision of the bank, in particular whether the group of which the bank will form part after the acquisition is organised in a manner that does not impede effective supervision; and
- whether there are grounds for assuming that money laundering or financing of terrorism, or any attempt to commit such act, is taking place in connection with the acquisition, or that the acquisition will increase the risk of such act.

Increases in ownership reaching 20, 30 or 50 per cent of the capital or voting rights in the bank, or any ownership share providing dominant influence pursuant to the provisions of the Public and Private Companies Acts, also require notification and approval by the regulatory authorities. As set out in question 25, any ownership in excess of 25 per cent will only be allowed for financial institutions.

As a general rule, the decision to authorise the acquirer or not shall be made within 60 business days from the time the FSAN confirmed receipt of the acquirer's notification.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

As noted under question 22, there are no regulatory restrictions on foreign ownership of banks in Norway. The authorisation process is not different for a foreign acquirer, but it may be more challenging, especially if the acquirer is incorporated in a country outside the European Union or EEA.

If the acquirer is a credit institution, insurance company, investment firm or holding company for a securities fund authorised to operate in another EEA member state, the FSAN shall consult the regulatory authorities of that member state before making a decision.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The factors considered by the Ministry of Finance or FSAN in an acquisition of control of a bank are listed under question 26.

29 Describe the required filings for an acquisition of control of a bank.

The required filing for an acquisition of control of a bank is limited to the notification described under question 26. Pursuant to current law, the notification shall as a minimum include information regarding:

- the size of the acquired holding;
- the size of the overall holding in the bank after the acquisition;
- complete information about the acquirer (if the acquirer is an entity, information about the entity's board of directors, management, owners and beneficial or ultimate owners);
- information about the target bank;
- the acquirer's evaluation of the bank's financial position and activities;
- the acquirer's business operations and available financial resources;
- the acquirer's ownership interests in other financial institutions;
- other owners with which the acquirer shall be consolidated; and
- the purpose of the acquisition.

Furthermore, the notification shall include responses to, inter alia:

- whether the acquirer has been filed for bankruptcy in Norway or abroad during the past 10 years;
- whether the acquirer during the past 10 years has been convicted for a criminal offence in Norway or abroad;
- whether the acquirer is indicted or charged for a criminal offence in Norway or abroad;
- whether the acquirer during the past 10 years has been subject to tax estimation or surtax or equivalent in Norway or abroad;
- whether the acquirer during the past 10 years has been subject to fines or penalties pursuant to the Norwegian Financial Supervisory Authority Act, the Securities Trading Act, the Accounting Act or securities legislation, or equivalent statutes abroad;

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- whether the acquirer during the past 10 years has had board positions, management positions or qualified ownership interest in entities involved in the above; and
- whether the acquirer previously has been assessed for authorisation as acquirer of a qualified ownership interest in a financial institution in Norway or abroad.

The FSAN may also require additional information at its discretion.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

Irrespective of the acquirer being domestic or foreign, the regulatory authorities in Norway are bound by the Financial Services Act to make a decision regarding the authorisation, as a main rule, within 60 business days from the time the FSAN received the acquirer's notification about the acquisition.

If, however, the Ministry of Finance or the FSAN, before 50 business days have lapsed since the notification, requires additional information in writing, the time limit will be extended. Pursuant to current law, the maximum extension is 20 business days in cases where the acquirer is subject to supervision or resident in the EEA. The typical time frame for regulatory approval is notification plus 60 business days.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The government recognises the vital role of banks in providing an environment conducive to the sustained development of the country's economy. Accordingly, it is the government's policy to promote and maintain a stable and efficient banking system that is globally competitive, dynamic and responsive to the demands of a developing economy.

2 Summarise the primary statutes and regulations that govern the banking industry.

The General Banking Law governs not only universal banks but also commercial banks. Section 71 provides that the organisation, ownership, capitalisation and powers of thrift banks (savings and mortgage banks, stock savings and loan associations, and private development banks), rural banks, cooperative banks and Islamic banks, as well as the general conduct of their businesses, are governed by the Thrift Banks Act, the Rural Banks Act, the Philippine Cooperative Code and the Charter of Al-Amanah Islamic Investment Bank of the Philippines respectively. The General Banking Law applies, however, to thrift banks and rural banks insofar as it is not in conflict with the provisions of the special laws governing such banks. On the other hand, the Philippine Cooperative Code recognises the primacy of the General Banking Law in the regulation of cooperative banks.

The rules implementing the above statutes are embodied in the Manual of Regulations for Banks (MORB) issued by the Bangko Sentral ng Pilipinas (BSP), the Philippine central bank. From time to time, additional circulars and other issuances are promulgated by the BSP to cover new matters, if not to amend, repeal, supplement or otherwise modify existing rules.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The BSP, through its Monetary Board, is primarily responsible for overseeing banks. The Philippine Deposit Insurance Corporation (PDIC) can also conduct examination of banks, with the prior approval of the Monetary Board, provided that no examination can be conducted by the PDIC within 12 months of the previous examination date.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Banks must insure their deposit liabilities with the PDIC. Each depositor is a beneficiary of the insurance for a maximum amount of 500,000 Philippine pesos or its foreign currency equivalent.

There are very few remaining government-owned or controlled banks (currently, only seven), owing to the government's privatisation programme.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

The grant of loans and other credit accommodations by a bank to its directors, officers, stockholders and their related interests (DOSRI) and to subsidiaries and affiliates is regulated. The MORB provides different ceilings for loans to DOSRI, and to subsidiaries and affiliates. Total outstanding loans to each of the bank's DOSRI is limited to an amount equivalent to their respective unencumbered deposits and book value of their paid-in capital contribution in the bank. On the other hand, total outstanding loans to each of the bank's subsidiaries and affiliates must not exceed 10 per cent of the net worth of the lending bank. For these purposes, an affiliate is an entity linked directly or indirectly to a bank by means of:

- ownership, control or power to vote of at least 20 per cent of the outstanding voting stock;
- interlocking directorship or officership;
- common stockholders owning at least 10 per cent of the outstanding voting stock of the bank and at least 20 per cent of the outstanding voting stock of the borrowing entity;
- management contract or any arrangement granting power to the bank to direct or cause the direction of management and policies of the borrowing entity; or
- permanent proxy or voting trusts in favour of the bank constituting at least 20 per cent of the outstanding voting stock of the borrowing entity, or vice versa.

The BSP recently excluded portions of loans and other credit accommodations covered by guarantees of international and regional institutions or multilateral financial institutions where the Philippine government is a member or shareholder, from the ceilings on loans granted by banks to their subsidiaries and affiliates.

Related-party transactions are generally allowed provided that these are done on an arm's-length basis. Banks, including their non-bank financial subsidiaries and affiliates, are expected to exercise appropriate oversight and implement effective control systems for managing exposures arising from related-party transactions.

Core banking consists of deposit taking and lending; all of which is subject to pertinent rules promulgated by the Monetary Board. In particular, commercial banking includes:

- accepting drafts;
- issuing letters of credit;
- discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt;
- accepting or creating demand deposits;
- receiving other types of deposits, as well as deposit substitutes;
- buying and selling foreign exchange, as well as gold or silver bullion;
- acquiring marketable bonds and other debt securities; and
- extending credit.

Universal banking includes the above functions and two additional powers, namely the capacity to invest in enterprises not allied to banking and to underwrite securities. However, no bank in the Philippines can engage in insurance business as an insurer.

6 What are the principal regulatory challenges facing the banking industry?

Among the principal regulatory challenges facing the banking industry at present are those posed by the use of financial technology, including compliance with know-your-customer (KYC) requirements, incorporating fintech into their systems and structures, and ensuring cybersecurity.

With the issuance of the implementing rules and regulations of the Data Privacy Act, banks (as with other entities that collect and process personal information) are expected to observe certain registration and compliance requirements. The BSP and the National Privacy Commission are currently reviewing possible overlaps in their functions with a view to harmonising them for a more efficient regulatory framework.

7 Are banks subject to consumer protection rules?

Banks are subject to the BSP's Financial Consumer Protection Framework, which sets out the minimum standards of consumer protection in the areas of:

- disclosure and transparency;
- protection of client information;
- fair treatment;
- effective recourse; and
- financial education.

The BSP is responsible for enforcing these rules in the banking sector.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

Legal and regulatory policy changes over the next few years will likely be driven by the following goals:

- aligning the country's financial regulations and policies with international standards to improve risk management and ensure competitiveness in view of Association of Southeast Asian Nations' integration;
- strengthening anti-money laundering capability and risk management systems to address weaknesses exposed by financial controversies;
- promotion of financial inclusion and access to financial services by the poor; and
- addressing risks arising out of new technology while at the same time encouraging innovation.

The BSP has expressed its intention to reduce the reserve requirement for banks, which at 20 per cent is among the highest in Asia, but is awaiting the right timing, in order to balance the supply of liquidity and the demand for liquidity.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The BSP examines the books of every bank once every 12 months, and at such other times as the Monetary Board may deem expedient. An interval of at least 12 months is required between annual examinations.

The BSP examiners are authorised to administer oaths to any director, officer or employee of any bank and to compel the presentation of all books, documents, papers or records necessary to ascertain the facts relative to the true condition of such bank.

The PDIC may also examine banks, with the prior approval of the Monetary Board, to determine whether they are engaging in unsafe and unsound banking practices. No examination can be conducted by the PDIC within 12 months of the last examination date. To avoid overlapping of efforts, the PDIC examination considers the relevant reports and findings of the BSP pertaining to the bank under examination.

10 How do the regulatory authorities enforce banking laws and regulations?

Violations of any of the provisions of the General Banking Law are subject to the penalties and other sanctions under the New Central Bank Act.

Any owner, director, officer or agent of a bank who, being required in writing by the Monetary Board or by the head of the supervising and examining department of the BSP, wilfully refuses to file the required report or refuses to permit a lawful examination into the affairs of such bank, will be punished by a fine of between 50,000 and 100,000 Philippine pesos or by imprisonment of not less than one year or no more than five years, or both, at the discretion of the court.

On the other hand, the wilful making of a false or misleading statement on a material fact to the Monetary Board or to the BSP examiners will be punished by a fine of between 100,000 and 200,000 Philippine pesos or by imprisonment of not more than five years, or both, at the court's discretion.

In turn, any person who is responsible for wilful violation of the General Banking Law or any order, instruction, rule, or regulation issued by the Monetary Board will, at the court's discretion, be punished by a fine of between 50,000 and 200,000 Philippine pesos or by imprisonment of not less than two years or no more than 10 years, or both. Whenever a bank persists in carrying on its business in an unlawful or unsafe manner, the Monetary Board may take action for the receivership and liquidation of such bank, without prejudice to the penalties provided in the first sentence of this paragraph and the administrative sanctions provided in the next paragraph.

Without prejudice to the foregoing criminal sanctions against culpable persons, the Monetary Board may impose administrative sanctions for any of the above violations, wilful violation of the charter or by-laws of the bank, any commission of irregularities, or conducting business in an unsafe or unsound manner as determined by the Monetary Board. These administrative sanctions are as follows:

- fines in amounts as may be determined by the Monetary Board to be appropriate, but in no case to exceed 30,000 Philippine pesos a day for each violation, taking into consideration the attendant circumstances, such as the nature and gravity of the violation or irregularity and the size of the bank;
- suspension of rediscounting privileges or access to the BSP credit facilities;
- suspension of lending or foreign exchange operations or authority to accept new deposits or make new investments;
- suspension of interbank clearing privileges; and
- revocation of the quasi-banking licence.

In addition, the Monetary Board can suspend or remove the offending director or officer of a bank. In this respect, the termination (or even the resignation) from office of such director or officer will not exempt him from administrative or criminal sanctions.

Moreover, the erring corporation may be dissolved by quo warranto proceedings instituted by the solicitor general. In this connection, an original quo warranto proceeding may be commenced with the Supreme Court of the Philippines.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

Cybersecurity concerns continue to confront financial institutions (both locally and worldwide). Top cyber-threats include card skimming, phishing attacks, ransomware and other malware. Accordingly, the BSP has directed banks to adopt advanced cybersecurity controls and countermeasures, and to improve the management of information security risks and exposures.

Meanwhile, the money laundering incident in 2016 where proceeds from the hacking of the Bangladesh Bank were permitted to enter the Philippine financial system prompted the BSP to update anti-money laundering guidelines. The new regulation emphasises the use of a risk-based approach to the KYC processes.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

As noted in question 19, the Monetary Board may appoint a conservator for a bank that is in a 'state of continuing inability or unwillingness to maintain a condition of liquidity deemed adequate to protect the interest of depositors and creditors'. The conservator will have such powers as the Monetary Board deems necessary to:

- take charge of the assets and liabilities of the bank;
- manage it or reorganise its management;
- collect all monies and debts due; and
- restore its viability.

If, based on the report of the conservator or its own findings, the Monetary Board determines that the continuance in business of the bank would involve probable loss to the depositors and other creditors of the bank, the bank would be placed under receivership and eventually liquidated. The PDIC is usually the designated receiver. If the bank notifies the BSP or publicly announces a bank holiday, or in any manner suspends the payment of its deposit liabilities continuously for more than 30 days, the Monetary Board may, summarily and without prior hearing, close the bank and place it under receivership of the PDIC.

The assets of a bank under liquidation are held in trust for the equal benefit of all creditors. The receiver must first pay the costs of the proceedings, before paying the debts of the bank, in accordance with the rules on concurrence and preference of credit under the Civil Code of the Philippines. The shareholders are the last to receive payment, if any funds remain. The depositors can claim from the PDIC the amount of their insured deposits.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

The directors and officers of a failing bank must cooperate with the regulators, including the conservator and receiver. The following acts of a director or an officer of such bank are subject to criminal penalties:

- refusal to turn over bank records and assets to the designated receiver;
- tampering with bank records;
- appropriating bank assets for himself or herself or another party;
- causing the misappropriation and destruction of bank assets;
- receiving or permitting or causing to be received in the bank any deposit, collection of loans, or receivables;
- paying out or permitting or causing to be paid out any fund of the bank; and
- transferring or causing to be transferred securities or property of the bank.

In addition, erring directors and officers will be included in the list of persons disqualified by the Monetary Board from holding any position in any bank or financial institution.

No voluntary dissolution and liquidation of a bank can be undertaken without the prior approval of the Monetary Board. For this purpose, a request for Monetary Board approval must be accompanied by a liquidation plan.

Domestic systemically important banks (DSIBs) are required to submit a recovery plan to the BSP.

14 Are managers or directors personally liable in the case of a bank failure?

The bank's directors and officers who knowingly assent to patently unlawful acts of the bank or who are guilty of gross negligence or bad faith in directing the affairs of the bank or acquire any personal or pecuniary interest in conflict with their duties as such directors or officers, will be liable jointly and severally for all resulting damages suffered by the bank and its shareholders.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

As discussed in question 13, DSIBs are required to submit a recovery plan to the BSP and to update the same annually. The recovery plan is intended to serve as a guide to recovery of a DSIB in distress. The recovery plan will take effect when the DSIB breaches the total required Common Equity Tier 1 capital or the minimum liquidity ratios prescribed by the BSP or both. The plan must contain a detailed list of options or courses of action that will be taken by the DSIB to address a range of severe stress scenarios to restore its financial strength and viability. It must take into account the DSIB's nature, size, interconnectedness, level of substitutability and complexity. It should be capable of being carried out during the recovery stage, when the DSIB has not yet reached the point of non-viability and the prospect of recovery is reasonable if appropriate recovery measures are taken. It should not assume any access to or receipt of government or public financial support or aid from the Philippine government. The board of directors of a DSIB is required to put in place a robust governance structure and sufficient resources to support the recovery planning process.

The list of DSIBs is updated annually and is considered by the BSP to be confidential.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The BSP prescribes the minimum level of capitalisation for banks. For instance, a universal bank with more than 100 branches must have a minimum capital of 20 billion Philippine pesos, while that of a commercial bank with similar number of branches is 15 billion Philippine pesos.

In addition, the BSP adopted Basel III-based capital adequacy requirements for universal banks and commercial banks. Thrift banks and rural banks that are not subsidiaries of universal banks or commercial banks continue to be subject to Basel II-based guidelines. In any case, the daily risk-based capital ratio of a bank, expressed as a percentage of qualifying capital to risk-weighted assets, must not be less than 10 per cent for both a solo basis (ie, head office plus branches) and a consolidated basis (ie, parent bank plus subsidiary financial allied enterprises, excluding an insurance company). The qualifying capital is the sum of Tier 1 (going concern) capital and Tier 2 (gone-concern) capital, less required deductions.

Universal and commercial banks have their respective internal capital adequacy assessment process that supplements the BSP's risk-based capital adequacy framework. These banks are responsible for setting internal capital targets consistent with their risk profile, operating environment and strategic plans.

17 How are the capital adequacy guidelines enforced?

In the event of non-compliance by a bank with the prescribed minimum ratio, the Monetary Board may, until that ratio is met or restored by such bank:

- limit or prohibit the distribution of net profits by such bank, and require that such profits be used, in full or in part, to increase the capital accounts of such bank;
- restrict or prohibit the acquisition of major assets by such bank; and
- restrict or prohibit the making of new investments by such bank, with the exception of purchases of readily marketable evidence of indebtedness of the Philippines and the BSP, and other evidence of indebtedness or obligation, the servicing and the repayment of which are fully guaranteed by the Philippines.

18 What happens in the event that a bank becomes undercapitalised?

If a bank becomes undercapitalised, it may be placed under conservatorship by the BSP, with a view to rectifying the capital deficiency. It may be possible to correct this condition, and the threatened insolvency of the bank may be averted by effective management reforms and infusion of additional capital.

The amended charter of the PDIC also provides for a resolution framework, where the PDIC may, in coordination with the BSP, commence the resolution of a bank upon failure of prompt corrective action as declared by the Monetary Board, or upon request by the bank. For this purpose, the PDIC may, among other things, determine a resolution package for the bank, identify possible acquirers or investors, and conduct a bidding to determine the acquirer of the bank.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

The Monetary Board may first appoint a conservator for a bank that is in a 'state of continuing inability or unwillingness to maintain a condition of liquidity deemed adequate to protect the interest of depositors and creditors'. If conservatorship is not successful or not deemed proper by the Monetary Board, the Monetary Board may summarily forbid the bank from doing business and designate the PDIC as its receiver. If the receiver determines that the bank cannot be rehabilitated or permitted to resume business, the Monetary Board may instruct the receiver to liquidate the bank.

Likewise, in case of a bank placed under resolution, in case the PDIC determines that the bank may not be resolved, the Monetary Board may place the bank under receivership and designate the PDIC as its receiver.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

See question 16. The capital adequacy requirements are based on Basel III guidelines for universal and commercial banks. Eventually, thrift and rural banks must observe those guidelines.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Control is defined as ownership of more than 50 per cent of the voting stock of a bank.

Foreign individuals and non-bank corporations controlled by foreign nationals can collectively own up to 40 per cent of the voting stock of a universal or commercial bank. However, Philippine citizens and non-bank corporations controlled by Philippine citizens can collectively own up to 100 per cent of the voting stock of such bank. Under Republic Act No. 10641, a qualified foreign bank can be authorised by the BSP to acquire up to 100 per cent of the voting stock of an existing domestic bank, form a 100 per cent-owned banking subsidiary, or establish a Philippine branch with full banking licence.

22 Are there any restrictions on foreign ownership of banks?

See question 21.

23 What are the legal and regulatory implications for entities that control banks?

Apart from being subject to DOSRI rules, entities controlling a bank are expected to see to it that such bank observes the BSP rules on corporate governance, which are anchored on the principle of transparency, accountability and fairness or equity.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

See question 23. In respect of transparency, the controlling entity or individual, as a 'principal stockholder' of a bank classified as a 'public company', must disclose the changes in its or his or her stockholding in the bank, under the Securities Regulation Code.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

The controlling entity or individual will not be liable to the creditors of the insolvent bank beyond the amount of its or his or her equity contribution to the bank.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

Any sale or transfer, or series of sales or transfers that will result in the ownership or control of more than 20 per cent of the voting stock of a bank by any person, whether natural or juridical, will require the prior approval of the Monetary Board.

Moreover, parties to an acquisition, where the value of the transaction exceeds 1 billion Philippine pesos and as a result of which the acquirer will own at least 35 per cent (or more than 50 per cent, if the acquirer already owns 35 per cent) of the outstanding voting shares of the corporation, must notify the Philippine Competition Commission (PCC) before the execution of the definitive agreements relating to the transaction.

Acquisition by a private party of majority of the outstanding capital stock of a state-owned bank, and acquisition by the government of the controlling interest of a private bank, are subject to review by the Governance Commission for Government-Owned or Controlled Corporations, in consultation with the supervising government agency to which the bank is attached, for recommendation to and approval by the President of the Philippines.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The regulatory process is no different for a foreign acquirer.

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28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The BSP will want to know the organisational and financial profile of the acquirer. For instance, a foreign bank acquiring a local bank must be widely owned or publicly listed, if not owned or controlled, by the government of its country of origin. The Monetary Board may also:
- ensure geographical representation and coverage;
- consider strategic trade and investment relationships between the Philippines and the country of incorporation of the foreign bank;
- study the demonstrated capacity, global reputation for financial innovations and stability in a competitive environment of the applicant;
- see to it that reciprocity rights are enjoyed by Philippine banks in the applicant's country; and
- consider the willingness of the applicant to fully share its technology.

The Monetary Board must also ensure that control of 60 per cent of the resources or assets of the entire banking system is held by domestic banks, which are majority-owned by Filipinos, at all times.

On the other hand, the PCC will assess whether a proposed acquisition is likely to substantially prevent, restrict, or lessen competition in the relevant market or in the market for goods and services, and take into account any substantiated efficiencies put forward by the parties to the proposed acquisition, which are likely to arise from the transaction.

29 Describe the required filings for an acquisition of control of a bank.

A written application (together with supporting documents) is to be filed with the BSP for the purpose of acquisition of control of a bank.

With respect to PCC notification, parties to the acquisition must give notification using the notification form prescribed by the PCC. An electronic copy of the form contained in a secure electronic storage device, must be submitted to the PCC, simultaneous with the filing of the aforementioned hard copy. Notification must be made within 30 days from the signing of the definitive agreements relating to the acquisition and prior to consummation of the transaction. The acquisition may not be consummated prior to the expiry of the waiting period prescribed under applicable law.

In case a bank is considered a reporting company under securities regulations, an acquisition of 35 per cent (or of such percentage as would cause the acquirer to own more than 50 per cent, if it already owns 35 per cent) of the outstanding voting shares of a bank in one or more transactions, within a period of 12 months, may trigger tender offer requirements.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The approval process with the BSP can be completed within one month.

With respect to PCC notification, parties to the transaction are prohibited from consummating the transaction before the expiry of the relevant periods provided in the regulations.

Singapore

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

In Singapore, banks are licensed under the Banking Act (Chapter 19 of Singapore). There are different licences granted by the Monetary Authority of Singapore (MAS).

Full banks may provide the whole range of banking activities permitted by the Banking Act. There are currently four local full banks and 29 foreign full banks with qualifying full bank privileges.

Wholesale banks do not carry out Singapore dollar retail banking activities, otherwise they may engage in the same range of business activities as full banks.

Offshore banks do not operate savings accounts or accept fixed deposits denominated in Singapore dollars in respect of residents of Singapore. With regard to non-residents, fixed deposits may be accepted in the denomination of Singapore dollars with a minimum deposit of S$250,000.

Merchant banks can only accept deposits or borrow from banks, finance companies, shareholders and companies controlled by shareholders. Their typical activities include corporate finance, underwriting of share and bond issues, mergers and acquisitions, portfolio investment management, management consultancy and other fee-based activities.

2 Summarise the primary statutes and regulations that govern the banking industry.

The main legislation in Singapore governing banks is the Banking Act. There are various subsidiary legislations relating to the Banking Act such as the Banking Regulations, Banking (Corporate Governance) Regulations and more. In addition, banks also need to comply the Financial Advisers Act (Chapter 110 of Singapore), Insurance Act (Chapter 142), the Securities and Futures Act (Chapter 289 of Singapore) and the relevant subsidiary legislation promulgated under these Acts in relation to activities which fall within the Acts.

Further, banks in Singapore must also comply with the relevant directives, notices, practice notes, codes and circulars issued by the MAS.

3 Which regulatory authorities are primarily responsible for overseeing banks?

In Singapore, the MAS is the primary regulator responsible for overseeing banks.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

In Singapore, deposits made by non-bank depositors (including sole proprietorships, partnerships and companies) are insured by the Singapore Deposit Insurance Corporation Limited under the deposit insurance scheme for up to S$50,000 per depositor, per bank. All full banks are members of the deposit insurance scheme. The Singapore Deposit Insurance Corporation is a company limited by guarantee under the Companies Act (Chapter 50 of Singapore) and its board of directors is accountable to the Minister in charge of the MAS.

The Singapore government's ownership interest in the banking sector is mainly through indirect holdings through a private investment company, Temasek Holdings (Private) Limited and its sovereign wealth fund, GIC Private Limited. For example, Temasek Holdings holds shares in, among others, the Bank of China Limited, China Construction Bank Corporation, DBS Group Holdings Ltd and Standard Chartered PLC.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

The following limitations apply under MAS Notice 639:

> *Banks must ensure that the aggregate of its exposures to their directors, shareholders holding at least 5% voting rights in the bank, and entities in which the bank owns more than 10% of the total issued shares or controls more than 10% of the voting rights do not exceed 25%.*

Banks are not allowed to:
- grant unsecured credit facilities exceeding S$5,000 to a director of the bank or any firm, partnership or company that the director has an interest in; or
- grant to any of its officers (other than directors) or employees of the bank any unsecured credit facility that in the aggregate, and outstanding at any one time, exceeds one year's emoluments of that person.

Under MAS Notice 643, banks must set out materiality thresholds for transactions where exposure arises for any related party of the bank. Where a new exposure to any related party would cause the materiality threshold to be exceeded, the transaction shall be subject to the approval of a special majority of three-quarters of its board.

Bank activities prohibited or regulated in Singapore are as follows:
- banks are prohibited from carrying out any non-financial business;
- banks cannot hold or acquire any equity investments in a single company with a value exceeding 2 per cent of the capital funds of the bank without prior approval by the MAS;
- banks must obtain the prior approval by the MAS before it holds or acquires, directly or indirectly, a major stake in any company. The MAS does not ordinarily grant its approval if the company carries on non-financial business;
- banks cannot hold or acquire interests in, or rights over, immovable property with a value exceeding 20 per cent of the bank's capital funds; and
- banks are required to limit their property sector exposure to 35 per cent or less under the Banking Regulations.

6 What are the principal regulatory challenges facing the banking industry?

Some of the key regulatory challenges facing the banking industry relate to the prevention of money laundering and information technology.

Anti-money laundering

In 2016, pursuant to investigations relating to the 1Malaysia Development Berhad fund, the MAS ordered the closure of BSI Bank Limited and Falcon Private Bank Limited for serious failures in anti-money laundering controls and improper conduct by some of the bank's staff. In addition, the MAS also imposed financial penalties on the Development Bank of Singapore Limited and UBS for breaches of anti-money laundering requirements and control lapses. This highlights the challenges faced by the MAS in relation to anti-money laundering. Ravi Menon, managing director of the MAS, stated that the investigations' recent findings have 'made a dent' in Singapore's reputation as a clean and trusted financial centre. In particular, apart from a sound regulatory framework, a strong enforcement capability is necessary. The MAS has recognised this and, in November 2016, announced its intention to form a dedicated anti-money laundering department together with a new enforcement department.

In addition to the above censures, various individuals have also been issued with prohibition orders. For example, a former representative of Maybank Kim Eng Securities Pte Ltd, was convicted of an offence under the Prevention of Corruption Act (Chapter 241 of Singapore) for bribing another individual with S$3,000 to expedite the preparation of a valuation report on PetroSaudi Oil Services Limited. The prohibition order, effective from 30 October 2017, will prevent the individual for a period of six years, from:

- providing any capital market and financial advisory services; and
- taking part in the management of, acting as a director of, or becoming a substantial shareholder of any capital market and financial advisory services firm in Singapore.

Information technology risks

In recent years, technological innovations have resulted in new areas such as mobile banking and internet banking. Information technology outsourcing is also becoming increasingly attractive. Cybersecurity is therefore a real regulatory challenge since there is now an increased risk of cyberattacks and system disruptions. For instance, it was reported that, between October and December 2015, about 50 mobile banking customers were targeted by malware. The malware attackers subsequently made various purchases, ranging from airline tickets to electronic devices. Some customers lost thousands of dollars as a result of such an attack. The Director of the Association of Banks of Singapore reported an increasing trend of unauthorised transactions using smartphones involving malware infections. The situation is exacerbated by the commoditised proliferation of malware on the internet. Malware can be readily obtained from the dark web, an encrypted network that is commonly used to sell illegal material.

7 Are banks subject to consumer protection rules?

In Singapore, the Consumer Protection (Fair Trading) Act (Chapter 52A of Singapore) (CPFTA) also extends to all banking activities under the Banking Act including deposits, mortgages, letters of credits, bank guarantees and more. Parties cannot contract out of the CPFTA. The CPFTA protects consumers against 'unfair practices' by the banks. 'Unfair practices' include misrepresentations, making false claims and taking advantage of consumers. A breach of the CPFTA gives the consumer a right to commence a civil action against the bank under the CPFTA if the claim does not exceed S$30,000. Commencing an action under the CPFTA confers several benefits for the consumers such as benefits relating to burdens of proof and interpretation of documents.

Further, the MAS also published the 'Guidelines on Fair Dealing' under the Financial Advisers Act in 2009. The Guidelines envisage five fair dealing outcomes:

- customers have confidence that they deal with financial institutions where fair dealing is central to the corporate culture;
- financial institutions offer products and services that are suitable for their target customer segments;
- financial institutions have competent representatives who provide customers with quality advice and appropriate recommendations;
- customers receive clear, relevant and timely information to make informed financial decisions; and
- financial institutions handle customer complaints in an independent, effective and prompt manner.

Further, customers are indirectly protected by the MAS in its supervisory actions. For example, the MAS took supervisory actions against the DBS Bank Ltd for the service outage of its online and branch banking systems on 5 July 2010, which caused significant inconvenience to its customers. The MAS required the DBS Bank to set aside an additional amount of S$230 million in regulatory capital. Such regulatory actions serve as a deterrence to banks, therefore indirectly protecting consumers.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

Currently, fintech is becoming more prevalent, resulting in the emergence of financial products or services utilising it. There may be uncertainty over whether the innovation meets regulatory requirements. In such circumstances, some financial institutions or companies may decide to adopt a cautious approach and choose not to implement such new financial products or services utilising fintech. The MAS has recently issued a statement that this outcome is undesirable as 'promising innovations may be stifled and this may result in missed opportunities'. The MAS is encouraging more fintech experimentation 'so that promising innovations can be tested in the market and have a chance for wider adoption, in Singapore and abroad'. In this regard, the MAS issued regulatory sandbox guidelines in November 2016. As new financial products or services that utilise fintech mature and gain wider adoption rates, it is anticipated that the MAS will alter the regulatory guidelines and tailor it to the circumstances. Therefore, regulations relating to such financial services or products utilising fintech are expected to undergo changes in the future.

In addition, cryptocurrencies and initial coin offerings present a unique problem to the MAS. Cryptocurrencies and initial coin offerings are becoming increasingly popular globally, especially in Asia. Mr Tharman Shanmugaratnam, Singapore's Deputy Prime Minister, Coordinating Minister for Economic and Social Policies, and Chairman of the MAS had stated that the cryptocurrencies and initial coin offerings fall outside of the MAS' current financial legislation. In addition, he stated that MAS does not recognise bitcoin as legal tender and that, instead of regulating bitcoin itself, the MAS will seek to regulate companies providing bitcoin payment services. The MAS had also previously issued a guide to digital coin offerings on 14 November 2017. In that guide, the MAS had cautioned that offers or issues of digital tokens may be regulated by the MAS if the digital tokens are capital markets products under the Securities and Futures Act. Capital markets products include any securities, futures contracts and contracts or arrangements for purposes of leveraged foreign exchange trading. Usage of cryptocurrencies and initial coin offerings are progressing at an alarming rate and it will be interesting to see how or if the MAS chooses to regulate this sector further.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Under the Banking Act, every bank is required to furnish the MAS with information. Such information includes a bank's latest audited financial statements, reports from the banks' auditors, reports from the banks' directors, interim profit and loss statements and more.

The MAS also has the power to occasionally inspect the books of each bank in Singapore and of any branch, agency or office outside Singapore opened by a bank incorporated in Singapore. The MAS adopts risk-focused supervision. The frequency or extent of the investigation depends on the MAS' evaluation of the risk profile of the bank, taking into account the quality of the institution's internal risk management systems and processes. In relation to a bank incorporated outside Singapore or a foreign-owned bank incorporated in Singapore, a parent supervisory authority may, with the prior written approval of the MAS, conduct an inspection in Singapore of the books of any branch or office of that bank within the country if conditions listed in the Banking Act are satisfied.

Further, under the Banking (Amendment) Bill proposed in January 2016, when a bank becomes aware of any development likely to have a material adverse effect on the financial soundness or reputation of the bank, the bank must immediately inform the MAS of such a development. This amendment will come into force on a date appointed by the Minister.

10 How do the regulatory authorities enforce banking laws and regulations?

The MAS has a range of enforcement tools at its disposal. This includes reprimands, warnings, fines, suspensions and revocations of licences, compositions, prohibitions orders, civil penalty actions and criminal penalty actions. The type of sanction depends on the nature and severity of the breach concerned.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

As stated, one of the most common enforcement issues faced by the MAS relates to anti-money laundering. In May 2016, the MAS ordered the closure of BSI Bank Limited for serious breaches of anti-money laundering requirements, poor management oversight of the bank's operations and gross misconduct by some of the bank's staff. The MAS also referred six members of BSI Bank Limited's senior management and staff to the Public Prosecutor for criminal investigations. In October 2016, the MAS also ordered the closure of Falcon Private Bank Ltd for breaching anti-money laundering requirements. Financial penalties amounting to S$1 million and S$1.3 million were also imposed on the Development Bank of Singapore Limited and UBS respectively for their breaches of anti-money laundering requirements.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

The MAS may assume control of, and manage the business of, a Singapore-incorporated bank or the part of the business of a foreign-incorporated bank in the following circumstances:

- a bank informs the MAS that it is, or is likely to become, insolvent or that it is, or is likely to be, unable to meet its obligations;
- a bank becomes insolvent or is unable to meet its obligations;
- if the MAS is of the opinion that the bank:
- is carrying on business in a manner likely to be detrimental to the interests of its depositors or its creditors;
- is, or is likely, to become insolvent, or is or is likely to be, unable to meet its obligations;
- has contravened any of the provisions of the Banking Act; or
- has failed to comply with any conditions attached to its licence; or
- the MAS considers it in the public interest to do so.

Directors and executive officers of banks are expected to be responsible for a bank's compliance with provisions of the Banking Act and other written laws. Under the Banking Act, any director or executive officer of a bank who fails to take all reasonable steps to secure compliance by the bank with any provision of the Banking Act, or any other written law applicable to banks in Singapore, are guilty of an offence and are liable, on conviction, to a fine or a term of imprisonment or both.

There is some measure of protection afforded to depositors and creditors. The MAS has the authority to conduct investigations into the books of any bank in Singapore if it has reason to believe that the bank is carrying on its business in a manner likely to be detrimental to the interests of the depositors or creditors. Further, as stated above, the MAS may assume control of and manage the business of a bank in such a situation as well. Also, banks are required to prepare and submit quarterly statements to the MAS showing all credit facilities and exposures of the bank to any related person. If the MAS is of the opinion that any credit facility or exposure of the bank to any person is to the detriment of the interests of depositors of the bank, it may direct the bank to secure repayment of the credit facility and prohibit the bank from granting any further credit facilities.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

Any bank that is, or is likely to become, insolvent, or is, or is likely to be, unable to meet its obligations, is required to inform the MAS immediately of that fact. Therefore, it follows that responsibility rests with a bank's management and directors to ensure that this is undertaken.

Further, when a bank is likely to become insolvent, its directors have a duty to take into account the interests of the creditors, such as minimising losses, when making decisions for the company.

See question 15 as to resolution plans.

14 Are managers or directors personally liable in the case of a bank failure?

Directors or managers of the bank may be made personally liable in certain situations:

- if it appears that the business of the bank had been carried out with the intent to defraud creditors or for any fraudulent purposes; or
- if a director or officer of the company was knowingly a party to the contracting of a debt when, at the time the debt was contracted, there was no reasonable or probable ground of expectation of the bank being able to repay that debt.

Also, where any company's officer has misapplied or retained or become liable or accountable for any money or property of the company or been guilty of any misfeasance or breach of duty in relation to the company, he or she may be compelled to repay or restore such property or be made to contribute the sum to the company's assets by way of compensation.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

The Monetary Authority of Singapore Act was amended in July 2017 to provide the MAS with the power to require a bank notified by it to propose, maintain and submit Recovery and Resolution Plans (RRP), which set out the procedures and establish the systems necessary to restore the financial strength and viability of the bank. The MAS expects banks to appoint an executive officer as the accountable person responsible for leading and overseeing the recovery planning process, as well as for maintaining and submitting the required information to the MAS to facilitate the resolution planning process. Upon reviewing the submitted RRP, the MAS may require the bank to make specific changes to address any material deficiencies in it or any impediments to its implementation. The MAS will also be empowered to require these banks to implement recovery measures where necessary.

Although the Monetary Authority of Singapore Act was amended in July 2017, the new provisions relating to the recovery and resolution planning have not yet come into force. Despite this, the MAS has issued a monograph titled 'MAS' Approach to Resolution of Financial Institutions in Singapore', that sets out, in brief, what its approach to recovery and resolution planning is as well as the requirements of the RRPs that are to be submitted to the MAS upon notification.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

In Singapore, capital requirements of banks differ depending on whether the bank is incorporated in Singapore or outside.

Bank incorporated in Singapore

Singapore-incorporated banks are required by the Banking Act to have a minimum paid-up capital of S$1,500 million. Subsidiaries of a Singapore-incorporated bank or wholesale banks incorporated in Singapore are required to have a minimum paid-up capital of S$100 million.

Singapore-incorporated banks must also have a capital adequacy ratio of at least 12 per cent as required by the Banking Act.

Further, MAS Notice 637 on Risk Based Capital Adequacy Requirements for Banks Incorporated in Singapore was amended to implement revisions to the Basel III capital framework. Where a Singapore-incorporated bank is designated by the MAS as a domestic, systemically important bank, it must maintain the minimum ratios as follows:

- minimum common equity Tier 1 capital adequacy ratio (CAR) of 6.5 per cent;

- minimum Tier 1 CAR of 8 per cent;
- minimum total CAR of 10 per cent; and
- minimum capital conservation buffer of at least 1.875 per cent in 2018 and 2.5 per cent in 2019.

In addition, Singapore-incorporated banks must maintain, pursuant to MAS Notice 649, a Singapore dollar liquidity coverage ratio of at least 100 per cent and an all currency liquidity coverage ratio of at least 90 per cent in 2018 and 100 per cent in 2019.

Banks incorporated outside Singapore
Foreign-incorporated banks are required by the Banking Act to have a minimum paid-up capital of S$200 million.

17 How are the capital adequacy guidelines enforced?

Under the Banking Act, the MAS has the authority to investigate the books of any bank in Singapore if it has reason to believe that it is contravening the provisions of the Act. Further, banks that fail to comply with the capital requirements are required to notify the MAS immediately.

18 What happens in the event that a bank becomes undercapitalised?

Where a bank fails to comply with the capital requirements, the MAS may restrict or suspend the operations of the bank or give such directions as appropriate.

Moreover, where the MAS is satisfied that the bank's director has wilfully caused the bank to contravene any provisions of the Banking Act or has, without reasonable excuse, failed to secure the compliance of the bank with the Act, the MAS may direct the bank to remove the directors.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

Under the Banking Act, any bank that is, or is likely to be, insolvent is required to immediately inform the MAS. Any bank that fails to do so is guilty of an offence.

Under the Monetary Authority of Singapore Act, the MAS may exercise any of the following powers where a bank is insolvent or is likely to be insolvent:

- acquire the relevant bank to immediately take any action as the Authority may consider necessary;
- appoint one or more persons as statutory adviser to advise the bank on the proper management of that part of the business as the MAS may determine; or
- assume control of and manage that part of the business of the bank as the MAS may determine.

Singapore-incorporated banks
Singapore-incorporated banks may be wound up under the Companies Act if it is insolvent. A company may be wound up under a court order on the application of the bank itself, any creditor, any contributory, or of the MAS. In addition, the Banking Act prescribes that certain bank liabilities shall have priority over all of the bank's unsecured liabilities, other than preferential debts, as specified in the Companies Act.

Foreign-incorporated banks
Foreign-incorporated banks registered under the Companies Act can also be wound up under the Companies Act. However, under the Companies Act, a liquidator of a foreign company being wound up in its home jurisdiction is required to realise or recover assets of the foreign company in Singapore and to pay any debts or liabilities incurred in Singapore before paying any remainder to the liquidator of that foreign company of the place where it was formed or incorporated.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

Capital adequacy requirements have been strengthened in Singapore. For instance, the requirement for Singapore-incorporated banks to meet a minimum common equity Tier 1 CAR of 6.5 per cent, Tier 1 CAR of 8 per cent and Total CAR of 10 per cent are higher than the Basel III minimum requirements of 4.5 per cent, 6 per cent and 8 per cent respectively.

As stated, the requirements are expected to be further strengthened, which is deemed by the requirements for Singapore-incorporated banks to maintain an all currency liquidity coverage ratio of at least 80 per cent in 2017, 90 per cent in 2018 and 100 per cent in 2019.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Under the Banking Act, a person must first obtain the approval of the Minister before becoming a substantial shareholder in a Singapore-incorporated bank. A substantial shareholder is a person who has an interest in 5 per cent or more of the bank's total votes.

Also, a person must first obtain the approval of the Minister before becoming:

- a 12 per cent controller;
- a 20 per cent controller; or
- an indirect controller.

A 12 per cent controller refers to a person who holds 12 per cent or more of the total issued shares or is in a position to control voting power of 12 per cent or more in the bank. A 20 per cent controller refers to a person who holds 20 per cent or more of the total issued shares or is in a position to control voting power of 20 per cent or more in the bank. An indirect controller refers to a person in accordance with whose directions, instructions or wishes the directors of the bank are accustomed or under an obligation to act, or a person who is in a position to determine the policy of the bank.

22 Are there any restrictions on foreign ownership of banks?

There are currently no restrictions on bank foreign ownership. However, as stated in question 21, any acquisition that results in a person becoming a substantial shareholder, a 12 per cent controller, a 20 per cent controller or an indirect controller of a Singapore-incorporated bank would require MAS prior approval.

23 What are the legal and regulatory implications for entities that control banks?

Under the Banking Act, the Minister may serve a written notice of objection on a substantial shareholder, a 12 per cent controller, 20 per cent controller or indirect controller of Singapore-incorporated banks, if he or she is satisfied that that person is not a fit and proper person, or if, having regard to the likely influence of the person, the bank is no longer likely to conduct its business prudently or comply with the provisions of the Banking Act. The Minister may also direct the transfer or disposal of all or any of the shares in the bank held by the person or any of his or her associates.

Further, the MAS may direct any Singapore-incorporated bank to obtain from its shareholders and to transmit to the MAS any information relating to its shareholders that the MAS may require for the purpose of ascertaining or investigating into the control of shareholding or voting power in the bank.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

As stated in question 23, the Minister may serve a written notice of objection or direct the transfer or disposal of all or any of the shares in the bank held by the person or any of his or her associates where the Minister is satisfied that that person is not a fit and proper person or if, having regard to the likely influence of the person, the bank is no longer likely to conduct its business prudently or to comply with the provisions of the Banking Act. Therefore, there is an implicit duty on the entities or individuals that control banks to be a fit and proper person, and not to negatively influence the bank in such a way that it is no longer likely to conduct its business prudently or to comply with the provisions of the Banking Act.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

In the event that a bank becomes insolvent, the MAS may assume control of, and manage that part of the bank's business, as the Authority may determine. This may have implications for its shareholders.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

See question 21.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

As stated in question 22, there are currently no restrictions on bank foreign ownership. However, any acquisition that results in a person becoming a substantial shareholder, a 12 per cent controller, a 20 per cent controller or an indirect controller of a Singapore-incorporated bank requires MAS prior approval. One of the conditions listed in the Banking Act relating to such an approval is that the Minister must be satisfied that it is in the national interests to approve the acquisition. Therefore, this may have implications for foreign acquirers.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

Under the Banking Act, in order for approvals to be granted to a person for control of Singapore-incorporated banks:

- the MAS must be satisfied that:
- the person is a fit and proper person; and
- having regard to the likely influence of the person, the designated financial institution will or will continue to conduct its business prudently and comply with the provisions of this Act; and
- the Minister must be satisfied that it is in the national interest to grant such an approval.

29 Describe the required filings for an acquisition of control of a bank.

As stated in question 29, a person must first obtain the approval of the Minister before becoming a substantial shareholder, a 12 per cent controller, a 20 per cent controller or an indirect controller in a Singapore-incorporated bank.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The time required for regulatory approval depends on the facts of the circumstances, including the characteristics of the potential acquirer.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

Spanish banking regulation is primarily focused on ensuring the stability of banks and other financial intermediaries, the efficiency of the financial markets and protecting the interests of clients and investors.

The global financial crisis of 2008 has shown the need to enhance the quality of prudential regulation of credit institutions. In Spain, in parallel with the rest of the European Union (EU) in general, and the eurozone in particular, this is achieved by way of a set of regulations that becomes more complex and wide-ranging every day, aimed at monitoring bank solvency and risk management on an ongoing basis.

Apart from solvency and prudential requirements, Spanish banking regulation is based on activities reserved for credit institutions (ie, receiving deposits from clients is only allowed to them), suitability requirements for directors and significant shareholders, corporate governance and the specific restructuring and resolution system of banks with financial difficulties.

This banking regulation is highly influenced (increasingly so) by determined EU regulation, especially in relation to solvency and capital requirements and the Single Supervisory Mechanism (SSM).

2 Summarise the primary statutes and regulations that govern the banking industry.

The primary statute governing the banking sector is Law No. 10/2014, on organisation, supervision and solvency of credit institutions. The purpose of this Law is twofold: implementing Directive 2013/36/EU (CRD IV) into Spanish law and recasting Spanish banking regulation into one single set of provisions. This Law governs:

- regulatory requirements and the authorisation process for incorporating banks;
- acquisition of significant holdings;
- requirements applicable to directors and senior officers (suitability, incompatibilities and limitations);
- corporate governance (including remuneration policies and internal functions);
- solvency;
- supervision; and
- disciplinary regime.

Law No. 10/2014 is developed by Royal Decree-Law No. 84/2015 and Circular No. 2/2016 of Banco de España (Bank of Spain), which regulates the aspects governed by it in more detail. Together with Law No. 10/2014, the pillar of financial stability is Law No. 11/2015, which governs the recovery and resolution of banking institutions and implements the Banking Recovery and Resolution Directive 2014/59/EU (BRRD).

Particular areas of the banking sector are governed by specific rules, including:

- Law No. 16/2011 (consumer credit);
- Law No. 16/2009 (payment services);
- Order No. EHA/2899/2011 (transparency of banking services); and
- several Bank of Spain circulars on prudential supervision and information reporting.

The Spanish legal framework is completed by directly applicable European regulation, such as Regulation (EU) No. 575/2013 on prudential requirements for credit institutions (CRR).

3 Which regulatory authorities are primarily responsible for overseeing banks?

The Bank of Spain is the national banking authority, responsible for supervision of Spanish banks. However, since the implementation of the SSM, it shares supervision duties with the European Central Bank (ECB). See question 9 for further information.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Deposits of up to €100,000 per depositor and per institution (with exceptions) are insured by the Deposit Guarantee Fund of Credit Institutions (FGD). The purpose of the FGD is to guarantee reimbursement of deposits to the clients of credit institutions. Cash and securities deposits are both covered by the FGD through two different divisions (for cash and securities deposits).

The FGD has its own legal personality, and it is mainly funded by the annual contributions of its members, namely all the Spanish credit institutions (banks, saving banks and credit unions), and branches of non-EU banks, if the deposits held in Spain are not covered by a guarantee system in their home country or if the protection provided by their national guarantee system is lower than the FGD's (in this case, the branches will join the FGD only for the difference between the FGD and their home country guarantee system).

Annual contributions are determined by the FGD's management committee (whose members are appointed by the Ministry of Economy, the Ministry of Finance, the Bank of Spain and banking associations). The FGD's financial resources must be at least 0.8 per cent of the guaranteed deposits (for the cash deposit division) and 0.3 per cent of the guaranteed securities (for the securities division).

FGD-guaranteed deposits are excluded from contribution to bail-in in the event of bank resolution. See question 13 for more information.

The FGD has contributed to the financial assistance of Spanish banks in the past through asset-protection schemes (eg, Caja Castilla-La Mancha, Caja de Ahorros del Mediterráneo and Unnim). However, the Spanish public authorities have acquired ownership interest in banks in resolutions processes through the Fund for Orderly Bank Restructuring (FROB). Since 2009, the FROB has provided public funds amounting to €53.6 billion as financial assistance for restructuring of the Spanish banking system in different forms of capital and become the controlling owner of a significant number of banking institutions. Currently, the FROB is divesting gradually regarding these institutions by selling its ownership interest to other banks and investors, holding stakes only in Bankia SA (through BFA Tenedora de Acciones SA).

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

The legal regime on the transactions that banks may carry out with their affiliates is made up of different rules and provisions. Their limitations refer mainly to the implications of intra-group transactions on calculating the banks' regulatory own funds. For example, holdings higher than 10 per cent in non-financial institutions should be deducted from own funds, and no risks taken against the non-consolidated part of the bank's group can be higher than 25 per cent of its own funds.

Additionally, there are restrictions on the possibility of incorporating affiliates abroad. In particular, incorporating a foreign credit institution in a non-EU member state and acquiring a significant stake in an institution are subject to the authorisation requirements of the Bank of Spain.

With respect to the activities that may be carried out by Spanish financial institutions, they depend on their specific regulatory status. Credit institutions (ie, banks, saving banks and credit unions) have the widest scope of activities, as they are the only institutions that may take deposits from the public. They may also render other banking services (eg, financing, payment services, e-money), investment services and even intermediation in insurance products. However, they may not manage collective investment schemes, although they may manage their investment portfolios under the activity of discretionary portfolio management upon delegation of the relevant management company.

The rest of financial institutions have a limited scope of services:

- investment firms may render investment services but not carry out banking activities;
- specialised credit institutions may only grant financing, under any form (consumer financing, mortgage loans, etc);
- payment entities may only provide payment services. Hybrid payment entities may also grant financing;
- electronic money entities may issue e-money and provide payment services; and
- crowdfunding platforms, whose activities are limited to promote and manage the crowdfunding platforms launched by them.

All the financial institutions above have an exclusive corporate purpose, meaning that they may only render the relevant financial services provided by law with exclusion of other activities. Exceptionally, they may carry out other activities if they are reasonably linked to their financial business.

6 What are the principal regulatory challenges facing the banking industry?

In recent years, Spanish regulation has taken important steps to consolidate the banking sector. Aspects such as transparency and client protection have been significantly developed, while consolidation of a prudential regime for resolution and restructuring of the banking sector and a harmonised regime on solvency have taken place.

However, the challenges to the Spanish banking sector are practical in nature. In particular, three aspects should be analysed in the coming years:

- the implications of providing third-party service providers with access to clients' information, following the obligations set out in Directive 2366/2015/EU (PSD2);
- the cooperation or competition relationships with firms applying disruptive technologies to fintech; and
- the business of securities distribution under the regime provided in Directive 2014/65/EU (MiFID II), which restricts the possibility to receive inducements from issuers and global distributors.

7 Are banks subject to consumer protection rules?

Banks are subject to general consumer protection rules, as well as to specifically approved bank consumer protection regulations.

The general consumer protection rules are compiled in Legislative Royal Decree-Law No. 1/2007, approving the recast text of the Law on the Protection of Consumers and Users. Legislative Royal Decree-Law No. 1/2007 provides a catalogue of possible contractual clauses with consumers that may be considered abusive, and therefore, void. The catalogue considers unfair those clauses linking the agreements to the will of the company, implying a restriction of consumers' basic rights or a lack of reciprocity between the parties to benefit the company. The catalogue includes all the abusive clauses listed in Annex to Council Directive 93/13/EEC of 5 April 1993, on unfair terms in consumer contracts, plus others, such as those stipulating the explicit submission to a court other than that corresponding to the consumer by virtue of his or her address, the place where the obligation is met, the location of the real estate asset, or the submission of the contract to foreign law with respect to the place where the consumer makes the business statement or where the company draws up contracts of an identical or similar nature.

Regarding specific banking regulation on consumer protection, the primary statute is Order No. EHA/2899/2011, which provides the general framework on banking transparency and the protection of bank service clients. It also governs the specific regime for mortgage loans and credits. Under this Order, banking institutions are required to provide clients with clear, appropriate, sufficient, objective and non-misleading pre-contractual information. This obligation is supplemented by the duty of financial institutions to provide clients with sufficient and suitable explanations about the main terms of any banking services.

The regulation of the Order in relation to credit and loans is especially notable. As a general principle, banking institutions are required to assess the clients' solvency before entering into any loan or facility agreement. This assessment may be carried out by considering the information provided by the clients themselves for this purpose, without prejudice to the banks using other sources they may consider appropriate. Additionally, the obligation to provide pre-contractual information is particularly stringent (if not burdensome and redundant) in relation to mortgage loans. There are at least three different documents that should be provided to clients on a pre-contractual basis:

- pre-contractual information, a standardised document describing the main terms of the mortgage financing, merely for guidance purposes as it is not prepared considering the personal information obtained from clients;
- a personalised information sheet, which provides clients with personalised information about the loan that may help them compare the loans available on the market and make a reasoned decision on whether to enter the loan agreement.
- once the client and the banking institution have decided to enter into a mortgage loan agreement, the client may request the bank to provide a binding offer, which will be valid for at least 14 calendar days from its delivery date.

The consumer protection banking regulation is completed by a set of specific provisions applicable to particular aspects of the banking sector, including:

- consumer credit, governed by Law No. 16/2011 (implementing Directive 2008/48/EC), which also requires banks to provide pre-contractual information on a standardised basis under the consumer credit information form;
- mortgage loans, where Law No. 1/2013, on measures for reinforce the protection of mortgage debtors, debt restructuring and social renting, which was approved in response to the high number of evictions in the recent years;
- distance marketing on financial services, governed by Law No. 22/2007, under which consumers may withdraw from the agreement without penalty and without giving any reason within a 14-day period;
- payment services, regulated by Law No. 16/2009, which also provides obligations on the information to clients and their rights, along with Royal Decree-Law No. 19/2017 on comparability of fees and payment accounts with basic features; and
- investment services, subject to the Securities Market Law (Legislative Royal Decree-Law No. 4/2015) and Royal Decree-Law No. 217/2008, implementing EU MiFID Directives into Spanish law.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

At this time, it is difficult to anticipate the next trends of regulatory provisions in Spain because prudential regulation has been approved and implemented recently by way of directly applicable EU regulation (ie, SSM and CRR) and its local developments. Any further change will be conducted at EU level.

With respect to other aspects of the banking business, Spanish regulation has been reinforced in recent years by way of approval of several sets of rules covering different aspects (corporate governance, consumer protection, transparency, etc) that are at a stage of consolidation rather than restructuring. There is, however, one aspect that should be followed up in the coming years: the use of intensive and disruptive technology, not only with respect to the provision of services (eg, robo-advisers), but also in relation to market infrastructures (eg, use of blockchain technology in post-trading services) and prudential supervision (RegTech applications). All these technological applications may lead the regulators to approve specific regulation in the future, which will have a significant impact on the activities of banks.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The SSM modified the Spanish banks' supervision regime on 4 November 2014. Currently, Spanish banks are supervised by the ECB and the Bank of Spain.

From a general perspective, the ECB's supervisory tasks are related to:

- granting and withdrawing authorisation to credit institutions;
- cross-border services in EU states not participating in the SSM;
- notifications of acquisition of qualifying holdings;
- supervisory reviews (eg, stress tests);
- compliance with the ECB's resolutions on prudential and governance requirements (including own resources, large exposure limits, liquidity and leverage);
- supervision of consolidated groups;
- recovery plans; and
- early intervention.

The way in which the ECB's supervisory tasks are carried out differs depending on whether the relevant credit institution qualifies as a significant or less significant supervised entity (also on a group basis, as the case may be). Qualification as significant or less significant depends on factors such as size, systemic importance, cross border activities, etc. In particular, the ECB is responsible for directly supervising significant institutions or groups, while the Bank of Spain (as the national competent authority) is responsible for directly supervising less significant institutions or groups. In any event, the Bank of Spain is subject to the overview of the ECB, which may address general instructions on less significant institutions to the Bank of Spain and retains investigatory powers over all supervised entities within the SSM. At any rate, Spanish significant institutions, by application of the size criterion, account for more than 90 per cent of the country's total deposits, so the ECB is, by far, in charge of most of the Spanish financial system.

The ECB's supervision powers include requesting information from supervised entities, conducting investigations and on-site inspections and imposing administrative penalties in the event of intentional or negligent breach of the obligations provided under the directly applicable EU regulation. The Bank of Spain assists the ECB in implementing any acts relating to the exercise of the ECB's supervisory tasks, including the ongoing, day-to-day supervision of significant institutions and related on-site inspections. Additionally, the ECB may exercise all the powers attributed to the Bank of Spain under EU directives and regulations and may instruct the Bank of Spain to make use of its powers under the Spanish national law.

Regarding the less significant institutions, the Bank of Spain has direct supervision powers in relation to:

- prudential requirements;
- cross-border activities in EU states not participating in the SSM;
- robust governance (risk management, internal control, remuneration policies, etc); and
- stress tests.

Some responsibilities in relation to these less significant institutions are allocated to the ECB, including the granting and withdrawal of authorisations to credit institutions and the assessment of notifications of acquisition and disposal of qualifying holdings in credit institutions, except in the case of a bank resolution. The Bank of Spain has powers to adopt all relevant supervisory decisions, request information and perform on-site inspections.

In any case, supervisory tasks not conferred on the ECB are carried out by the Bank of Spain. Such tasks are related to supervising:

- non- 'credit institution' entities (ie, those not authorised to take deposits);
- non-EU institutions operating through branches or free to provide services;
- receiving notifications on the right of establishment and the free provision of services;
- prevention of money laundering and terrorist financing; and
- consumer protection.

The Bank of Spain has discretionary powers to carry out inspections in the credit institutions for matters for which it is responsible. Apart from this, the Bank of Spain has to review the systems, strategies and procedures of the credit institutions and the risks taken by them, in order to determine whether they have implemented solid risk management. The frequency of these reviews depends on the systemic importance, nature and complexity of the activities of the relevant banks.

10 How do the regulatory authorities enforce banking laws and regulations?

As stated in question 9, banking regulation may be enforced by the ECB and the Bank of Spain under the SSM.

The widest enforcement powers are conferred to the ECB, which is not only competent to enforce EU regulation (including regulations directly applicable and directives conferring powers to the Bank of Spain), but also national laws in relation to powers not conferred to the ECB under the SSM Regulation.

The enforcement powers of both the ECB and the Bank of Spain include:

- restricting or limiting the bank business and operations;
- requesting divestment of activities posing excessive risks;
- requiring institutions to limit variable remuneration;
- requesting the use of net profits to strengthen own funds;
- imposing specific liquidity requirements;
- removing members from the management body at any time; and
- imposing administrative pecuniary penalties for breaching regulations.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

In recent years, there have been two enforcement issues with important implications in the banking sector: the promotion of preferred shares to retail investors and the execution of agreements and transactions for hedging floating rates.

Between 2005 and 2010, preferred shares were markedly commercialised to retail investors, mainly by savings banks, taking advantage of their use as capital instruments for solvency purposes. They were typically marketed as an alternative to deposits (with low returns at that time). Retail investors were provided with insufficient and misleading information about the product's characteristics and risks. Many of them have been able to get their funds back, alleging lack of information in court claims and arbitration systems. In order to prevent these cases, the Spanish government has approved Order No. ECC/2316/2015, which requires classifying products by risk level using a colour and numeric scale.

With respect to agreements for hedging floating rates, products such as over-the-counter derivatives were marketed to retail clients and small companies without providing sufficient information about the risks of these products. Many of them have been declared null and void by the courts because of the misleading information provided. However, the most relevant case is the wide spread insertion of floor clauses (ie, minimum interest rate) in consumer mortgage loan agreements, to those who have been unable to the take advantage of the low floating market rates. Based on the European Union Court of Justice judgment of 21 December 2016 (joined cases C-154/15, C-307/15 and C-308/15), which declares the nullity of such floor clauses and requires the refund of all payments made by consumers under them, the Spanish government approved Royal Decree-Law No. 1/2017, under which banks have to implement pre-judicial claim systems allowing their clients to apply for such repayment.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Under Law No. 10/2014, the Bank of Spain may decide to intervene in a credit institution, or to provisionally replace its governing body, if:

- a significant holding in the credit institution has been acquired without complying with the applicable regime (see question 21 below), or there are accredited reasons to understand that the influence of the acquirers may jeopardise the sound and prudential management of the institution and its financial situation; or
- there is evidence that the situation of the credit institution may damage its stability, liquidity and solvency, when such situation is different from those governed by Law No. 11/2015.

Additionally, credit institutions may be intervened in the cases provided by Law No. 11/2015 (ie, the set of rules establishing the general framework for the restructuring and resolution of credit institutions (and investment firms), which are the same outlined in the BRRD).

Bank intervention and resolution is governed by the following principles:

- shareholders will have to bear losses first;
- creditors will bear losses after the shareholders and pursuant to the seniority of their credits;
- creditors with same seniority will be treated equivalently;
- shareholders and creditors will not bear higher losses than those that would have been borne under an insolvency proceeding;
- directors may be replaced and will be liable for any damages caused to the bank; and
- guaranteed deposits (see question 4) are fully protected.

The mechanisms of Law No. 11/2015 were applied in June 2017 to the resolution of Banco Popular Español SA, one of the largest Spanish banks. Following Regulation (EU) No. 806/2014 and the ECB's statement about the significant deterioration of the liquidity of the bank, the European Single Resolution Board (SRB) resolved to transfer all shares and capital instruments of the bank to Banco Santander SA for €1. Such resolution was notified to the Spanish resolution authority (FROB) for implementation.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

The role of management and directors in a bank's failure depends on the specific bank situation.

In any case, Spanish credit institutions must draw up and maintain a recovery plan providing measures to be taken to restore their position in the event of a significant deterioration in their financial situation. The plan must be approved by the bank's management body and updated at least annually, or after a material change in its situation. See question 15 for further information.

In addition to the recovery plan, and also on a preventive basis, the resolution authority, after consulting the FROB and the competent authority, as well as the resolution authorities of the jurisdictions in which any significant branches are located insofar as is relevant to the significant branch, should draw up a resolution plan for each institution that is not part of a group subject to consolidated supervision. This resolution plan provides the resolution actions which will be taken by the resolution authority it the bank meets the conditions for resolution.

The resolution plan may not assume any extraordinary public financial support, any central bank emergence liquidity assistance or any central bank liquidity assistance provided under non-standard collateralisation, tenor and interest rate terms. Resolution plans should be reviewed and updated at least annually and after any material changes.

In the case of groups, group-level resolution authorities, together with the resolution authorities of subsidiaries and after consulting the resolution authorities of significant branches insofar as is relevant to the significant branch, draw up group resolution plans. Group resolution plans should include a plan for resolution of the group headed by the parent undertaking as a whole, either through resolution of the parent undertaking or through break-up and resolution of the subsidiaries. In the case of bank resolution, the members of the board of directors and the managing director will be replaced, unless considered strictly necessary for achieving the purpose of the resolution. In any case, directors must provide all possible assistance under the resolution process.

14 Are managers or directors personally liable in the case of a bank failure?

Directors' liability in the event of bank failure may be civil, criminal and administrative.

Civil liability implies that the directors may be liable for any damages caused if the bank failure is because of gross negligence or wilful misconduct of the directors.

Criminal liability exists in cases of:

- false accounting;
- negligent business management;
- destruction of required documentation; and
- fraudulent transactions, etc.

From an administrative perspective, pecuniary sanctions may be imposed on directors in the event of obstructing the functions of the authorities with respect to analysis of the bank's situation.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

As a preventive measure under Law No. 11/2015, Spanish credit institutions must draw up and maintain a recovery plan providing measures that would be taken to restore their position in the event of a significant deterioration in their financial situation. The recovery plan must include quantitative and qualitative indicators that will be taken as reference to initiate the relevant measures. The plan may not assume any access to, or receipt of, extraordinary public financial support.

The plan must be approved by the bank's management body and reviewed by the supervisor. It must be updated at least annually, or after a material change in its situation (its business, organisational structure, financial situation, etc), although the competent authorities may require banks to update their recovery plans more frequently.

In the case of consolidated groups, recovery plans should consist of a recovery plan for the group headed by the parent undertaking as a whole and provide measures that may be required to be implemented by the parent undertaking and each individual subsidiary.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Spanish credit institutions are subject to Regulation (EU) 575/2003 (CRR), which provides the general prudential requirements for all the European credit institutions and investment firms by implementing the standards of the Basel Committee of December 2010 (Basel III).

Under the CRR, banks must at all times meet the following own funds requirements:

- a common equity Tier 1 (CET1) capital ratio of 4.5 per cent;
- a Tier 1 capital ratio of 6 per cent; and
- a total capital ratio of 8 per cent.

The CRR requirements are supplemented by individual arrangements established by the national authorities. In the case of Spain, these are provided by Royal Decree-Law No. 84/2015, which sets the levels of countercyclical capital buffer and systemic risk buffer, and Circular No. 2/2016 of the Bank of Spain.

In addition, Spanish banks should have a minimum share capital of €18 million.

With respect to contingent capital arrangements, the CRR requires that instruments recognised in the Additional Tier 1 capital of a credit institution be written down, or converted into CET1 instruments, when the CET1 capital ratio falls below 5.125 per cent, without prejudice that institutions may issue Additional Tier 1 instruments if there is a trigger higher than 5.125 per cent. Apart from this, there are no other forms of contingent capital for the purposes of meeting regulatory capital requirements.

17 How are the capital adequacy guidelines enforced?

Credit institutions are required to report information about their financial situation (own funds, liquidity, leverage, etc) to the authorities on an ongoing basis. Based on such information, the Bank of Spain may detect whether a bank is not duly capitalised and, if this is the case, to proceed as described in question 18.

18 What happens in the event that a bank becomes undercapitalised?

Credit institutions breaching the combined capital buffers are required to draft a capital conservation plan, which will be submitted to the Bank of Spain within five days of the date on which the breach is verified. This plan will have to provide an estimate of balance, profit and losses, information about the measures for increasing capital ratios and a schedule for increasing the bank's own resources. The Bank of Spain will have to approve the plan; otherwise, new restrictions on distributions and a new schedule may be imposed.

If it is foreseeable that the bank will not be able to comply with the solvency requirements in the near future, but it is in a position to revert to the fulfilment on its own, then the Bank of Spain may adopt certain preventive measures, including:

- requesting the bank's management bodies to apply additional measures;
- requesting the dismissal or replacement of directors; and
- appointing a representative to monitor the process.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

If, despite the measures mentioned in question 18 above, a bank is not able to comply with the solvency requirements in the near future, or if it is insolvent (or will be in the near future), the FROB may initiate the bank's resolution, which implies replacing the directors. The bank's resolution may result in the sale of the bank's business, the transfer of the assets and liabilities to a bridge institution or a management company, or the internal recapitalisation of the bank. The process is handled under Law No. 11/2015.

Banks are not exempted from ordinary, court-driven insolvency proceedings (eg, under the general Insolvency Law No. 22/2003). Banks may end up filing for bankruptcy if the FROB decides, under Law No. 11/2015, that it is not worthwhile to resolve the bank otherwise, or subsequent to the application of special resolution or recovery tools under Law No. 11/2015, an institution (with its legacy assets) may be rerouted to the bankruptcy court.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

The capital adequacy rules are not expected to be amended in the near future. The approval of CRD IV and CRR in the EU means the establishment of a single book harmonising the banking prudential regulation in the EU. The development of this regulation was approved in Spain by way of Law No. 10/2014, Royal Decree-Law No. 84/2015 and Circular No. 2/2016 of the Bank of Spain. Note, however, that this regulation system is to be phased in, and has not entirely been implemented, and further amendments may be expected as new standards are agreed in the Basel Committee in the next few months (Basel IV).

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

The acquisition or transfer, either directly or indirectly, of a significant holding in a bank is subject to the ECB's prior consent, upon the proposal of the Bank of Spain. For this purpose, a stake is considered 'significant' if:

- it exceeds 10 per cent of the capital or voting rights;
- together with the stake already held by the potential acquirer, it reaches 20, 30 or 50 per cent of the capital or voting rights or, regardless of the amount, it results in the potential acquisition of control over the institution; or
- whatever its amount, it enables the holder to exercise 'significant influence' (for these purposes, the capacity to appoint or dismiss a director is always deemed 'significant influence').

Consent to the transaction will not be granted if the acquirer does not meet the requirements of business reputation and solvency or if, as a result of the transaction, it would not be possible to supervise the bank properly. Additionally, prior to granting authorisation for the transaction, the Bank of Spain will request a report from the anti-money laundering (AML) authority (SEPBLAC), which will also analyse the transaction and the acquirer.

22 Are there any restrictions on foreign ownership of banks?

There is no general restriction, that is, foreign persons may own banks. Notwithstanding, specific prudential rules apply.

When incorporating a bank, if it is to be controlled by another financial institution authorised in an EU member state, or by its shareholders, the Bank of Spain will have to inform the relevant national authority about the incorporation process before granting the authorisation.

However, once the transaction is completed, if the persons controlling the Spanish bank are to be domiciled or authorised in a non-EU state, the Bank of Spain may require a guarantee covering all the activities of the Spanish bank.

23 What are the legal and regulatory implications for entities that control banks?

Entities controlling banks are subject to limited supervision of the Bank of Spain for prudential purposes. In particular, entities controlling banks will have to comply with the duties and responsibilities referred to in question 24.

Controlling entities, and holders of significant stakes, are liable to administrative sanctions if they exercise a negative influence over, or otherwise destabilise, the entity in question.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

In addition to question 23, parent companies of banks are subject to suitability requirements that also apply to their directors, meaning that directors and senior officers of the parent companies must comply with the requirements of business reputation, experience and independence applicable to bank directors. For example, the parent company's proposal for appointing directors will have to be submitted to the Bank of Spain prior to its effectiveness. The Bank of Spain may refuse the appointment if the proposed directors do not meet the suitability requirements.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

Under the resolution regime of banks, shareholders will be the first in bearing losses, but they will not bear any losses higher than those that the shareholders would have to bear within an insolvency proceeding. In the case of banks, this means that the maximum losses that shareholders must bear is their contribution to the share capital. Additionally, any debts that shareholders holding at least 5 per cent of the share capital may have against the bank are considered subordinated credits, meaning that they will have less seniority in comparison with other credits in the banks' accounts.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The acquisition of a significant holding in a bank is subject to ECB approval (non-opposition), upon the proposal of the Bank of Spain. This proposal will be issued by previously considering the SEPBLAC's report on the implications of the transaction from the perspective of AML.

For this purpose, a significant holding means a direct or indirect holding in a bank representing 10 per cent or more of the share capital or of the voting rights, or that makes it possible to exercise a significant influence over the management of that bank.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The regulatory process may be slightly different if the acquirers are foreign persons. As discussed in question 22, if the control of the bank will be held by another financial institution authorised in an EU member state, or by its shareholders, the relevant national authorities of such state will have to be informed by the Bank of Spain.

If, however, the control of the bank will be held by persons domiciled or authorised in a non-EU state, then the Bank of Spain may require a guarantee covering all the activities of the Spanish bank.

In general, the Bank of Spain is receptive to foreign acquirers and has given the go-ahead to certain purchases of Spanish banks by investors located in non-European jurisdictions. The Bank of Spain's assessment is focused on the continuity of the proper prudential supervision of the bank, including the fulfilment of the AML regulation, and that the jurisdiction of the purchasers should not be an obstacle per se.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

The factors analysed by the Bank of Spain when assessing the acquisition of control in a Spanish bank are mainly:

- the business reputation of the acquirer and the persons controlling it;
- the directors and senior officers of the bank who may be appointed as a result of taking control, who will have to comply with the requirements of business reputation, experience and independence;
- the financial solvency of the acquirer for complying with the commitments in relation to the activities to be carried out by the bank;
- the capacity of the bank for complying, on a stable basis, with the applicable disciplinary rules;
- the acquisition of control should neither jeopardise the proper prudential supervision of the bank, nor impede the exchange of information between the competent authorities and the allocation of duties and responsibilities between them; and
- the existence of signs that may reasonably lead to suspicion that the transaction is related to money laundering and terrorism financing.

29 Describe the required filings for an acquisition of control of a bank.

The following information must be filed with the Bank of Spain as part of the authorisation process for acquiring control of a Spanish bank:

- information about the acquirer and its controlling persons:
  - identity;
  - group structure;
  - composition of the managing bodies;
  - reputation and experience;
  - financial situation;
  - existence of links and relationships (financial and non-financial) with the bank; and
  - assessments carried out by international AML bodies; and
- information about the transaction:
  - purpose;
  - price and payment terms;
  - impact on the distribution of voting rights; and
  - financing of the transaction and existence of agreements with third parties or other shareholders in relation to the transaction; and
- impact on the bank:
  - business and strategic plans;
  - amendments to the corporate governance structure;
  - internal controls; and
  - AML processes.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The Bank of Spain and ECB must accept or oppose to the transaction within 60 business days following the receipt of the application, provided it includes all the required information. This period may be extended if the application is not complete or if the Bank of Spain has to consult other regulators.

If there is no express resolution from the Bank of Spain on the proposed transaction within this period of 60 business days, authorisation may be considered granted.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The Swiss banking sector is subject to official supervision.

From a Swiss perspective, a banking activity means the taking of deposits from the public (or by way of refinancing from other banks) for the purpose of financing a large number of persons or entities. Banking activities may only be conducted in or from Switzerland if the relevant entity has been granted a licence by the Swiss Financial Market Supervisory Authority (FINMA).

FINMA grants the licence to the legal entity pursuing the banking activities (but not to managers or shareholders). The various criteria to be complied with in order to obtain a licence are set out in the Federal Banking Act. Among other things, the applicant must establish that the persons entrusted with its management enjoy a good reputation and thereby assure the proper conduct of business operations (ie, guarantee of irreproachable activity). If, at a later stage, any of the licence requirements are no longer satisfied, FINMA may take administrative measures, including, in extreme cases, the withdrawal of the banking licence.

One of the most highly publicised aspects of Swiss banking regulation is Swiss banking secrecy. Disclosure of information pertaining to the client–bank relationship is prohibited under the Federal Banking Act. Banking secrecy rules encompass all data that pertain to the contractual relationship between the bank and its clients. Disclosure means communication to any third party, including the parent company of the bank as well as the supervisory authority of this parent company or any other affiliate. As a matter of principle, any disclosure amounts to a breach of banking secrecy and may trigger administrative and criminal sanctions, as well as civil liability, for the bank concerned. Exceptions apply under certain circumstances, for instance, in the context of consolidated supervision over an international banking group or pursuant to a formal request issued by Swiss public authorities (acting, as the case may be, based on a request for international judicial or administrative assistance issued by a non-Swiss public authority, including foreign financial intelligence units for anti-money laundering (AML) purposes). Since 1 January 2017, the situation has, however, changed with the implementation of the automatic exchange of information (see question 6).

2 Summarise the primary statutes and regulations that govern the banking industry.

The Federal Banking Act is the main statute governing the conduct of banking activities in, or from, Switzerland. The provisions of the Federal Banking Act have been detailed in several implementing ordinances issued by the Swiss government (Swiss Federal Council) and by FINMA. Furthermore, FINMA issued a series of circulars setting out its interpretation of the regulatory framework. These regulations are complemented by the Federal Act on the Swiss Financial Market Supervisory Authority (FINMASA), which can be considered as a framework law governing the supervisory activities and instruments of FINMA.

In addition to being licensed as banks, most Swiss financial institutions need a licence as a 'securities dealer'. Securities dealing activities are governed by the Swiss Federal Act on Stock Exchanges and Securities Trading (SESTA), as well as the Financial Markets Infrastructure Act (FMIA) and their respective implementing ordinances. From a Swiss perspective, 'securities dealing' refers to five broad categories of activities, namely:

- issuing houses;
- derivative suppliers;
- market makers;
- brokers operating on a short-term basis for their own accounts; and
- brokers acting in a professional manner for the account of their clients.

Swiss banks also qualify as 'financial intermediaries' within the meaning of the Swiss anti-money laundering legal framework and, as such, fall within the ambit of the Federal Anti-Money Laundering Act (AMLA) and its implementing ordinances.

A Swiss bank may also serve as custodian for collective investment schemes. This type of activity is subject to the Collective Investment Scheme Act and its implementing ordinances.

Furthermore, the organisation and operation of financial market infrastructures are governed by the FMIA, which also sets out the general requirements regarding market behaviour rules.

Finally, the Swiss banking supervision system allows for the delegation of certain duties to self-regulating organisations. The Swiss Bankers Association and the Swiss Funds and Asset Management Association regularly issue self-regulatory guidelines to their members, which FINMA recognises as minimum standards that need to be complied with by all Swiss banks. This is particularly true regarding the duty of due diligence in identifying the contracting party and the beneficial owner (Agreement on the Swiss Bank's Code of Conduct with regard to the Exercise of Due Diligence), the rules of conduct for securities dealing and the guidelines governing portfolio management.

3 Which regulatory authorities are primarily responsible for overseeing banks?

FINMA is the supervisory authority in charge of supervising, in particular:

- banks;
- securities dealers;
- collective investment schemes and their managers;
- insurance companies; and
- other financial intermediaries for anti-money laundering purposes.

Systemic risks are in turn addressed by the Swiss National Bank. FINMA and the Swiss National Bank have agreed on principles to coordinate their respective tasks.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

As a general rule, deposits with Swiss banks are not insured by any public authority in Switzerland.

Special rules apply to cantonal banks; namely, banks that are controlled by a Swiss canton (at least one-third of the capital and voting rights must be held by a Swiss canton in order for a bank to be characterised as 'cantonal'). The relevant cantonal legislation will specify to what extent the liabilities incurred by a cantonal bank are insured by the concerned canton.

In addition, the Federal Banking Act provides for a privileged deposit scheme. Small cash deposits, up to an amount determined by FINMA on a case-by-case basis, are paid out as soon as possible to each depositor following the bankruptcy of a Swiss bank and are not subject to the standard liquidation procedure set out in the Federal Banking Act and the Federal Debt Enforcement and Bankruptcy Act.

In addition, Swiss banks are under an obligation to participate in a deposit-protection scheme that aims at securing the payment of cash deposits up to 100,000 Swiss francs. Such deposits also rank in a privileged class in the bankruptcy estate of a Swiss bank. The deposit-protection scheme is limited to a maximum aggregate amount of 6 billion Swiss francs.

Finally, banks are required to secure preferential deposits by claims against third parties secured in Switzerland, or by assets in Switzerland, for a total amount corresponding to at least 125 per cent of the preferential deposits they hold. FINMA may increase this amount or grant derogations.

The Federal Banking Act includes in addition specific provisions on reorganisation procedures, prompter repayment of preferential deposits and the continuation of basic banking services during insolvency proceedings.

On 15 February 2017, the Swiss Federal Council instructed the Federal Department of Finance (FDF) to prepare a consultation draft aiming at strengthening the current deposit protection scheme on the basis of the recommendations of the group of experts on further development of financial market strategy and the ongoing discussions between the State Secretariat for International Financial Matters, FINMA and the Swiss National Bank on this issue. In this context, the Swiss Federal Council has retained a certain number of measures that are to be implemented in the proposed draft. Namely, in case of bankruptcy, Swiss banks would have to pay out cash deposits within seven business days, which is in line with international standards. The consultation draft should be made available during the course of 2018.

At present, FINMA considers that the two Swiss largest banks, Credit Suisse and UBS, which are subject, like other systemically important financial institutions (SIFIs), to a specific regime namely, in terms of capital adequacy (see question 16), have improved their crisis resistance over the years by establishing detailed recovery and resolution plans and implementing the necessary organisational measures. For example, both banks now have a non-operating holding company acting as their respective group parent and have transferred their Swiss-based systematically important functions to separate subsidiaries. That said, according to FINMA, further steps are to be undertaken to reduce financial and operational dependencies that persist in the groups. Both banks have to submit for FINMA's review viable emergency plans by 2019, to address, inter alia, this issue.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Swiss banking law does not provide for limitations that expressly apply to transactions between a bank and its affiliates. A bank's transactions with its affiliates may, however, fall under the general limits imposed on a bank's risk exposure towards a single counterparty (or a group of related counterparties) for diversification purposes. Risk exposure towards one single counterparty or a group of related counterparties exceeding 10 per cent of the bank's capital is to be monitored by the bank and, under certain circumstances, reported to FINMA. As a rule, such risk concentrations cannot exceed 25 per cent of the bank's overall capital. With effect from 1 January 2019, the revised Capital Adequacy Ordinance (CAO) provides that risk concentrations will be measured only according to core capital (Tier 1), as supplementary capital (Tier 2) will generally not be taken into account. FINMA Circular 2019/1 'Risk diversification – banks' has been revised to reflect these changes and will enter into force on 1 January 2019.

Under Swiss banking laws, entities are considered 'affiliates' if they are linked through a controlling relationship (ie, directly or indirectly held with more than 50 per cent of the voting rights or capital or dominated in any other manner) or by a factual or legal obligation to assist.

It is worth noting that a financial group or conglomerate, which comprises a Swiss bank or securities dealer or is effectively managed from Switzerland, may be subject to the consolidated FINMA supervision. In this context, intra-group positions of a Swiss bank would, in principle, fall within the limits imposed on single-risk positions for diversification purposes. Only risk positions towards fully consolidated 'affiliates' may, under certain circumstances, be exempted from these limits. In terms of capital adequacy requirements (see question 16), it should be noted that the Swiss Federal Council has requested that the FDF prepare a draft on the risk weighting principles applicable to positions held in subsidiaries and a consultation procedure has been opened up until 30 May 2018 in the general context of the partial revision of the CAO. On its part, FINMA has decided in October 2017, to retroactively apply, as of 1 July 2017, a special regime to Credit Suisse and UBS. This new regime provides, inter alia, for an abolition of the full deduction of parent companies' positions held in subsidiaries from core equity capital and of the accompanying relief measures allowed for these two large banks and for their replacement with the implementation, after a transition period, of a risk weighting with weights up to 250 per cent with respect to positions in Swiss-based subsidiaries and 400 per cent with respect to positions in foreign subsidiaries of these two large banks. These requirements relate to the parent companies' capital ratios only, to the exclusion of consolidated ratios. It is planned that the new risk weightings will also apply to all other banks as of 1 January 2019.

6 What are the principal regulatory challenges facing the banking industry?

In our view, the principal regulatory challenges facing the Swiss banking industry may be summarised as follows.

Banking secrecy and administrative assistance

On 13 March 2009, the Swiss Federal Council announced that Switzerland would adopt the Organisation for Economic Cooperation and Development (OECD) standard on administrative assistance in tax matters, in accordance with article 26 of the OECD Model Tax Convention. This amendment would in turn allow the lifting of Swiss banking secrecy in situations where suspicions of tax non-compliance exist. The Swiss government, therefore, started the renegotiation of the network of double taxation agreements to which Switzerland is a party. In June 2010, the Swiss parliament had already approved the first 10 double taxation agreements integrating article 26 of the OECD Model Tax Convention. As of today, 51 double-taxation agreements have been signed and have entered into force. As a result of this process, the distinction between tax fraud and tax evasion is no longer relevant in the context of international assistance.

In parallel, on 19 November 2014, the Swiss Federal Council approved a declaration aimed at joining the Multilateral Agreement on the Automatic Exchange of Information in Tax Matters developed by the OECD. On 5 June 2015, the Swiss Federal Council adopted the dispatches on the OECD and Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and on the Federal Act on Automatic Exchange of Information (AEOI Act). Both drafts, as well as the Multilateral Agreement on the Automatic Exchange of Information in Tax Matters, were approved by the Swiss parliament on 18 December 2015. Following this, the Swiss Federal Council adopted the relevant implementing ordinance (AEOI Ordinance) on 23 November 2016. Both the AEOI Act and the AEOI Ordinance finally entered into force on 1 January 2017. As a result, Switzerland's first exchange of information started in 2018 regarding information from 2017 between the relevant foreign countries (including all EU member states, in accordance with the agreement of 27 May 2015 regarding the amendment to the EU Savings Tax Agreement with Switzerland).

In January 2016, FINMASA was amended to allow, under certain circumstances and under FINMA supervision, regulated entities to directly transmit non-public information to foreign financial market supervisory authorities responsible for their supervision, provided the prerequisites for granting international administrative assistance would be fulfilled and client and third-party (confidentiality and banking secrecy) rights are preserved. Following the entry into force of this revision, FINMA has enacted new Circular 2017/6 'Direct transmission', which sets out under which criteria supervised institutions may directly transmit non-public information to foreign authorities and entities. This Circular entered into force on 1 January 2017.

Anti-money laundering regulation and implementation of the latest Financial Action Task Force recommendations

Between 2013 and 2014, the Swiss government amended AMLA with a view to adapting it to the revised Financial Action Task Force (FATF) recommendations. The entry into force of the revised AMLA took place in two stages; first in July 2015 and then in January 2016. The revision included, inter alia:

- the obligation for financial intermediaries to establish the identity of the beneficial owner(s) of unlisted operating companies (ie, individuals holding 25 per cent of the share capital or voting rights or controlling the company in any other manner) or, if no beneficial owner can be identified, the identity of the most senior member of management; and
- a two-stage mechanism following the reporting of suspicions to the Money Laundering Reporting Office (MRO) of the Swiss Federal Office of Police, which requires the monitoring of the concerned account by the financial intermediary, for a period up to 20 days during the analysis of the case by the MRO, to suspend any transaction that may result in preventing the confiscation of the concerned asset, followed, if the case is transferred to a criminal prosecution authority, by the implementation of a full freeze on the account for five days until the decision to maintain the freeze is made by the criminal authority.

In the above context, the provisions of the FINMA AML Ordinance of 8 December 2010 and the AML Ordinance of 11 November 2015 were partially revised in order to align them on the revised AMLA. The entry into force of this revision took also place on 1 January 2016. In parallel, the Swiss Bankers Association published the 2016 version of its Agreement on the bank's code of conduct with regard to the exercise of due diligence (CDB), which entered into force on the same day. Finally, the revised FINMA AML Ordinance and the CDB introduced the possibility for financial intermediaries to on-board clients exclusively online. In this context, FINMA published a circular on video and online identification (FINMA Circular 2016/7), which entered into force on 18 March 2016. One of the main purposes of this circular is to clarify and facilitate video and online client identification for financial intermediaries, subject to know-your-customer duties (see Update and trends).

Following the latest FATF assessment of the Swiss AML legal framework, FINMA has decided to further revise the FINMA AML Ordinance in order to address certain remaining shortcomings identified by the FATF, as well as to implement FINMA's practice in this area. As things stand, the draft FINMA AML Ordinance would introduce, inter alia, a duty to check information on beneficial ownership for all clients, including low-risk clients, as well as duty to perform regular updates of client information. It is further expected that the revised text includes clarifications on the monitoring of legal and reputational risks within international financial groups. The revised FINMA AML Ordinance is expected to enter into force in 2019.

Outsourcing projects

Outsourcing by banks, securities dealers, as well as insurers will be governed from 1 April 2018 by FINMA Circular 2018/3 'Outsourcing – banks and insurers'. This new Circular 2018/3, which replaces the current FINMA Circular 2008/7, lays down the requirements applicable to the outsourcing of significant functions (ie, functions having a material effect on compliance with the aims and regulations of financial market legislation). It should be noted that FINMA has aligned this new text to reflect not only its principle-based approach, but also its technology-neutral approach enabling financial institutions to comply with outsourcing requirements, irrespective of their business model. FINMA has further clarified the rules governing the outsourcing of risk management and compliance functions. One of the main changes is that financial institutions are to maintain an inventory of all outsourced services and to assess on their own (self-assessment) whether those are linked to significant functions. Further, any outsourcing outside Switzerland requires that financial institutions make sure that all necessary data for reorganisation, resolution and liquidation purposes remain accessible in Switzerland at all times. Finally, it is worth noting that this new Circular 2018/3 partially applies to intra-group outsourcing projects. The intra-group nature of such projects is to be taken into consideration within the risk assessment to be performed by financial institutions. This new Circular provides for a transitional period up to five years.

New proposed Swiss legislation on financial services and financial institutions

On 27 June 2014, the Swiss Federal Council published two drafts of the Financial Services Act (FinSA) and the Financial Institutions Act (FinIA). While the purpose of the draft FinIA is to provide a 'new legal framework' governing all financial institutions, the objective of the draft FinSA is to regulate financial services in Switzerland, whether performed in Switzerland or on a cross-border basis.

Following the hostile reaction of participants on certain aspects during the consultation procedure, the Swiss Federal Council requested that the FDF significantly amend the drafts and prepare a dispatch by the end of 2015. On 4 November 2015, the Swiss Federal Council adopted its dispatch on both revised draft instruments. The preparatory commission of the Council of States has requested some further amendments and simplifications, which further delayed the legislative process. Debates before the Swiss parliament started in December 2016 and will continue in the 2018 sessions. At this stage, it is difficult to assess how long the legislative procedure will take prior to the entry into force of the FinSA and FinIA, which is currently not expected before mid-2019. The introduction of the new FinSA and FinIA would, inter alia, involve the following key changes to the current Swiss regulatory framework:

- under the proposed legislative framework, financial services and institutions will be governed in Switzerland by a general set of regulations on the supervision of financial services, embodied in the FinSA, the FinIA and the Financial Market Infrastructure Act;
- the draft FinSA introduces an obligation for foreign services providers, which would be subject to an authorisation in Switzerland, to register, as a prerequisite to providing financial services in Switzerland;
- the draft FinSA introduces categorisation rules based on the European Union concept of 'professional clients' and 'private clients';
- the draft FinSA also introduces market conduct rules, including the obligation to verify the appropriateness and suitability of financial services, as well as inducements and transparency rules (integrating into the draft FinSA the most recent case law of the Swiss Supreme Court as regards the transparency and consent requirements for a financial institution to keep trailer fees);
- the draft FinSA further introduces uniform prospectus rules that generally shall apply to all securities offered publicly into or in Switzerland, as well as a change of paradigm in the enforcement of the claims of investors against financial institutions; and
- the draft FinIA provides that independent asset managers who are currently not subject to prudential supervision will be newly supervised. Although they will not be directly subject to FINMA supervision, their supervision will be conducted by independent supervisory organisations approved and monitored by FINMA.

Financial market infrastructure

The FMIA, including its implementing ordinances (FMIO and FMIO-FINMA), entered into force on 1 January 2016. The purpose of this statute is twofold:

- first, from a formal perspective, the Financial Market Infrastructure Act aims at achieving consistency by gathering in one single statute all existing provisions related to the organisation and operation of market infrastructures, including conduct of business rules (eg, shareholding disclosures); and
- second, it aims at harmonising Swiss financial legislation with international recommendations and standards (including the European Union's MiFID 2, MiFIR and EMIR), in particular, regarding the regime applicable to negotiation platforms, central counterparties, central securities depositories, payment and securities settlement systems and derivatives trading.

The introduction of the FMIA involved, inter alia, the following key changes to the Swiss regulatory framework:

- the introduction of a licensing regime similar to the one applied to stock exchanges for multilateral trading facilities and organised trading facilities;
- the introduction of a licensing obligation for central counterparties, central securities depositories and trade repositories with the application of specific additional requirements; and
- the introduction of clearing, reporting and risk-mitigation obligations for determined exchange-traded and over-the-counter derivative transactions to which a professional investment firm is party.

Following the entry into force of the new regime, financial market infrastructures and the operators of organised trading facilities were granted a one-year transitional period to comply with a certain number of new requirements (eg, pre- and post-trade transparency information duties). Moreover, participants on a trading venue and securities dealers were released from fulfilling the extended record-keeping and reporting duties regarding securities transactions until 1 January 2017. This transitional period was based on the expected date on which the corresponding provisions in MiFID II were expected to become. Because this date was postponed by a year, the Swiss Federal Council has decided to extend the corresponding transitional period to 1 January 2018. As of 1 October 2018, this reporting obligation will be expanded to include derivatives with an underlying asset admitted to trading on a Swiss trading venue. However, the new rules contemplate a 'backloading' period. All derivatives transactions that would be reportable under the new rules transpiring between 1 January 2018 and 30 September 2018 will have to be reported by 31 December 2018.

It is worth noting that, in October 2017, FINMA further decided to grant non-financial counterparties with low derivatives' trading volumes a deadline extension until 1 January 2019 for over-the-counter derivatives' transactions and until 1 July 2019 for exchange-traded derivatives' transactions to start their reporting to trade repositories in cases of derivatives' transactions with foreign counterparties that do not report in accordance with FMIA (FINMA Guidance 05/2017).

Separately, in February 2017, FINMA announced the partial revision of the FMIO-FINMA rules regarding the disclosure of significant interests held in listed companies for third-party accounts in order to align it with recent Swiss case law. Under the new disclosure regime that entered into force on 1 March 2017, positions held for third-party accounts can now be aggregated and disclosed at the level of the entity that is, in effect, making the decisions with respect to the exercise of voting rights. Depending on the circumstances, this entity can be the asset management entity itself (ie, the entity that has the contractual relationship with the relevant client) or an entity higher up in the chain of control, if that particular entity is effectively controlling the manner in which the voting rights are being exercised by its subsidiaries. Alternatively, it remains possible to aggregate and disclose client positions at the level of the person who ultimately controls the entity. The new rules provide for a transitional period of six months for implementation. Filings made prior to March 2017 are not grandfathered. Previous disclosures of client positions must have been updated by 31 August 2017.

In December 2017, FINMA launched a consultation on the amendment of the FMIO-FINMA with the aim of designating the categories of OTC derivatives that will, for the first time, be subject to the clearing obligation. FINMA is introducing the clearing obligation for certain OTC standardised interest-rate and credit derivatives listed in Annex 1 of the proposed draft FMIO-FINMA. The OTC derivatives are already subject to the clearing obligation under EU regulations. The consultation process will last until 12 February 2018. After any necessary adjustments have been made, the publication of the amended Annex 1 FINMA-FMIO is scheduled for summer 2018.

Corporate governance in the banking sector

In November 2016, FINMA published its corporate governance requirements for banks by consolidating provisions of a certain number of related circulars and its relevant FAQs into a new circular, the FINMA Circular 2017/1 'Corporate Governance – Banks'. The revised regime entered into force in July 2017.

The purpose of Circular 2017/1 is to streamline the regulatory framework by providing for principles and guidelines in relation to corporate governance. In particular, it leaves banking institutions free to implement the requirements in question, taking into account their own business models and the specific risks associated with them. The circular sets minimum requirements, not only regarding the composition of boards and the qualifications of their members, but also for the organisation of the banks' internal control systems. Further, it details the allocation of responsibilities between the board of directors and the executive board of the banking institutions. Moreover, it provides exceptions to the rule most committee members must be independent (eg, absence of links with the institution, which may lead to a situation of conflict of interest). It is worth noting that smaller banks are now allowed to have a combined audit and risk committee, instead of two separate committees.

FATCA implementation

On 14 February 2013, the Swiss and US governments signed a cooperation agreement to facilitate the implementation of FATCA (FATCA Agreement). This agreement, which entered into force on 2 June 2014, is based on a model agreement (Model II) tailored for countries, such as Switzerland, that do not have an automatic information exchange in place with the United States. Model II allows for an aggregate reporting of pre-existing accounts in the absence of consent of the client to individual disclosure, which may give rise to a group request by the US Internal Revenue Service (IRS). In this context, the Swiss government has further worked on a federal statute dealing with the implementation of the FATCA Agreement to detail financial institutions' participation, identification and communication obligations and to frame the procedures applicable to information exchange and to the levy of a withholding tax under the agreement. On 27 September 2013, the FATCA implementing act was approved by the Swiss parliament along with the FATCA Agreement. The FATCA implementing act entered into force on 30 June 2014. Participating Swiss and deemed-compliant financial institutions were to register with the IRS by 25 April 2014. On 8 October 2014, the Swiss Federal Council adopted a specific mandate to discuss a changeover to Model I with the United States. Meanwhile, it is unknown when the new agreement introducing Model I will be implemented.

7 Are banks subject to consumer protection rules?

Generally speaking, Swiss regulatory law does not provide for a specific consumer protection legal framework. However, within a certain type of credit, Swiss financial institutions are to observe mandatory provisions that cannot be altered to the detriment of consumers. Credits granted to individuals for purposes other than business or commercial activities, in the range of 500 Swiss francs and 80,000 Swiss francs (providing that the consumer is not obliged to reimburse the credit within less than three months, are subject to the Consumer Credit Act (CCA). The CCA sets out a series of mandatory consumer protection rules, including the following:

- the consumer credit contracts must be made in writing and comply with a with a maximum rate of interest set by the authorities (ie, in principle and since 1 July 2016, 10 per cent plus the three-month Swiss franc Libor interest rate, it being specified that the maximum interest rate shall at least amount to 10 per cent);
- the consumer credit contracts must list a series of absent information null and void (eg, the right of the consumer to revoke a line of credit in writing and within seven days of sending or the delivery of the contract to the borrower); and
- the lender is to check the borrower's credit capacity and to report the granted consumer credit to the Consumer Credit Information Office.

It should be also noted that within national and international transactions with consumers under the Swiss Code of Civil Procedure, the Lugano Convention or the Swiss Private International Law Act, depending on the countries involved, specific consumer protection rules may apply as regards the determination of the competent jurisdiction.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

According to FINMA's general strategic goals for 2017 to 2020, the following fall within its main policy challenges:

- ensuring that banks and insurance companies have strong capitalisation;

- making a sustainable, positive impact on the conduct of financial institutions;
- mitigating the 'too big to fail' issue through viable emergency plans and credible resolution strategies;
- contributing to the protection of creditors, investors and insured persons through accompanying structural change in the financial industry;
- promoting the removal of unnecessary regulatory obstacles for innovative business models;
- providing for principle-based financial market regulation and promoting equivalence with relevant international requirements; and
- keeping the cost of supervision stable and achieving further efficiency gains.

In addition, one of the main challenges for the upcoming years is the entry into force and implementation of the FinSA and the FinIA, which will constitute a complete overhaul of the legal framework applicable to financial institutions and the provision of financial services in Switzerland.

In the same vein, the implementation of the automatic exchange of information will continue to have a significant impact on the Swiss banking industry. In particular, tax-related banking secrecy has been significantly weakened in relation to foreign clients.

Moreover, after the implementation in the Swiss regulatory framework, over the previous years, of a substantial part of the legal and regulatory capital adequacy requirements for banks deriving from the Basel III standards, the banks will face the comprehensive implementation of the remaining parts of those standards over the next two years (see questions 16 and 20).

Finally, FINMA intends to strengthen Switzerland's position as one of the leaders in the fintech sector. To this end, the Swiss regulator engaged in a number of international bodies to establish a framework aimed at promoting innovation, as well as the protection of customers and investors in this area. In 2016, FINMA further put in place a special fintech desk to address this sector's issues more efficiently (see Update and trends).

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Swiss banking supervision is based on a division of tasks between FINMA and the banks' external auditors.

Pursuant to this two-tier supervision system, the auditors conduct on-site audits, while FINMA retains responsibility for overall supervision and enforcement measures. To a certain extent, the auditors act as an extension (long arm) of FINMA, exercising direct supervision through regular audit checks.

In addition to examining the annual financial statements with an independent valuation of assets and liabilities, the auditors also review whether the banks comply with their articles of association and their organisational rules, as well as with the provisions of Swiss banking law, the circulars issued by FINMA and any applicable self-regulatory provisions.

External auditors must, on an annual basis, prepare 'long-form reports' addressed to the members of the board of directors of the bank concerned and to FINMA. These reports provide a comprehensive overview of the business activities and the internal organisation of the relevant bank. The purpose of these reports is to allow FINMA to ensure that the financial institution complies with the regulatory requirements and that the individuals entrusted with its management enjoy a good reputation and thereby assure the proper conduct of business operations (ie, guarantee of irreproachable activity). These audit reports are the main informational tools through which FINMA exercises its supervision.

In addition to the long-form reports, the auditors are obliged to inform FINMA if they suspect any breach of law or uncover other serious irregularities. FINMA then initiates investigations and takes other measures necessary to ensure compliance with the legal framework and to eliminate irregularities.

A special supervisory regime has been put in place for the largest Swiss banks, UBS, Credit Suisse, Zürcher Kantonalbank and the financial groups Raiffeisen and Postfinance given the systemic risk caused by the size of these institutions. In short, FINMA does not exclusively rely on the reports received from the auditors but carries out its own investigations in accordance with its risk-based supervision approach.

10 How do the regulatory authorities enforce banking laws and regulations?

The enforcement of Swiss banking laws and regulations is closely linked to the obligation for Swiss banks to ensure compliance, at all times, with the requirements for a banking licence (continuing compliance with the conditions of a banking licence).

If, at any time after the licence has been granted, any of the licence requirements are no longer satisfied, FINMA may take administrative measures aimed at ensuring the breach be remedied. FINMA may also appoint an investigator in order to clarify the factual situation and to facilitate the implementation of the measures imposed by the authority. Should the breach of the legal and regulatory framework be characterised as serious, FINMA could ultimately withdraw the banking licence, something that would trigger the forced liquidation of the bank.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The most common enforcement issues encountered in the practice of FINMA may be generally summarised as follows:

- the forced liquidation of unauthorised securities dealers;
- the insolvency procedures and protective measures related to authorised and unauthorised entities;
- procedures against individuals, including entry onto a watch list (ie, a database with information on individuals whose business conduct is questionable or does not meet legal requirements) and the sending of business conduct letters whereby FINMA informs the individual of its reservations as regards the assurance of proper business conduct;
- the issues related to the compliance with the know-your-customer rules set out in the Federal Anti-Money Laundering Act and the Agreement on the Swiss Banks' Code of Conduct with regard to the Exercise of Due Diligence (see question 2) and the diligence requirements within the provision of cross-border financial services, as well as insider trading and market manipulation; and
- the ongoing supervision of licensed entities (especially banks and securities dealers), in particular, in order to ensure that the persons entrusted with the management of these entities fulfil on an ongoing basis the guarantee of irreproachable activity.

Since spring 2015, FINMA publishes a summary enforcement report aiming at improving the transparency of its enforcement activity and having a preventive action on the financial market. This report contains anonymised summaries of cases and includes references to court decisions and statistics on FINMA's enforcement activity.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Swiss law does not provide for any specific rules setting out the conditions and situations in which a Swiss banking institution may be taken over by the government or regulatory authorities. Hence, the UBS recapitalisation that took place in 2008 where the Swiss Confederation made a capital injection into UBS through the subscription of mandatory convertible bonds for 6 billion Swiss francs required the enactment of a special, urgent law, the Federal Ordinance of 15 October 2008 on the Recapitalisation of UBS AG, by the Swiss government.

By contrast, the involvement of FINMA within bank reorganisation and liquidation proceedings is now expressly provided for in the Banking Act and the implementing FINMA-Bank Insolvency Ordinance (see questions 13 and 18).

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

FINMA requires that Swiss banks have sound business contingency management in place to ensure that critical business functions can be maintained or restored as quickly as possible in the event of a crisis. SIFIs are, in addition, required to have contingency or recovery plans (often called 'living wills') in place. The responsibility for the establishment of such plans lies with the bank's board of directors and senior management.

Also, if a bank becomes over-indebted or experiences serious liquidity issues, FINMA can order broad and far-reaching protective measures, which may directly affect the bank's conduct of business and the role of the bank's management and directors. These protective measures may be taken independently from or in addition to the ordering of formal restructuring or liquidation proceedings. In this context, FINMA is, in particular, vested with the power to:

- give direct instructions to the bank's governing bodies;
- limit the powers of the bank's directors or managers or remove them from office;
- remove the bank's statutory audit company;
- limit the business activities of the bank;
- forbid the bank to make or accept payments or undertake securities transactions;
- order a temporary stay of a counterparty's right to enforce a debt against the bank; and
- order a temporary stay of any contractual termination or termination of a counterparty right with respect to any contracts (subject to certain conditions) (see question 18).

14 Are managers or directors personally liable in the case of a bank failure?

Swiss law does not provide for a specific liability regime applicable to directors or managers of a bank. Should the bank's failure result from an intentional or negligent breach of the directors' or managers' duties, the general rules of Swiss company law would apply to determine the managers' or directors' personal liability for the damage caused to the company, its shareholders or creditors.

This liability for mismanagement must be distinguished from the liability regime applicable to the (managing or non-managing) partners of a Swiss bank, which is set up as a partnership or a limited partnership (often referred to as a Swiss private bank). In case of bankruptcy of a Swiss private bank, the partners with unlimited liability would be jointly and severally liable with their own personal assets.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

In line with international standards and as mentioned above, SIFIs are to have both a recovery and a resolution plan aimed at identifying risks with respect to the stability of the financial system owing to their systemically important nature and determining viable ways to deal with the impact of a crisis.

In accordance with the Banking Ordinance, a SIFI is to establish a recovery plan that contains the measures that it would take in case of crisis and that would allow it to pursue its activity without requiring governmental funds. Responsibility for drafting and regularly updating the recovery plan rests with the executive board level of the SIFI and must be embedded in a viable corporate governance framework. The recovery plan, as well as any amendment of it, is subject to FINMA's approval. Provided that the legal requirements are met, FINMA approves the recovery plan and then elaborates a resolution plan on its own, based on the information provided by the SIFI. Presently, FINMA considers that the two largest Swiss banks, Credit Suisse and UBS, have improved their crisis resistance over the years by establishing detailed FINMA-approved recovery plans and implementing the necessary organisational measures (see question 4). The resolution plan presents how, in concrete terms, a recovery measure or a SIFI liquidation could take place. FINMA is not obliged to disclose the resolution plan to the SIFI in question and may, in practice, deviate from the SIFI's planned strategies and measures, if it deems appropriate.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The granting of a banking licence is subject to a minimum equity requirement. The fully paid-up share capital of a Swiss bank must amount to a minimum of 10 million Swiss francs and must not be directly or indirectly financed by the bank, offset against claims of the bank, or secured by assets of the bank. In practice, FINMA determines in each case the appropriate level of capital with regards to the scope of the contemplated activities. Capital adequacy and measurement rules are detailed in the revised CAO, the revised Liquidity Ordinance (LiqO) and the revised FINMA Circular 2015/2 'Liquidity risks – banks' (see question 20).

The current regime provides for minimum capital requirements that call at all times for an aggregate (Tier 1 and Tier 2) capital ratio of 8 per cent of the bank's risk-weighted assets. In addition, risk-weighted positions must be covered at a ratio of 4.5 per cent with common equity Tier 1 (CET I) capital and at a ratio of 6 per cent with Tier 1 capital. Furthermore, banks are to have, from 1 January 2016, a capital buffer in the form of CET I capital between 2.5 and 4.8 per cent of the risk-weighted assets. Finally, under certain circumstances, the Swiss National Bank can request that the Swiss government order that an additional countercyclical buffer of up to 2.5 per cent of all, or certain categories of the risk-weighted assets, be maintained in Switzerland in the form of CET I capital. In February 2013, such a countercyclical buffer was activated at the level of 1 per cent on loans secured against residential properties in Switzerland. On 30 June 2014, as per the request of the Swiss National Bank, the Swiss Federal Council increased the countercyclical buffer at the level of 2 per cent. From 1 July 2016, banks with total assets of at least 250 billion Swiss francs, of which the total foreign commitment amounts to at least 10 billion Swiss francs, or with a total foreign commitment of at least 25 billion Swiss francs, are required to maintain an extended countercyclical buffer in the form of common equity Tier 1 capital. Finally, if FINMA deems risks not adequately covered by these capital requirements, it can order banks to maintain additional capital.

In November 2017, the Swiss Federal Council decided to revise, as of 1 January 2018, the CAO in order to introduce, in addition to the above requirements, a leverage ratio. In accordance with Basel III requirements, the revised CAO requires a risk-weighted capital ratio that rise with increasing size, as well as an unweighted capital adequacy requirement for all non-systemically important banks. A safety net in the form of a leverage ratio has been implemented with this capital adequacy requirement based on the leverage ratio. In this context, a minimum core capital (Tier 1) to a total exposure ratio of 3 per cent is now required for all non-SIFIs. In December 2017, FINMA launched a consultation until mid-February 2018 on the updating of Circular 2015/3 'Leverage Ratio' so that banks can also apply the Basel III standard approach for derivatives when calculating the leverage ratio.

As regards quantitative liquidity requirements applied to non-systemic banks, the LiqO was first revised on 1 January 2015 in line with the Basel III requirements in order to introduce two minimum standards: a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR). The LCR was introduced to ensure that banks hold a liquidity buffer to offset increased net cash outflows under a specified 30-day stress scenario. According to the LiqO, non-systemic banks were to comply with 60 per cent of the LCR's requirements as of 1 January 2015. By each of the following three years they have to comply with an additional 10 per cent until they have complied with 90 per cent of the LCR's requirements for 2018 (phase-in until 1 January 2019). The NSFR, which requires non-systemic banks to have sufficient stable funding available to cover illiquid assets, initially had to be implemented in January 2018. That being the case, owing to delays with the introduction of the NSFR on the European Union and United States financial markets, the Swiss Federal Council has decided to review the situation at the end of 2018 and not to postpone the introduction of this requirement this year. It should be noted that the LiqO has been further revised based on practice and feedback since the implementation of the LCR requirement. Since 1 January 2018, the revised LiqO provides for a relaxation of the LCR requirements for small banks. The revised FINMA Circular 2015/2 'Liquidity risk – Banks', which also entered into force on 1 January 2018, clarifies, inter alia, the regime applicable to small banks in this context.

With regard to SIFIs, the CAO sets out a specific capital adequacy regime. The latter calls for more stringent requirements as regards the bank's risk-weighted assets, which broadly comprise a basic requirement of leverage ratio of 4.5 per cent, in line with the Basel III minimum requirements applicable to all banks, an additional component of risk-weighted assets of 12.86 per cent and a surcharge. These requirements must not fall below 3 per cent with respect to the leverage ratio and 8 per cent as regards risk-weighted assets that the SIFI is to maintain at all times. With regard to the surcharge, its size is set with respect to the degree of systemic importance (ie, the total exposure and the market share of the relevant SIFI). As from 1 January 2018, SIFIs may also be subject to a total exposure ratio up to 10 per cent.

SIFIs also have to satisfy countercyclical equity buffers and leverage ratio requirements. In addition to capital, liquidity, organisational and risk diversification requirements, the applicable regime also entails provisions that allow the government to order adjustments to the remuneration system of a bank which would have to rely on government funding.

17 How are the capital adequacy guidelines enforced?

Enforcement of the capital adequacy requirements is part of the ongoing supervision process aimed at ensuring that the requirements of the banking licence are met. Compliance with capital adequacy requirements has to be reported to the Swiss National Bank on a quarterly basis and is one of the topics addressed in the long-form reports issued by the bank's external auditors on a yearly basis (see question 9).

18 What happens in the event that a bank becomes undercapitalised?

FINMA benefits from an exclusive competence to intervene in the event of a bank's undercapitalisation.

Upon the occurrence of a risk of undercapitalisation or insolvency, FINMA can take various protective measures, such as a moratorium of claims. Further, in case of need, FINMA may appoint a trustee in charge of the bank's reorganisation. The latter is then to propose to FINMA a reorganisation plan with the purpose of protecting the bank's creditors. Such a scheme generally aims to recapitalise the bank, for example, through converting debt into equity. As a result of the financial crisis, FINMA was also granted additional powers with a view to increasing the likelihood of successful restructuring of a distressed bank. FINMA may order the transfer of all, or part of the bank's activities, to a 'bridge bank', compel a conversion of certain convertible debt instruments issued by the bank (eg, CoCos) or a reduction (or cancellation) of the bank's equity capital, or both, and, as an ultima ratio, order the conversion of the bank's debt obligations into equity. FINMA is also authorised to liquidate insolvent banks, in particular if no reorganisation is possible. These measures are set out in more detail in the FINMA-Bank Insolvency Ordinance.

Moreover, in the context of the entry into force of the Federal Act on Financial Market Infrastructure, the Banking Act and Ordinance have been amended in order to allow FINMA to couple any protective measure or reorganisation measure with a temporary stay of any contractual termination or termination right of a counterparty with respect to any contracts or the exercise of certain netting, realisation and transfer rights (which prevail in the absence of a stay ordered by FINMA) for up to 48 hours. In this context, the Banking Ordinance generally requires, for enforceability purposes, that banks only enter into new agreements or agree to amendments to agreements, which are subject to foreign law or provide for a foreign jurisdiction, provided the counterparty acknowledges FINMA's stay right. This obligation has been further specified in the revised FINMA-Bank Insolvency Ordinance, which entered into force in April 2017. According to this revised text, agreements entered into by foreign group entities are only subject to this obligation if the respective financial contract was guaranteed or otherwise secured by a bank or securities dealer whose seat is in Switzerland.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

FINMA benefits from the power to intervene in the event a bank becomes insolvent. See questions 13 and 18 for the intervention tools that are available to FINMA.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

In addition to the special capital adequacy regime and the leverage ratio regime imposed on Swiss SIFIs (see question 16), FINMA implemented capital adequacy and liquidity rules in line with international standards (see question 16). In order for banks to build up the required capital and replace or phase out capital that no longer qualifies under the new rules, transitional rules provide for an implementation schedule over a time period stretching to 2019.

On 1 January 2016, the revised FINMA Circular 2016/1 'Disclosure – banks' entered into force. This revision aimed at aligning the disclosure duties of banks on risks, risk management, equity capital and liquidity on Basel III requirements in relation to it. In the same vein, the revised FINMA Circular 2017/7 'Credit risks – banks', which came into force on 1 January 2017 with a transitional period of one year, aims at aligning the credit risk capital requirements for banks with enhanced international standards.

In October 2017, FINMA announced that it will revise five of its bank-related circulars (ie, 2008/6 'Interest rate risks – banks', 2011/2 'Capital buffer and capital planning – banks', 2013/1 'Eligible capital – banks', 2016/1 'Disclosure – banks', 2017/7 'Credit risks – banks'), in accordance with changes in Basel III rules and international financial reporting standards. A consultation was opened until the end of January 2018 for this purpose. It is expected that the changes become effective in 2019, at the earliest, one year later than under the international implementation schedule.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

For purposes of the Federal Banking Act, a participation is deemed to be a qualified participation if it amounts to 10 per cent or more of the capital or voting rights of the bank or if the holder of the participation is otherwise in a position to significantly influence the business activities of the bank (a 'qualified participation'). In practice, FINMA often requires the disclosure of participations of 5 per cent or more for its assessment of whether or not the requirements of a banking licence are continuously met.

The Federal Banking Act does not set any restrictions on the type of entities or individuals holding a controlling interest in a bank. However, one of the general requirements for a bank to obtain a licence is that individuals or legal entities holding, be it directly or indirectly, a qualified participation in a bank must ensure that their influence has no negative impact on the prudent and reliable business activities of the bank. Therefore, the bank's shareholders and their activities can be relevant for the granting and the maintenance of a banking licence.

Examples of circumstances where shareholders with a qualified participation may have a negative influence on the bank are a lack of transparency, unclear organisation or financial difficulties of financial conglomerates, as well as an influence of a criminal organisation on the shareholder. Should FINMA be of the view that the requirements for the banking licence are no longer met because of a shareholder with a qualified participation, it may suspend the voting rights in relation to such qualified participation or, if appropriate and as a measure of last resort, withdraw the licence, which would trigger a liquidation proceeding.

22 Are there any restrictions on foreign ownership of banks?

If foreign nationals with qualified participations directly or indirectly hold more than half of the voting rights of, or otherwise a controlling influence on, a bank incorporated under Swiss law, the granting of the banking licence is subject to additional requirements. In particular, the corporate name of a foreign-controlled Swiss bank must not indicate or suggest that the bank is controlled by Swiss individuals or entities and the countries where the owners of a qualified participation in a bank have their registered office or domicile must grant 'reciprocity', which is:

- Swiss residents and Swiss entities must have the possibility to operate a bank in the respective country; and
- such banks operated by Swiss residents are not subject to more restrictive provisions compared to foreign banks in Switzerland.

The reciprocity requirement is subject to any obligations to the contrary in governmental treaties and is, therefore, not applicable to World Trade Organization member states. Furthermore, FINMA may request that the bank is subject to adequate consolidated supervision by a foreign supervisory authority if the bank forms part of a group active in the financial sector.

Update and trends

Since 2015, FINMA's focus has been on adapting the applicable legal and regulatory framework to the needs of the fintech sector. In order to promote innovation in the financial sector, FINMA is reviewing new licensing categories with less stringent requirements. In this context, on 2 November 2016, the Swiss Federal Council instructed the FDF to prepare a consultation draft aiming to relax certain licensing requirements for fintech companies. On 1 February 2017, the Swiss Federal Council proposed for public consultation a draft focusing of the following three main elements:

- the introduction of a maximum period of 60 days (as opposed to seven days, in accordance with FINMA's current practice) for the holding of monies on settlement accounts (eg, for crowdfunding projects), without any limitation in terms of amounts;
- the creation of an innovation area called 'sandbox', where companies are allowed to accept public deposits up to a total amount of 1 million Swiss francs and without the need to apply for a banking licence, subject to certain conditions, such as disclosures, prohibition to invest deposits, etc; and
- the introduction of a new fintech licence granted to institutions whose activities are limited to deposit-taking activities, to the exclusion of lending activities involving maturity transformation. In such a case, the total amount of the deposits would not exceed 100 million Swiss francs. Moreover, the minimum equity capital of companies benefitting from such a licence would have to amount to 5 per cent of the public funds and would be, in any case, above 300,000 Swiss francs.

The first two pillars of the fintech sandbox regime were adopted by the Swiss Federal Council on 5 July 2017 and entered into force on 1 August 2017. Following this, FINMA published a revised version of its Circular 2008/03 on public deposits with non-banks in December 2017. This Circular, which entered into force on 1 January 2018, specifies the sandbox regime and gives concrete examples with respect to the extension of the time frame applicable to settlement accounts. On this issue, FINMA clarified that the settlement account exemption does not apply to cryptocurrency dealers as long as their activity is comparable to that of a forex exchange trader.

The third item, the 'fintech license light', is currently being debated in the Swiss parliament as part of the adoption of the FinSA and FinIA (see question 6). It is therefore not expected to enter into force before mid-2019.

The Swiss banking regulatory framework is expected to remain in a state of flux in the coming years, with changes aimed at strengthening client protection and promoting innovation in the financial sector.

If a bank incorporated under Swiss law becomes foreign controlled as described above or if, in the case of a foreign-controlled bank, the foreign holders of a direct or indirect qualified participation in the Swiss bank change, a new special licence for foreign-controlled banks must be obtained prior to such event. For the purposes of the Federal Banking Act, a 'foreigner' is:

- an individual who is not a Swiss citizen and has no permanent residence permit for Switzerland; or
- a legal entity or partnership that has its registered office outside Switzerland or, if its registered office is in Switzerland, is controlled by individuals as defined above.

23 What are the legal and regulatory implications for entities that control banks?

There are no restrictions as to the business activities of the entities holding qualified participations in a bank, providing the conditions for the granting and maintenance of the licence (see question 21) are complied with. Generally, transactions between the (controlling) shareholders of a bank and the bank itself may be subject to specific requirements (eg, the granting of loans to significant shareholders must be in compliance with generally recognised principles of the banking industry).

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

Each controlling shareholder has the duty to give notification of the acquisition or disposal of a qualified participation, as well as its participation reaching, exceeding or falling below certain thresholds (see question 29). Further, as mentioned above, the holder of a qualified participation must not negatively influence the prudent and reliable business activities of the bank, otherwise the bank may lose its licence.

In cases where justified concerns exist that a bank is over indebted, no longer complies with the capital adequacy rules or has serious liquidity problems, FINMA may order certain protective measures and the establishment of a recapitalisation plan. Under a recapitalisation plan, the rights of creditors and shareholders may be impaired (see question 18).

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

There are no specific implications for a controlling shareholder of a bank if the bank becomes insolvent, other than those described in question 18.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

Even though the acquisition of a qualified participation in a bank by a Swiss individual or a Swiss entity triggers, in theory, only notification obligations (see question 29), it is necessary to seek a letter of no objection from FINMA for the account of the bank prior to an envisaged transfer of a controlling stake in a Swiss bank, since FINMA controls the continuing compliance with the conditions of a banking licence. FINMA will examine whether the influence of the new shareholder with a qualified participation would be detrimental to the prudent and reliable business activities of the bank.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The notification requirements outlined in question 29 also apply to non-Swiss acquirers. In addition, if a foreign individual or entity acquires a qualified participation in a Swiss bank, the bank must apply to FINMA for a special licence, provided that foreign nationals with qualified participations directly or indirectly hold more than half of the votes of, or otherwise a dominant influence on, the bank. For the conditions of the additional licence, see question 22.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

FINMA generally considers whether the requirements for the banking licence are still met and, in particular, whether the new shareholders with a qualified participation will not negatively influence the bank's prudent and reliable business activities.

29 Describe the required filings for an acquisition of control of a bank.

Each individual or legal entity must notify FINMA prior to acquiring or selling a direct or indirect qualified participation in a bank organised under Swiss law. This notification duty also applies if a qualified shareholder increases or reduces its qualified participation and attains, falls below or exceeds 20, 33 or 50 per cent of the capital or voting rights in the bank. The notification must include a declaration whether the participation is held for the own account and whether any option or similar rights have been granted over the participation.

The bank itself is also required to notify FINMA of any changes triggering the notification duty of the shareholders once it becomes aware of such change, in any case, at least once a year.

In the case of a foreign-controlled bank, prior to any change of a foreign holder of a qualified participation, the bank must apply with FINMA for a special licence. In its application, the bank has to demonstrate all the facts based on which FINMA may assess whether the conditions for the special permit are fulfilled.

As mentioned in question 26, it would be advisable that the bank contacts FINMA prior to a change of a holder of a qualified participation even if the bank is Swiss controlled. This would not need to be in the form of a formal application.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

Generally, the timing of the approvals or statements by FINMA largely depends on its workload. The process for a special banking licence in the case of a foreign-controlled bank may take three months. However, if the country of domicile or residence of the foreigner is not a World Trade Organization member, the process may take much longer. FINMA will have to assess whether that country grants the right of reciprocity.

If the acquirer is not a foreigner, there is no formal approval or licence required and, thus, a statement of FINMA is available within a shorter time frame.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The purposes of banking laws and regulations are, among others, to improve the banking business, to protect the rights and interests of depositors and to coordinate with the development of industries and the national financial policy.

2 Summarise the primary statutes and regulations that govern the banking industry.

The primary laws and regulations governing the Taiwan banking industry include:
- the Banking Act, which provides rules of conducting banking business, including:
  - the setting-up and dissolution of banks;
  - general business scope of various types of banks;
  - compliance requirements; and
  - business restrictions, etc;
- the Central Bank of the Republic of China (Taiwan) Act, which sets out general rules as well as the powers and functions of Taiwan's central bank;
- the Financial Holding Company Act (FHCA), which governs the establishment, business, finance and supervision of financial holding companies;
- the Deposit Insurance Act, which governs Taiwan's deposit insurance system; and
- the Financial Consumer Protection Act, which governs the protection of the interests of consumers who deal with financial institutions.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The Financial Supervisory Commission (FSC) is an independent primary regulatory authority governing the financial services industry in Taiwan, which determines financial policy, drafts regulations and rules with regard to the financial industry, conducts financial examinations and supervises financial institutions. While the FSC issues regulations relating to financial services generally, the Banking Bureau regulates banking and bill finance, and the Examination Bureau is in charge of financial inspection and audits of financial institutions regulated by the FSC.

The Central Bank of the Republic of China (Taiwan), Taiwan's central bank, regulates monetary and credit policies. It also manages official foreign exchange reserves, issues currency, adjusts reserve ratios and inspects banks.

The Central Deposit Insurance Corporation (CDIC) is delegated under the Deposit Insurance Act to handle deposit insurance-related matters, to manage deposit insurance risk and to deal with failing and failed insured institutions.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The CDIC is delegated under the Deposit Insurance Act to handle matters regarding the deposit insurance system in Taiwan. The CDIC is now jointly owned by the FSC and the central bank. Financial institutions duly approved to accept deposits should apply to the CDIC to participate in the deposit insurance programme. If an insured financial institution is ordered by a relevant competent authority to suspend its operations, the CDIC should pay the insurance amount to the depositors with a coverage limit of NT$3 million per depositor. The types of deposits covered generally include:
- deposits in current accounts (checking deposits);
- demand deposits;
- time deposits;
- deposits required by law to be deposited in certain financial institutions; and
- any other deposits as approved by the competent authority.

It has been Taiwanese government policy to privatise certain government-owned banks and financial holding companies and to sell the government's shareholdings in privatised banks.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

In general, the major provisions and limitations regarding the transactions between a bank and its affiliates include (without limitation) the following.

Prohibition on extension of unsecured credit

No unsecured credit shall be extended by a bank to:
- enterprises in which the bank holds 3 per cent or more of the total paid-in capital;
- its responsible person;
- its employees;
- its major shareholders (defined as a person who holds 1 per cent or more of the total issued shares of the bank); and
- any interested party of its responsible person or an employee in charge of credit extensions, subject to certain exceptions.

Limitation on extension of secured credit

Any secured credit extended by a bank to the following persons shall be fully secured, and shall not be more favourable than the terms and conditions offered to other same type of clients:
- enterprises in which the bank holds 5 per cent or more of the total paid-in capital;
- its responsible person;
- its employees;
- its major shareholders (defined as a person who holds 1 per cent or more of the total issued shares of the bank); and

- any interested party of its responsible person or an employee in charge of credit extensions.

If the credit amount to be extended by a bank to any of the said persons exceeds an amount set by the Banking Bureau, the credit extension should be approved by three-quarters or more of the directors present at a board meeting attended by two-thirds or more of the directors.

Limitation on real estate transaction

Any real estate transaction between a commercial bank and any of the following persons should be in the normal course of operation of the bank, and should be approved by three-quarters or more of the directors present at a board meeting attended by two-thirds or more of the directors:

- enterprises in which the bank holds 3 per cent or more of the total paid-in capital;
- its responsible person;
- its employees;
- its major shareholders (defined as a person who holds 1 per cent or more of the total issued shares of the bank); and
- any interested party of its responsible person.

Limitation on transactions other than extension of credit

If a bank is a subsidiary of a financial holding company, the bank's transactions (other than extension of credit) with the following persons shall not be more favourable than the terms and conditions offered to other persons of the same type:

- the financial holding company or any of its responsible persons or major shareholders;
- enterprises solely invested in by or a partnership invested in by a responsible person or major shareholder of the financial holding company, or organisations in which the responsible person or major shareholders concurrently serves as the responsible person or representative;
- the financial holding company's affiliates or any of the affiliate's responsible person or major shareholder; and
- the financial holding company's bank subsidiary, insurance subsidiary, securities subsidiary or any of the subsidiary's responsible persons.

6 What are the principal regulatory challenges facing the banking industry?

A regulatory challenge facing the banking industry is owing to the new amendments to anti-money laundering (AML) laws. The 'Money Laundering Control Act' (which took effect in June 2017) and the 'Directions Governing Internal Control Systems of Anti-Money Laundering and Countering Terrorism Financing of Banking Business, Electronic Payment Institutions and Electronic Stored Value Card Issuers' were newly amended in June 2017, mainly to reflect the 40 Recommendations of the Financial Action Task Force. The main amendments include, among others:

- expanding the definitions of anti-money laundering, related crimes, and criminal gains;
- strengthening the know your customer (KYC) procedures to be conducted;
- requiring the necessary transaction records be kept for five years; and
- increasing the level of punishments.

We believe that the amendments would to some extent affect the business of banks as well as increase their compliance costs.

7 Are banks subject to consumer protection rules?

The Financial Consumer Protection Act (FCPA) (last amended in December 2016) protects the financial consumers (defined under the FCPA) who consume any financial product or service offered by a bank. Major principles include (without limitation):

- the terms and conditions of the contract signed between a bank and a financial consumer shall be based on the principles of fairness, reasonableness, equality, reciprocity and good faith;
- any conspicuously unfair term and condition of a contract with a financial consumer should be null and void;
- if the terms and conditions are ambiguous, their interpretation should be favourable to a financial consumer;
- when carrying out advertising, promotional or marketing activities, the bank shall not falsify, conceal, hide or take any action that will mislead financial consumers, and should be obliged to ensure the truthfulness of the advertisements while the obligations of the bank toward financial consumers in an advertisement shall not be less than those indicated in the materials or explanations made to financial consumers during the said advertising, promotional or marketing activities; and
- when signing contracts with a financial consumer, the bank shall fully know the relevant information of the financial consumer (KYC) to ensure the suitability of the particular product or service concerned and should provide the financial consumer with sufficient explanations of the content of the materials and sufficient risk disclosure regarding the financial product concerned.

The FSC may take disciplinary actions against a bank violating the FCPA. In addition, the Financial Ombudsman Institution (FOI) has been established by the government as an independent foundation to provide an alternative dispute resolution system for disputes between financial consumers and financial services providers (eg, a bank). All the services provided by the FOI to financial consumers are free of charge.

As described in question 11, in recent years the FSC's attention has been on the banks' business on derivatives and structured products, and whether a bank has appropriately performed its required procedures (eg, assessing suitability, KYC processes, risk disclosure) with respect to sale of complex high-risk financial products to financial consumers.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

One of the most important policy objectives in Taiwan is to promote fintech innovation. For this purpose, the FSC has permitted financial holding companies and banks to invest in fintech companies as well as information services companies, subject to certain conditions. It is expected that more regulatory reform will be conducted by the FSC to promote fintech, to encourage more local fintech companies to develop and provide cross-border products and services with international competitiveness.

In December 2017, the Taiwanese parliament passed a law for a regulatory sandbox, the FinTech Development and Innovation and Experiment Act, in order to enable fintech businesses to test their financial technologies. According to the Act, a fintech company needs to apply to, and obtain approval from, the FSC in order to enter the sandbox. After the application is approved, the sandbox entity may perform experiments in compliance with applicable regulations and guidelines governing the sandbox and its approved experimental activities may enjoy exemptions from FSC licensing requirements and certain legal liability exemptions.

After completing the approved experiments, the FSC will analyse the results of the experiments. If the result is positive, the FSC would actively examine the existing financial laws and regulations to explore the possibility of amending them, after which the business model or activities previously tested in the sandbox could become feasible under law (but the sandbox entity might still be required to apply to the FSC in order to formally conduct the activities as previously tested in the sandbox).

According to the relevant news published in local newspapers, the FSC will promulgate the enforcement rules for the regulatory sandbox in the first quarter of 2018 and start accepting applications from the second quarter of 2018. It is generally expected that relevant market players of some controversial business models and activities (such as initial coin offerings) would apply to enter the sandbox, but whether or not the results of these experiments would be positive should really depend on the FSC's then attitude towards the tested models and activities.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The Banking Bureau may, at any time, appoint its staff, professionals (eg, attorneys or accountants), authorised organisations or officials of local competent authorities to examine the business, financial and other affairs of a bank and request a bank to submit its financial reports, property inventories or other relevant documents for examination. The central bank, when it thinks necessary, may also conduct examination on a bank and request a bank to submit its financial reports, property inventories or other relevant documents for examination.

10 How do the regulatory authorities enforce banking laws and regulations?

The actions that the Banking Bureau may take in exercising its regulatory functions include (without limitation):

- prescribing corrective measures or issue an improvement order;
- partially suspending a corporation's operations, or dissolving the corporation;
- ordering the dismissal of managerial officers or employees of a corporation;
- ordering the removal of directors or supervisors of a corporation, or prohibiting the corporation from carrying out its activities; and
- taking other necessary actions.

For the actions that the FSC may take if a bank becomes undercapitalised, see question 18.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The FSC announced on its official website that its examination of the banks in 2018 would focus on, among others:

- the derivatives business of a bank such as the risk control and evaluation;
- the suitability, KYC, risk disclosure with respect to sale of derivatives and structured products;
- AML and anti-terrorism such as compliance with the reporting requirements;
- financial consumer protection such as KYC assessment procedures, implementation of internal control and risk management systems for financial services and personal data protection; and
- digital financial business such as identity verification and monitoring of unusual transactions with respect to online applications for services and mobile payment services.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

The FSC may place a bank in receivership if any of the following occur:

- there is a concern that a bank might be unable to pay its debts when due or there might be a detriment to the depositors' interests owing to obvious deterioration in the bank's business or financial condition;
- a bank's capital is graded as being seriously inadequate and 90 days have lapsed since the date the bank is listed as having seriously inadequate capital. However, if a bank is ordered by the FSC to undertake capital restructuring or a merger within a prescribed period and fails to comply, the 90 days should be calculated from the day subsequent to the prescribed period; or
- the losses of a bank exceed one third of the bank's capital and the bank fails to make up the deficit within three months.

According to the latest statistics (as of 31 December 2017) published by the CDIC, seven banks were placed under receivership during 2006 to 2008, but none afterwards.

The interests of the depositors, shareholders, creditors or employees should not be generally affected solely because the FSC issues the order of receivership, until the receiver of the bank takes any further actions as described in question 13. In local practice, however, if a bank is placed under receivership and has been included in the coverage of the Financial Restructuring Fund set up by the Taiwanese government's cabinet, the rights of the shareholders of the bank should be forfeited except for entitlement to distribution of remaining assets.

For the seven banks in crisis during 2006 to 2008, the FSC divided their assets into 'bad banks' (non-performing assets) and 'good banks' (the other assets) and sold them separately. The bad banks were sold to asset management companies; the businesses of the good banks were sold to, and assumed by, the banks that, at the time, needed additional bank channels at a consideration that the FSC agreed to pay to the assuming banks some compensation. The depositors and employees suffered little loss, but the shareholders and non-deposit creditors generally received nothing following the disposal.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

If the FSC places a bank into receivership, the bank's operations and management power and the powers to administrate and dispose of the bank's properties shall be owned by the FSC-appointed receiver. The duties and powers of the bank's shareholders' meeting, board of directors, directors, supervisors or audit committee should be suspended.

The receiver may formulate a concrete plan for taking the following actions toward a bank under receivership, which should be subject to the FSC's approval:

- mandating other banks, financial institutions or the CDIC to operate all or part of the business;
- increasing capital, reducing capital or increasing capital after reducing capital;
- selling all or part of the business, assets or liabilities;
- a merger with another bank or another financial institution; and
- other important actions as determined by the FSC.

14 Are managers or directors personally liable in the case of a bank failure?

If a bank is placed under receivership, the FSC may notify relevant authorities or institutions to prohibit the transfer, delivery or creation of rights in the properties owned by the bank or its responsible persons or employees who are suspected of violating laws and may request the immigration authority to prohibit said persons from departing the country. Also, the directors might be subject to civil liabilities for breach of fiduciary duties under Taiwan's Company Act as well as criminal liability for criminal breach of trust.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

Currently, no requirements exist regarding 'resolution planning' or 'living wills' under Taiwanese law.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The current capital adequacy requirements are set by the FSC to be in line with the standards under the Basel III framework, which are set out as below.

	2013	2014	2015	2016	2017	2018	From 2019
Common Equity Tier 1 Ratio (per cent)	3.5	4	4.5	5.125	5.75	6.375	7
Tier 1 Capital Ratio (per cent)	4.5	5.5	6	6.625	7.25	7.875	8.5
Total Capital Adequacy Ratio (per cent)	8	8	8	8.625	9.25	9.875	10.5

These ratios are generally defined as follows:

- Common Equity Tier 1 Ratio: net Common Equity Tier 1 divided by total risk-weighted assets;
- Tier 1 Capital Ratio: net Tier 1 Capital divided by total risk-weighted assets; and
- Total Capital Adequacy Ratio: aggregate amount of net Tier 1 Capital and net Tier 2 Capital divided by total risk-weighted assets.

17 How are the capital adequacy guidelines enforced?

A bank shall periodically report relevant capital adequacy-related ratios to the FSC, and the FSC may at any time request a bank to do so. The FSC may assess a bank's capital based on the report made by the bank.

A bank is also required to self-assess its capital adequacy and establish its strategy to maintain its capital adequacy. The FSC may, based on a bank's self-assessment, request the bank to improve its risk management. If the bank fails to do so, the FSC may require the bank to raise the minimum Total Capital Adequacy Ratio, adjust its regulatory capital and risk-weighted assets or submit a capital restructuring plan within a certain period.

18 What happens in the event that a bank becomes undercapitalised?

The level of capitalisation (capital grades) of a bank is classified into four categories as follows:
- adequate capital;
- inadequate capital;
- significantly inadequate capital; and
- seriously inadequate capital.

These four categories are defined based on the relevant ratios as described under question 16, and the ratios increase year by year until 2019. Take 2018 for example, the relevant ratios for the level of undercapitalisation are as follows:

Level of Capitalisation (Capital grades)	Total Capital Adequacy Ratio	Tier 1 Capital Ratio	Common Equity Tier 1 Ratio
Adequate capital	9.875 per cent or more	7.875 per cent or more	6.375 per cent or more
Inadequate capital	7.875 per cent (inclusive) to 9.875 per cent (exclusive)	Less than 7.875 per cent	Less than 6.375 per cent
Significantly inadequate capital	2 per cent (inclusive) to 7.875 per cent (exclusive)	–	–
Seriously inadequate capital	Less than 2 per cent.	–	–
	A bank whose ratio of 'net worth to total assets' is less than 2 per cent		

The FSC should take all or some of the following actions if a bank becomes undercapitalised.

Inadequate capital
- order the bank or its responsible person to submit a plan for capital restructuring or improvement of finance and business. If a bank fails to submit or implement the plan, the FSC may take the actions applicable to the next capital grade; or
- restrict the new acquisition of risky assets or take other necessary actions.

Significantly inadequate capital
- take the actions applicable for inadequate capital;
- remove the responsible person from his or her position;
- order the bank to obtain FSC prior approval before acquiring or disposing of specific assets;
- order the bank to dispose of specific assets;
- restrict or prohibit credit extension or other transactions with interested parties;
- restrict the investment activities or some businesses of the bank, or order the bank to close a branch or department within a prescribed period;
- limit the interest rates for deposits to a level not exceeding the interest rates offered by other banks for comparable deposits or deposits of the same nature;
- order the reduction in remuneration of responsible persons; or
- assign officials to take conservatorship over the bank's operations or take other necessary actions.

Seriously inadequate capital
- take the actions applicable for significantly inadequate capital; or
- place the bank in receivership after 90 days have lapsed since the date the bank was listed as having seriously inadequate capital. However, if a bank is ordered by the FSC to undertake capital restructuring or merger within a prescribed period but fails to comply, the 90 days should be calculated from the day subsequent to the prescribed period.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

As to the circumstances where a bank may be taken over (ie, receivership) by the government, see question 12.

Also, the FSC may order a bank to suspend and wind up its business if there is a concern that the bank might be unable to pay its debts when due or there might be a detriment to the depositors' interests because of obvious deterioration in the bank's business or financial condition. In such a case, the duties and powers of the bank's shareholders' meeting, board of directors, directors, supervisors or audit committee should be suspended.

For the winding-up of a bank, the major processes are generally as follows:
- the FSC designates a liquidator to handle the relevant proceedings;
- after appointment of a liquidator, the liquidator makes a public announcement requesting creditors to declare their claims within 30 days;
- the liquidator prepares the balance sheet and property inventories and the liquidation plan for submission to the FSC within three months of the expiry of the declaration period;
- repayment of debts: for creditors who have been repaid in the winding-up proceeding, the unpaid part of their claims should be deemed extinguished;
- distribution of the remaining assets (if any) to the bank's shareholders; and
- within 15 days of the completion of winding up, the liquidator makes a public announcement of the relevant books and records and makes a filing with the FSC for cancelling the bank's licence.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

As described in questions 16 and 18, the relevant capital adequacy requirements are set by the FSC to be in line with the standards under the Basel III framework, and the relevant ratios are to be increased year by year until 2019. As of 1 January 2019, the Common Equity Tier 1 Ratio shall not be less than 7 per cent, the Tier 1 Capital Ratio shall not be less than 8.5 per cent, and the Total Capital Adequacy Ratio shall not be less than 10.5 per cent.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Both entities and individuals may own a controlling interest in a bank, subject to the Peoples' Republic of China (PRC) ownership restriction (see question 22) and prior approvals (see question 26).

In addition, Taiwan's FHCA generally requires that if a person (including related parties) concurrently has a 'controlling interest' in at least two types of business entities (being a bank, a securities firm or an insurance company), the person should apply to the FSC for setting up a financial holding company (to indirectly hold stakes in the bank, securities firm or insurance company), subject to certain exceptions. 'Controlling interest' means:
- holding more than 25 per cent of the issued bank's voting shares, securities firm or insurance company; or
- otherwise having the direct or indirect power to appoint the majority of the directors of the bank, securities firm or insurance company.

22 Are there any restrictions on foreign ownership of banks?

Currently there is no general restriction on foreign ownership of banks, except for certain restrictions on investment in a bank by persons from the PRC. Generally, no PRC investor may invest in a Taiwanese bank, unless the PRC investor is, among others:

- a PRC bank (the definition may be complicated, which generally also includes a bank not incorporated in the PRC but is 30 per cent owned by PRC persons and controlled by PRC persons), subject to the following restrictions on ownership percentage:
  - a PRC bank's investment in a Taiwanese bank may not exceed 5 per cent of the total issued voting shares or capital amount of the Taiwanese bank; and
  - a PRC bank's investment in a Taiwanese bank, together with investment by other PRC investors (generally the qualified domestic institutional investors (QDII) as approved by the PRC's securities regulator, as further explained below), may not exceed 10 per cent of the total issued voting shares or capital amount of the Taiwanese bank; and
- other PRC investors:
  - any QDII is generally allowed to trade listed shares of a Taiwanese bank cumulatively up to a 10 per cent shareholding of any single Taiwanese bank.

23 What are the legal and regulatory implications for entities that control banks?

See question 26 for the FSC's prior approval required for acquisition of banks.

If the entity controlling a bank is a financial holding company, it should be subject to regulation under the FHCA, which covers, among other things, shareholders' reporting obligations, business (eg, permitted investment activities), and finance (eg, permitted use of short-term funds, capital adequacy) with respect to a financial holding company.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

See question 26 for the FSC's prior approval required for the acquisition of a bank, and question 29 for required filing for the acquisition of a bank.

If the entity controlling a bank is a financial holding company, it should be subject to the regulation under the FHCA, which covers, among other things, shareholders' reporting obligations, business (eg, permitted investment activities) and finance (eg, permitted use of short-term funds, capital adequacy) with respect to a financial holding company.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

There is no criminal or administrative sanction set out under the Banking Act that would be imposed on an entity or individual simply because it controls a bank in the particular event that the bank becomes insolvent.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The following are the major regulatory approvals generally required for acquisition of a bank.

FSC

The FSC's prior approval would be required for any acquisition of 10 per cent, 25 per cent and 50 per cent of the issued bank's voting shares by a person (including related parties). The definition of 'related party' of a bank generally includes the following (assuming that the investor is a juridical person):

- the juridical person and its chair and general manager, as well as their spouses and relatives by blood within the second degree of kinship;
- an enterprise in which the juridical person and natural persons referred to in the above hold more than one-third of voting shares or capital contribution;
- the enterprise or foundation in which the juridical person and natural persons referred to above serve as the chair, general manager or majority of the directors; and
- the affiliated enterprises of the juridical person.

In addition, the shares held by a third party for, or on behalf of, the person or related party in trust, by mandate or through other types of contract, agreement or authorisation should be aggregated with the shareholdings held by the person or the related party.

See question 21 for the requirement of setting up a financial holding company to hold a bank, securities firm or insurance company.

Investment Commission (IC)

Foreign and PRC investors (other than foreign and PRC investors who have registered with the Taiwan Stock Exchange for making investments in the Taiwan securities market) wishing to make direct investments in a Taiwanese bank are generally required to submit a foreign or PRC investment approval application to the Investment Commission of the Ministry of Economic Affairs or other applicable government authority. However, see question 22 for the PRC ownership restriction.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The FSC is generally receptive to foreign acquirers, provided that PRC investors should be subject to the PRC ownership restriction as described under question 22.

There is no major difference in acquisition of a Taiwanese bank by a foreign acquirer (compared with a local acquirer) except for the PRC ownership restriction as described in question 22 and the prior approval from the IC) as described under question 26.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

During the application process for the FSC prior approval (as described in question 26), the FSC would normally require the applicant to provide certain supporting information regarding the applicant or relevant plan post-closing, or both, such as:

- the applicant's good faith, integrity, interests in the bank (in the case of approval for 10 per cent investment);
- whether the applicant's business and finance conditions may improve the safety and soundness of the operations of the bank (in the case of approval of a 25 per cent investment); and
- operation plan, information on future management team, protection of employees' interests (in the case of 50 per cent investment).

The FSC may have sole discretion as to whether to grant the approval.

Where an entity wishes to set up a financial holding company (to hold a bank, securities firm or insurance company) (see question 21 for the requirement), the FSC would examine the following factors:

- the soundness of the financial and business condition as well as the management capacity;
- capital adequacy; and
- the impact on the competition in the financial market and improvement in the public interest.

29 Describe the required filings for an acquisition of control of a bank.

See question 26 for prior approvals required for acquisition of a bank.

In addition, the following are other certain important notification and reporting obligations with respect to substantial shareholding in a bank.

1 per cent shareholding notification to the bank

If an investor (together with the investor's spouse and minor children (as applicable)) in aggregate has held 1 per cent or more of voting shares in a bank, the investor shall report this fact to the bank. This notification need only be made to the bank and not the FSC.

5 per cent shareholding reporting to the FSC

If an investor (including related parties) acquires or holds more than 5 per cent of the bank's voting shares, it shall report this fact to the FSC within 10 days. Thereafter, in the event of any 1 per cent cumulative change (increase or decrease) in these shareholdings, further reporting is required to be made to the FSC within 10 days of this change. The definition of 'related party' of a bank generally includes the following (assuming the investor is a juridical person):

- the juridical person and its chair and general manager as well as their spouses and relatives by blood within the second degree of kinship;

- an enterprise in which the juridical person and natural persons referred to in the above hold more than one-third of voting shares or capital contribution;
- the enterprise or foundation in which the juridical person and natural persons referred to above serve as the chair, general manager or majority of the directors; and
- the affiliated enterprises of the juridical person.

In addition, the shares held by a third party for, or on behalf of, the person or related party in trust, by mandate or through other types of contract, agreement or authorisation should be aggregated with the shareholdings held by the person or the related party.

10 per cent shareholder's monthly reporting
By the fifth day of each month, an investor (including related parties) holding more than 10 per cent of a bank's voting shares should report its shareholding changes during the preceding month to the bank, and the bank should report this information to the Taiwan Stock Exchange or Taipei Exchange and make the required announcement by the 15th day of each month.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

For a domestic acquirer, prior approval from the IC would not be required. It would typically take about two months for the FSC to grant its approval.

For a foreign acquirer, FSC and IC approvals are both required. It would typically take between three to four months to receive both of the approvals.

See question 26 for the requirement for prior approvals.

The above timeframe starts from the time that all required documents and information are in order for filing, so it would take more time for document preparation (eg, notarisation and legalisation of relevant required documents would generally be required for a foreign acquirer). The actual time spent depends on individual cases.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The principal governmental and regulatory policies that govern the banking sector are:
- UAE Federal Law No. 10 of 1980 concerning the Central Bank;
- the Monetary System and the Organisation of Banking (the Banking Law);
- UAE Federal Law No. 18 of 1993, as amended (the Commercial Code);
- UAE Federal Law No. 6 of 1985 concerning Islamic banks, financial establishments and investment companies (the Islamic Banking Law); and
- various circulars, notices and resolutions issued by the board of governors of the UAE Central Bank, from time to time.

2 Summarise the primary statutes and regulations that govern the banking industry.

The Banking Law establishes the UAE Central Bank and contains detailed provisions on the role of the UAE Central Bank, which, among other things, includes:
- issuance of currency;
- organising, promoting and supervising banking;
- directing the credit policy;
- advising the government on financial and monetary issues;
- acting as the government's bank;
- maintaining gold and foreign exchange reserves; and
- acting as bank for other banks in the UAE.

The Banking Law also contains detailed provisions on the registration, licensing and operation of:
- commercial banks;
- investment banks;
- financial institutions;
- monetary and financial intermediaries; and
- representation offices.

The Banking Law is, however, not applicable to:
- public credit institutions set up by law;
- governmental investment institutions and agencies;
- governmental development funds;
- private savings and pension funds; and
- insurance and reinsurance companies and agencies.

The Commercial Code contains detailed provisions on banking operations, which include, among others, provisions governing:
- bank deposits;
- bank accounts;
- guarantees;
- documentary credits;
- bills of exchange;
- loans;
- promissory notes; and
- cheques.

The Islamic Banking Law contains provisions relating to the establishment and operation of Islamic banks. Islamic banks shall also be subject to the provisions of the Banking Law, with certain exceptions.

The various circulars, regulations, notices and resolutions issued by the UAE Central Bank deal with various aspects of banking including:
- bank accounts;
- maintaining certain reserve ratios;
- capital adequacy norms;
- measures to combat money laundering; and
- reporting requirements to the UAE Central Bank.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The UAE Central Bank is primarily responsible for overseeing banks in the UAE, except in the Dubai International Financial Centre (DIFC), where the regulatory authority is the Dubai Financial Services Authority (DFSA) and in the Abu Dhabi Global Market (ADGM), where the regulatory authority is the Financial Services Regulatory Authority (FSRA).

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Deposits are not insured in the UAE. In practice, the government has intervened on occasions to ensure that depositors do not suffer a loss. From time to time, the governments of various emirates of the UAE or entities owned by such governments have taken ownership interests in the banking sector. Such interests have not increased or decreased as far as we are aware.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

In this regard there are prescribed percentages of maximum exposure that a bank may incur to its parent company or subsidiaries or other subsidiaries of its parent company. A subsidiary is a company in which a bank holds a minimum of 40 per cent of share capital or has controlling influence (eg, through the composition of the board of directors).

Also, Circular No. 16/93 issued by the UAE Central Bank governs large exposures incurred by banks. Large exposures are funded exposures (fewer provisions, cash collateral and deposits under lien). Banks are restricted from exceeding the maximum exposure per client or group. Circular No. 32/2013 dated 11 November 2013 has been issued by the UAE Central Bank to replace Circular No. 16/93. Revised restrictions have been imposed with regard to lending to government and government-owned entities. Banks cannot lend sums exceeding 100 per cent of their capital to governments or their related companies or more than 25 per cent to an individual borrower. The rules also prescribe the manner in which different categories of assets are to be risk-weighted. The 2013 Circular provided five years to the banks to meet the exposure limits set out in the circular. Given the current banking situation, the deadline is likely to be extended.

With respect to permissible activities of a commercial bank, under the Banking Law, a commercial bank is an institution that customarily receives funds from the public in the form of demand, under notice, time deposits, or that carries on the placement of debt instruments or deposit certificates to be used, in whole or in part, for its account and at its risk, for granting loans and advances. The Banking Law further provides that commercial banks also carry on operations relating to the issue and collection of cheques, the placing of public or private bonds, trade in foreign exchange and precious metals, or any other operations allowed for commercial banks either by law or by customary banking practice.

With respect to Islamic banks, permissible activities are not specified in the Islamic Banking Law, which provides that Islamic banks means those whose memoranda of association include a commitment to abide by the provisions of sharia law and conduct their activities in accordance with them. Islamic banks have the right to carry on all or part of banking, commercial, financial and investment services and operations. They have the right to engage in all types of services and operations practised by banks and referred to in the Banking Law whether those operations and services were conducted for the Islamic bank's own account or for or in partnership with a third party. Islamic banks also have the right to establish companies and participate in enterprises provided that activities of the latter are in conformity with shariah. The Islamic Banking Law provides that Islamic financial institutions and investment companies shall have the right to carry out lending, credit and other financial operations. They may also participate in enterprises, invest their funds in movable assets and receive deposits for investment thereof in accordance with the provisions of shariah law. In terms of the Islamic Banking Law, Islamic banks are subject to the provisions of the Banking Law.

With respect to prohibited activities, article 90 of the Banking Law provides that no commercial bank shall:

- carry on for its own account commercial or industrial activities or acquire, own or trade in goods, unless the acquisition of such goods is for settlement of debts due from others, in which case the goods must be disposed of within the period defined by the governor of the UAE Central Bank;
- acquire immovable property for its own account, except immovable property required for the conduct of the bank's business or for housing or amenities for its staff, or immovable property acquired in settlement of debts, in which case, however, the property must be sold within three years (this period may be extended by decision of the governor of the UAE Central Bank);
- hold or deal in the bank's own shares unless they are acquired in settlement of a debt, in which case they must be sold within two years from the date of their acquisition; and
- purchase shares of, or bonds issued by commercial companies, in an amount that would raise the bank's holding in it above 25 per cent of the bank's own funds, unless acquired in settlement of a debt, in which case the excess must be sold within two years from the date of acquisition.

Article 90 of the Banking Law further states that the prohibition shall not apply to the acquisition or holding of bonds issued or guaranteed by the government or other public-sector institutions.

Article 91 of the Banking Law provides that commercial banks shall not grant loans or advance funds on current accounts to members of their board of directors, to managers of departments or to similar staff members, except by prior licence from the board of directors of the UAE Central Bank, which must be renewed annually. Article 91 further provides that this prohibition shall not include the discount of commercial paper, the issuance of bank guarantees or the opening of documentary letters of credit. Article 91 provides that no bank may offer to its customers credit facilities against the shares in the bank. Further, no bank may grant loans or advances for the purpose of constructing commercial or residential buildings, exceeding in total 20 per cent of its total deposits. This prohibition does not apply to banks specialising in real estate loans and authorised to do so by the UAE Central Bank.

Article 92 of the Banking Law provides that no commercial bank may issue travellers' cheques without prior authorisation from the UAE Central Bank. Article 93 of the Banking Law provides that no person who has been convicted of theft, dishonesty, fraud, embezzlement or the writing, with bad intent, of cheques against insufficient funds may be or remain a member of the board of directors of any commercial bank and no member of the board of directors or manager of any commercial bank may hold, without permission from the board of directors of his bank, a position as bank manager or member of the board of directors of any other bank.

The Islamic Banking Law does not contain specific provisions for prohibited activities. However, article 4 of the Islamic Banking Law provides that Islamic banks, financial institutions and investment companies incorporated in the country, along with branches and offices of foreign Islamic banks, financial institutions and investment companies licensed to operate in the country shall be exempted from the provisions of clause (a) of article 90 of the Banking Law (see above). Article 4 of the Islamic Banking Law further provides that Islamic banks, financial institutions and investment companies shall also be exempted from provisions of clause (b) of article 90 of the Banking Law and in a manner not contravening established legislation in the emirate concerned.

6 What are the principal regulatory challenges facing the banking industry?

The principal regulatory challenges derive from the fact that the Banking Law has not been amended or updated since it was promulgated in 1980 and, accordingly, does not address developments in financial services that have taken place since 1980. The subsisting regulations generally lack sophistication. Draft amendments to the Banking Law were proposed a decade ago but have yet to be promulgated.

In addition, the banks and the financial institutions in the UAE are now required to comply with the US Foreign Account Tax Compliance Act. The UAE and the US reached an agreement in May 2014 to include the UAE on the list of jurisdictions to be treated as having an intergovernmental agreement (IGA) in effect. The UAE has adopted Model 1 and banks and financial institutions in the UAE have started to comply with IGA requirements.

In another significant regulatory change, banks are required to implement the International Financial Reporting Standards 9 (IFRS 9) from January 2018. The new regulation strongly affects the way credit losses are recognised. This is likely to increase the compliance costs and have an impact on the balance sheets of the banks.

The UAE has committed to implement the Common Reporting Standard (CRS), with the first exchange to take place by September 2018. The banks have started collecting information from their customers on tax residency status for the purposes of CRS reporting.

7 Are banks subject to consumer protection rules?

The UAE has promulgated Federal Law No. 24 of 2006 and certain other regulations for consumer protection. However, this legislation does not expressly include 'banks' within their ambit. In addition, as the banks are supervised by the UAE Central Bank, it is unlikely that this legislation would have a bearing on the banking sector.

There are no specific customer protection rules for the banking sector. However, any complaint against a bank can be made by a consumer to the UAE Central Bank.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

As noted in question 6, an overhaul or substantial amendment of banking legislation is overdue. DIFC's successful completion of a decade in the Emirate of Dubai, with its own jurisdiction and body of modern laws, and its widening jurisdictional approach, is precipitating changes to wider UAE legal and regulatory policies. Following the success of DIFC, a financial free zone in Abu Dhabi (Abu Dhabi Global Market) became operational from the second half of 2015; becoming, to date, quite active.

The regulatory policy for the banking industry is likely to follow a conservative approach.

In a significant development that would have wide-ranging implications, the new Bankruptcy Law of the UAE was enacted on 20 September 2016 as Decree-Law No. 9 of 2016 (the Bankruptcy Code). It came into effect on 31 December 2016. The new Bankruptcy Code replaces and repeals the previous legislation on the subject, Book 5 of the Commercial Code, which was seldom used in light of its perceived shortcomings. Perhaps the most important new feature of the new Law is the introduction of a regime that allows for protection and reorganisation of distressed businesses.

In a significant development, Value Added Tax (VAT) was introduced in the UAE from 1 January 2018. The rate of VAT is kept low at 5 per cent for most goods and services (unless exempted or zero rated). Interest-bearing banking transactions are zero rated, while transaction fees and margin-based transactions will attract VAT at the rate of 5 per cent. For the purposes of VAT, Islamic banking products will be generally treated at par with conventional banking products. The development will marginally increase the cost of banking for customers.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Banks are supervised by the UAE Central Bank through the various reports that are required to be filed by banks with the UAE Central Bank on a periodic basis. Further, under the Banking Law, the UAE Central Bank is entitled to inspect the books, records and accounts of any bank at its discretion. In certain cases, the Central Bank has appointed administrators or representatives to temporarily manage a bank. These audits are ordinarily conducted once a year and are reasonably extensive.

10 How do the regulatory authorities enforce banking laws and regulations?

Any failure by banks to comply with the laws and regulations would be notified by the UAE Central Bank, with the bank given an opportunity to rectify the breach. Continued failure would attract consequences ranging from fines to cancellation of the licence to conduct banking.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The most common issues facing the regulator and banks have included approval of investment products, issues pertaining to selling of investment products and concerns regarding institutions operating within the scope of their licences. In July 2012, the Emirates Securities and Commodities Authority (SCA) issued the much-anticipated new UAE Investment Fund Regulation (Fund Regulation). The Fund Regulation transfers regulatory responsibility for the licensing and marketing of investment funds and for a number of related activities from the UAE Central Bank to the SCA. The sale, marketing and promoting of foreign securities and funds in the UAE and the establishment of domestic funds requires SCA consent. However, even under the new regulations, the ambiguity regarding registration requirements for an investment product continues.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

The banks may be taken over by the government or regulatory authorities in the interest of the bank's depositors. If a bank has insufficient liquidity to meet its obligations and there is risk to the bank's depositors, the bank may be taken over by the government.

While such instances are uncommon, a few such takeovers were reported recently in the wake of the financial crises. The Dubai Bank was taken over by the government of Dubai in 2011 through its majority-owned bank, Emirates NBD.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

Any commercial bank operation in the UAE is required to maintain a minimum paid-up capital. If the bank's capital falls below the required minimum, the deficiency must be met within the time prescribed by the UAE Central Bank. This period must not be more than one year from the date the deficiency is made known to the concerned bank. There is no specific plan or similar document prescribed under UAE laws.

14 Are managers or directors personally liable in the case of a bank failure?

Managers or directors are not personally liable unless the bank's failure is attributable to any fraud or illegality committed by them.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

There are no such mandatory requirements.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The UAE Central Bank issued a new circular, Circular No. 52/2017, dated 23 February 2017, whereby all banks are obliged to comply with Basel III. Therefore, the UAE banking system has moved from Basel II to the Basel III standard.

These regulations and the accompanying standards apply to all banks in the UAE. Banks must ensure that these regulations and standards are adhered to on the following two levels:

- the solo level capital adequacy ratio requirements, which measure the capital adequacy of an individual bank based on its standalone capital strength; and
- the group level capital adequacy ratio requirements, which measure the capital adequacy of a bank based on its capital strength and risk profile after regulatory consolidation of assets and liabilities of its subsidiaries.

Compliance with the regulations is effective from 1 January 2018.

17 How are the capital adequacy guidelines enforced?

Banks are required to report compliance with the capital adequacy guidelines as per the format and frequency prescribed by the UAE Central Bank. In case of breach, the UAE Central Bank is most likely to issue a notice and seek adherence to the guidelines. If the breach continues, the UAE Central Bank has wide discretion to take appropriate actions for enforcing the guidelines.

18 What happens in the event that a bank becomes undercapitalised?

If a bank is undercapitalised at any point, it must rectify the deficiency within one year or any shorter period as may be notified to it by the Central Bank. Any failure to so rectify could attract consequences ranging from fines up to cancellation of its licence to conduct banking.

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

Commercial banks in the UAE are incorporated as public joint-stock companies or as branches of foreign banks. Investment banks and other financial institutions may be incorporated as public joint-stock companies, private joint-stock companies or as branches of foreign investment banks and financial institutions. Monetary and financial intermediaries may be incorporated as public joint-stock companies, private joint-stock companies, limited liability companies or as branches of foreign monetary and financial intermediaries.

Insolvency of public joint-stock companies, private joint-stock companies, limited liability companies and branches of foreign companies are governed by the provisions of the UAE Federal Law No. 2 of 2015, as amended (the Companies Law) and the provisions of the Bankruptcy Code. Additionally, pursuant to the Banking Law, a notice of liquidation of any commercial bank must be published in the Official Gazette and in at least two local daily newspapers.

The notice of liquidation shall give the bank's customers at least three months' notice to take necessary steps to enforce their rights. The notice shall also provide the name of the liquidator entrusted with the payment of the outstanding deposits and other transactions relating to the bank.

Traditionally, if locally incorporated banks faced a bankruptcy situation, they were merged with other banks.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

See question 16.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Under the Companies Law, at least 51 per cent of any company incorporated in the UAE (outside the free zones) must be owned by UAE nationals or entities wholly owned by UAE nationals. Additionally, as per the relevant UAE Central Bank's resolutions, for finance companies, at least 60 per cent of the shares must be held by UAE nationals or entities wholly owned by UAE nationals.

22 Are there any restrictions on foreign ownership of banks?

Yes. A bank incorporated in the UAE must be majority owned by UAE nationals. There are several branches of foreign banks operating in the UAE.

23 What are the legal and regulatory implications for entities that control banks?

The experience and expertise of an entity that acquires control of a company involved in banking and financial services will be considered by the UAE Central Bank to approve the controlling acquisition. However, there are no formal restrictions on such an entity carrying on any other business.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

The legal and regulatory duties and responsibilities of an entity or individual who controls the bank would be to ensure that the banking operations are conducted in accordance with the requirements of the Banking Law, the Commercial Code and the various notices, circulars and resolutions of the UAE Central Bank. There will be no express obligation on the shareholders to provide additional capital in the event that a bank becomes undercapitalised, but the Central Bank will require the capital to be increased, failing which the bank may be fined or have its licence cancelled.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

Generally, no legal liability attaches to the controlling entity as a result of insolvency of a bank.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

There is no specific definition of control (save in relation to determination of large exposure). Therefore, 'control' should mean a majority shareholding interest in the bank, a right to exercise control through representation at the bank's board, or both. Any change in such a controlling entity requires the prior written approval of the UAE Central Bank. Upon receipt of the approval, subsequent approvals of the emirate's local licensing authorities where the bank is incorporated must also be obtained.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

In the view of the local ownership requirements, a foreign party may not acquire a UAE-incorporated bank.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

A change in ownership or control of a bank is a relatively rare phenomenon in the UAE. Most of the locally incorporated banks are owned by the governments or the ruling families of the relevant emirates in which they are based. In the event of a proposed acquisition, we would expect the UAE Central Bank to consider issues such as the identity of the acquirer, its track record, any conflicts of interest as well as the purpose and term of the investment.

29 Describe the required filings for an acquisition of control of a bank.

See questions 26 and 27.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

All approvals from the UAE Central Bank are at its discretion and no approximate time frames may be stated. However, depending on the identity of the acquirer, approval of the Central Bank would be a matter of months, rather than days or weeks.

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

The banking sector is regulated for prudential purposes by the Prudential Regulation Authority (PRA), which is part of the Bank of England, the UK central bank. A committee of the Bank of England, the Prudential Regulation Committee (PRC), is responsible for exercising the functions of the Bank in its role as the PRA. The Financial Conduct Authority (FCA) is the conduct regulator for the banking sector and coordinates closely with the PRA. The Financial Policy Committee (FPC), which operates from within the Bank of England, acts as the macro-prudential regulator for the UK financial system.

The work and purpose of the regulators are defined in legislation by the Financial Services and Markets Act 2000 (FSMA 2000). The PRA's general statutory objective is to promote the safety and soundness of PRA-authorised persons. That objective is to be advanced primarily by first seeking to ensure that the business of PRA-authorised persons is carried on in a way that avoids any adverse effect on the stability of the UK financial system, and second 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. The PRA will soon be required to advance its general objective in ways that reflect its regulatory role in respect of ring-fenced banks (see question 6 for further details on ring-fencing). The PRA's strategy is determined in relation to its objectives, and reviewed from time to time. The PRA published a paper setting out its approach to banking supervision in March 2016. At the time of writing, it is consulting on its approach to authorising and supervising international banks in light of the UK's withdrawal from the EU.

The FCA must, so far as is reasonably possible, act in a way that is compatible with its strategic objective and advances one or more of its operational objectives. The FCA's overarching strategic objective is ensuring that the financial markets function well. The FCA's operational objectives are:
- securing an appropriate degree of protection for consumers;
- protecting and enhancing the integrity of the UK's financial system; and
- promoting effective competition in the interests of consumers in the markets for regulated financial services.

The FCA set out its approach to advancing its objectives in a document published in December 2015.

The FPC has primary responsibility to protect and enhance the resilience of the UK's financial system. This involves identifying, monitoring and taking action to reduce systemic risks. It also has a secondary objective to support the economic policy of the government. Alongside the PRC, the FPC contributes to the design and calibration of the stress testing framework for banks. It also has the power to direct the regulators to take action including setting a counter-cyclical capital buffer for the UK and adjusting sectoral capital requirements for UK firms in certain areas.

2 Summarise the primary statutes and regulations that govern the banking industry.

The primary statute governing banking in the UK is FSMA 2000. Extensive amendments were made to FSMA 2000 by the Financial Services Act 2012 that established the PRA, FCA and FPC as regulatory bodies. Further changes were made by the Financial Services (Banking Reform) Act 2013 (FS(BR)A 2013) to implement key reforms such as ring-fencing requirements for the banking sector and the introduction of the Senior Managers Regime and the Certification Regime (see question 8).

Under FSMA 2000, it is a criminal offence for a person to engage in 'regulated activities' in the UK unless he or she is authorised to do so or is exempt from the authorisation requirement. Regulated activities are defined in secondary legislation.

Accepting deposits is a regulated activity where such deposits are lent to third parties, or where any other activity is financed wholly or to a material extent out of capital or interest on deposits. Banks must therefore obtain authorisation under FSMA 2000 to accept deposits.

Other regulated activities that may be relevant to banks for the purposes of the UK financial services regime include:
- dealing in investments as principal;
- dealing in investments as agent;
- arranging deals in investments;
- managing investments;
- safeguarding and administering investments (ie, custody); and
- providing investment advice and mortgage lending.

Investments include:
- shares;
- debentures (including *sukuk*);
- public securities;
- warrants;
- futures;
- options;
- contracts for differences (eg, swaps); and
- units in collective investment schemes.

The primary regulatory framework for consumer credit activities is also set out in FSMA 2000 and in the Consumer Credit Act 1974 (as amended).

A Special Resolution Regime (SRR) to facilitate the orderly resolution of banks in financial difficulties is set out in the Banking Act 2009 (BA 2009) and comprises pre-insolvency stabilisation options, a bank insolvency procedure and bank administration procedure. An insolvency regime that applies to investment banks (including banks carrying on investment banking activities) is set out in the Investment Bank Special Administration Regulations 2011 (see question 19, among others).

3 Which regulatory authorities are primarily responsible for overseeing banks?

The PRA is the principal regulator of banks and is responsible for both authorisation and prudential supervision. The FCA regulates banking for conduct of business purposes. Both the PRA and the FCA have disciplinary and enforcement powers. Since 1 April 2014, the FCA has also been responsible for the regulation of consumer credit. The FCA has competition powers to enforce prohibitions on anticompetitive behaviour in relation to the provision of financial services, which are exercised concurrently with the powers of the UK Competition and Markets Authority (CMA). The Bank of England, together with the UK

Treasury, has a role in operating the SRR for failing banks (see questions 13 and 19). As discussed, the FPC acts as a macro-prudential regulator responsible for identifying and taking action to reduce systemic risks. The Payment Systems Regulator regulates retail payments systems. Its powers are cast broadly and impact not only on payment systems themselves, but also banks that participate in them.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

Deposits are not insured by the UK government but by the Financial Services Compensation Scheme (the Scheme). The Scheme is an independent body set up under FSMA 2000. The PRA and the FCA are responsible for determining the rules within which the Scheme operates, including the persons eligible to make a claim, and the level of compensation. The Scheme is free to consumers and protects deposits as well as covering insurance policies, insurance broking, investment business and mortgage advice. It is funded by the financial services industry through levies collected by the FCA.

The Scheme pays compensation, up to certain limits, to eligible customers of financial services' firms that are unable, or likely to be unable, to pay claims against them. The maximum compensation sum payable in relation to a protected deposit is currently £85,000, subject to certain exceptions. The rules for compensation relating to deposit claims under the Scheme are based on, and implement, EU legislation. Among other things, banks are required to develop a single customer view – a means of identifying all depositors that would be eligible if the bank were to default – which would provide the Scheme with the information required to meet claims within a target time frame of seven days from default. Deposits that are eligible for compensation under the Scheme are treated as preferential debts and are given a higher priority within the class of preferential debts than other deposits, ranking ahead of unsecured non-preferred creditors on an insolvency.

At the height of the global financial crisis in 2008 and 2009, the UK government adopted a number of emergency measures in the banking sector, including liquidity assistance, recapitalisations and an asset protection scheme. Major UK banks were required to increase their Tier 1 capital significantly. RBS Group plc (RBS) and Lloyds Banking Group (LBG), unable to raise additional capital externally, received government capital injections. RBS benefited from a second capital injection at the time of its accession to the UK government's asset protection scheme in 2009. The government's support to banks also included the nationalisation of failed mortgage lenders Northern Rock and Bradford & Bingley.

The total current level of government support provided to banks has fallen significantly from its peak level. In August 2015, the government began the process of selling RBS shares back to the private sector. It still owns about 71.5 per cent of total voting rights. LBG returned to full private ownership in May 2017. Following a good bank, bad bank split, the viable part of Northern Rock's business was sold to Virgin Money in November 2011. The closed mortgage books of Bradford & Bingley and Northern Rock are managed by UK Asset Resolution Limited, a holding company established by the government, which is pursuing a strategy of reducing its balance sheet, while creating value for the taxpayer and ensuring continued fair treatment of customers.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

There are a number of relevant considerations. The directors of a bank must act in a way that they consider is most likely to promote its success. While directors can take into account a bank's membership of a wider group, they are not entitled to subordinate the interests of the bank to those of other group companies, such as by lending to an insolvent parent or sister company.

If a bank is a member of a group whose shares are listed on the London Stock Exchange, the Listing Rules impose requirements in respect of 'related party transactions'. Group companies are related parties.

The PRA also restricts large exposure (LE). A LE is an exposure of 10 per cent or more of a bank's Tier 1 and Tier 2 capital (after deductions from capital) to a single counterparty or a group of connected clients. A firm's total exposure to the rest of its group is limited to 25 per cent of its eligible capital (Tier 1 plus a portion of Tier 2). Banks can apply to the PRA, subject to conditions being met, to assign a 0 per cent risk weight for exposures to certain UK entities within their consolidation group. These exposures are exempt from the LE limit. All the entities included in this permission are referred to as a firm's core UK group. A bank can also apply to the PRA to increase its total exposures to certain cross-border group entities from 25 per cent to 100 per cent of its own eligible capital. These entities are referred to as the non-core LE group. Total exposures from a firm's core UK group to its non-core LE group are limited to 100 per cent of eligible capital. The PRA is currently consulting on proposed changes and clarifications to this regime. Under the ring-fencing regime (see question 6), a ring-fenced bank will be required treat intragroup exposures to entities outside the ring-fenced bank sub-group as equivalent to third-party exposures.

As for permissible and prohibited activities, a bank may not carry on insurance business because EU directives restrict writing insurance to firms authorised to do so and prohibit them from carrying on any other activity. A bank may, however, own an insurance subsidiary.

Ring-fenced banks will be prohibited from carrying out certain activities, referred to in FSMA 2000 as 'excluded activities', which equate broadly to investment and wholesale banking activities that are considered to pose a risk to the provision of 'core' retail deposit-taking services, because they may impose losses on the bank or they may make the bank's resolution more complicated (see question 6). Most essential banking services provided to individuals and small and medium-sized enterprises (SMEs) will in practice be undertaken by ring-fenced banks. Although most wholesale market activities will be prohibited for ring-fenced banks, limited wholesale market activities in respect of funding, hedging and liquidity will be permitted. Ring-fenced banks will also be permitted to offer 'simple' derivative products to SMEs and individuals for hedging purposes.

6 What are the principal regulatory challenges facing the banking industry?

A recent area of focus for many of the larger UK banking groups has been the development of retail banking ring-fencing planning arrangements, the requirements for which were introduced through FS(BR)A 2013. We expect the ring-fencing and structural reform agenda to continue to dominate the regulatory landscape for affected banks. The ring-fencing regime will require certain UK banking groups with significant retail and SME banking operations to 'ring fence' certain core deposit-taking activities for retail and SME depositors in a legal entity that will not be permitted to carry on certain specified wholesale and investment banking activities. Compliance with the requirements involves significant business model, operational and legal reorganisations, which will need to be carried out by 1 January 2019. A number of UK banks are currently in the process of restructuring their businesses to comply with the requirements through the use of a ring-fencing transfer scheme, for which an application must be made to court. Court direction hearings began in 2017 and continue into 2018.

Banks are being forced to devote greater resources to enhancing the security, vigilance, and resilience of their cybersecurity defences. This is becoming one of the more important sources of legal, regulatory and reputational risk for banks. PRA interest in cybersecurity was further heightened by an attack in November 2016 on Tesco Bank, which affected approximately 40,000 accounts (with money being removed from approximately half of these).

For some time, digital technologies have been playing an increasingly important role in creating new opportunities and challenges for banks. Although fintech has arguably yet to materially change the competitive landscape, the banking sector is increasing its investment, participation and collaboration in this area.

The UK's departure from the EU raises significant uncertainty for the UK's banking industry. At the time of writing it is difficult to predict how the regulatory framework applying to banks will change in the medium to long term. Many banks are preparing for the possibility that the UK will no longer remain a member of the EU single market becoming, for regulatory purposes, a 'third country'. Some banks are therefore considering or accelerating restructuring plans for their EU business or seeking deposit-taking licences in multiple jurisdictions. In the meantime, banks are expected to continue to comply with requirements derived from EU law and to continue implementing legislation that is yet to come into effect in the period of negotiations for a UK–EU settlement.

7 Are banks subject to consumer protection rules?

There are numerous pieces of legislation providing for the protection of UK consumers covering areas such as the supply of goods and services, unfair contract terms and distance selling. Banks must comply with these generally applicable measures as much as any other business. Among other things, this legislation implies certain terms into consumer contracts for:

- goods and services;
- protecting consumers from unfair or unclear contractual terms;
- mandating how businesses must contract with consumers under certain circumstances (such as distance selling); or
- supplying certain types of services (such as consumer credit).

Key strands of consumer protection law in the UK were consolidated by the Consumer Rights Act 2015, which deals with:

- unfair terms in consumer contracts;
- rights and remedies in relation to contracts for goods and services;
- extended powers of, and remedies that can be imposed by, enforcement authorities; and
- enabled consumers to bring private collective actions against anticompetitive behaviour by businesses.

Further to secondary legislation implementing EU Consumer Rights Directive 2011/83/EU, there is a ban in the UK on excessive payment surcharges attached to certain methods of payment and rules on distance and doorstep selling.

One of the FCA's objectives is to ensure an appropriate degree of protection for all consumers. Towards the end of 2017, the FCA published an Approach to Consumers paper which is intended to explore its approach to regulating for retail consumers. As regulated firms, banks are subject to the FCA's Treating Customers Fairly (TCF) regime, which requires them to pay due regard to the interests of their customers and to treat them fairly. This is an overarching principle that applies to every aspect of a bank's business, but is supported by more specific FCA rules mandating how banks should deal with customers when providing certain services such as investment advice. The FCA enforces the TCF regime and can fine or publicly censure banks that breach TCF requirements, as well as requiring them to offer consumer redress where appropriate.

The FCA, in conjunction with the CMA, has competition powers to enforce prohibitions on anticompetitive behaviour in relation to the provision of financial services. It can also carry out market studies and refer markets to the CMA for in-depth review. Recent work in this context includes an investigation into the supply of retail banking services to personal current account customers and SMEs. The FCA has also explored competition in investment and corporate banking.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

The PRA's and FCA's policy for supervising banks and banking activity has hardened since the global financial crisis and reflects a more cautious and stability-focused approach to bank supervision. We see no reason for this approach to soften in the near term.

As noted in question 6, the implementation of ring-fencing for banks – the regime separating critical banking services from wholesale and investment banking services – will remain a top priority. The ring-fencing regime will be implemented in the UK from 1 January 2019.

Banks have been required to hold increasing levels of capital and liquidity resources in recent years. The capital and prudential regime for banks continues to evolve with reforms set out in the proposed EU Capital Requirements Directive V (CRD V) (adopted by the European Commission in November 2016) amending the Capital Requirements Regulation (EU) No. 575/2013 (CRR) and the Capital Requirements Directive 2013/36/EU (CRD IV). The reforms include the introduction of Basel III measures into EU law, such as the leverage ratio and the net stable funding ratio, the implementation of the total loss absorbing capacity standard and revisions intended to improve lending to SMEs and to infrastructure. A new package of Basel measures, referred to as Basel IV, was agreed in December 2017. The impact of these will vary from bank to bank.

UK regulators continue to indicate that they want to open up competition in the UK banking industry to new banks. In January 2016, the PRA and FCA launched the New Bank Start-up Unit, a joint initiative, giving information and support to newly authorised banks and those thinking of becoming a new bank in the UK.

Following the global financial crisis, during which senior individuals in banks were blamed for mismanaging their businesses, regulators continue to scrutinise senior management responsibility. The Senior Managers regime replaced the Approved Persons regime for banks on 7 March 2016 and was accompanied by a new certification regime for other important bank staff and a new set of conduct rules. The underlying policy is aimed at supporting a change in culture at all levels in banks and other firms through a clear identification and allocation of responsibilities to individuals responsible for running them, and is considered to be an important element of the PRA's approach to the ongoing assessment of the adequacy of management and governance at firms. We expect the shift in regulatory focus from the collective responsibility of a bank's board to the individual responsibility of directors and senior managers in the banking sector to continue.

Over the next few years, particular importance will be placed on the way in which regulatory policy responds to the development and commercialisation of new financial business models and technology and its impact on banks and fintech. Bank investment in fintech will continue to be heavy, both on own account and through incubators and other sponsored investment arrangements. Banks are looking at the digitisation of all aspects of their back, middle and front office operations, both in the wholesale and retail sphere, with particular emphasis on customer interface and market infrastructure. Innovative uses of technology are bringing benefits to the risk management of banks, as recognised by UK regulators. We expect the use of artificial intelligence and algorithmic solutions in areas such as advice and investment management to continue gaining traction. See also the impact of Brexit in question 6.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The PRA applies the principle of proportionality in its supervision of firms (proportionality being judged in terms of the threats that firms can pose to the PRA's primary objectives). It divides the firms it supervises into five categories of 'potential impact', and the frequency and intensity of supervision applied to firms varies in line with this. The PRA also varies the resource it applies to firms based on their proximity to failure and resolvability. Judgements about a firm's proximity to failure are captured by its position within the PRA's Proactive Intervention Framework (PIF) (see question 14). Other factors, including the complexity of the firm's business and organisation, are also relevant to the level of supervision exercised.

The PRA gathers and analyses information from banks on a regular basis (eg, through regulatory returns). It may request additional, firm-specific data (eg, management information or forecasts). It also requires firms to participate in meetings with supervisors at a senior and working level. The PRA also conducts onsite testing or inspections of a particular area. The stress testing regime allows the PRA to examine the potential impact of a hypothetical adverse scenario on the health of the banking system and the largest firms within it. As noted in question 1, the PRA has published a document setting out is approach to bank supervision in which further details can be found.

The FCA makes its conduct assessment of firms through the firm systematic framework (FSF). This enables the FCA to assess whether a firm is being run, currently and prospectively, in a way that results in the fair treatment of customers, minimises risks to market integrity, and does not impede competition. The FSF is the means by which the FCA conducts structured assessments of firms across all sectors. Common features of the FSF involve:

- business model and strategy analysis, which includes consideration of sectoral risk; and
- the TCF regime, which examines consumer culture and control systems.

The FCA will engage directly with priority firms (including retail banks) on an annual basis as well as carrying out cross-sectoral and thematic reviews to address broad areas of concern.

Both the PRA and FCA have demonstrated a proactive and interventionist approach to their supervisory roles. Enforcement issues are addressed in questions 10 and 11.

10 How do the regulatory authorities enforce banking laws and regulations?

If the PRA or FCA identify a breach of their rules or principles they may bring enforcement proceedings. In particular, the FCA aims to intervene early to tackle potential risks to consumers and market integrity before they crystallise. Sanctions include:

- withdrawal of authorisation;
- fines;
- banning orders; and
- public disclosure of non-compliance ('naming and shaming').

The PRA and FCA also have powers to prosecute certain criminal offences (eg, insider dealing, market manipulation, or carrying on a regulated activity without authorisation) the PRA or FCA (as relevant). In 2017, the FCA pursued a number of criminal prosecutions, though generally fewer criminal cases are pursued in comparison with regulatory action.

The PRA and FCA are required to cooperate closely in taking enforcement action, although the PRA may veto enforcement action by the FCA if this may threaten the stability of the UK's financial system, or cause the failure of a PRA-authorised person in a way that would adversely affect financial stability. In most cases, including insider dealing and money laundering, the FCA is the authority responsible for prosecuting financial services offences.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

In previous years fines have been levied by the PRA and the FCA on banks in respect of:

- failings to be open and cooperative with the regulator;
- anti-money laundering (AML) control failures;
- failings in assessing, maintaining and reporting financial resources; and
- on individuals in respect of failures to exercise due skill, care and diligence in carrying out their roles.

Other recent themes in enforcement that we have addressed in previous editions of this publication have been the attempted manipulation of financial benchmarks and failings in payment protection insurance complaints' handling processes. Enforcement outcomes under the senior managers regime and certification regime are likely to emerge in due course. We also expect banks to be a prime target of enforcement action in relation to new criminal offences for any entity that fails to prevent the facilitation of (UK or foreign) tax evasion by its associated persons, which came into force on 30 September 2017 pursuant to the Criminal Finances Act 2017.

In terms of the most recent enforcement action, in January 2018, the FCA imposed a financial penalty of £250,000 on former RBS interest rate derivatives trader, Neil Danziger, and prohibited him from performing any function in relation to any regulated financial activity. It found that Mr Danziger was knowingly concerned in RBS's failure to observe proper standards of market conduct.

In October 2017, Merrill Lynch International was fined £34,524,000 by the FCA for failing to report 68.5 million exchange traded derivative transactions between 12 February 2014 and 6 February 2016. This was the first enforcement action under the European Markets Infrastructure Regulation against a firm for failing to report details of trading in exchange traded derivatives.

In March 2017, the FCA fined Christopher Niehaus, a former investment banker, £37,198 for sharing client confidential information over WhatsApp. The FCA found that Mr Niehaus failed to act with due skill, care and diligence.

In February 2017, the PRA imposed a fine of £17,850,000 on the Bank of Tokyo-Mitsubishi UFJ Limited and a fine of £8,925,000 on MUFG Securities EMEA for failing to be open and cooperative with the PRA in relation to an enforcement action into the former entity by the New York Department of Financial Services. The PRA emphasised that the timely and accurate provision of information by firms is crucial to the PRA's ability to supervise firms effectively and to meet its statutory objectives. In January 2017, the FCA fined Deutsche Bank AG disgorgement of £9,076,224 and a penal element of £154 million in relation to failures in its AML control framework between 1 January 2012 and 31 December 2015. The financial crime risks were highlighted by 'mirror trades' arranged by the bank's Russia-based subsidiary and booked to the bank's trading books in London.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

See question 19. The Bank of England has responsibility for the resolution of a failing bank, and their group companies, under BA 2009. A number of stabilisation powers are exercisable in relation to a bank under BA 2009 pursuant to the SRR. The aim of the SRR is to provide a mechanism for resolving failing firms that would only be used in situations where failure is imminent, and the other powers of the relevant UK authorities to address the situation are insufficient. The tools available include the transfer of all or part of a bank to a 'bridge bank' owned by the Bank of England or the temporary public ownership of a bank or a bank's holding company. The administration procedure for investment banks (to the extent that they are not authorised deposit-taking institutions) is governed by separate secondary legislation. The Bank of England published a document setting out its approach to resolution in October 2017.

Bank nationalisation is very uncommon in the UK; occurring only to protect the stability of the financial system. Non-systemic banks are subject to insolvency proceedings (mainly bank insolvency and administration, see question 19). Northern Rock was nationalised on 22 February 2008. Bradford & Bingley was nationalised on 28 September 2008, although the deposits and branch network were simultaneously sold to the Santander Group. On 28 March 2009, the Bank of England acquired the commercial lending and poorer quality mortgage portfolio of the Dunfermline Building Society. The deposits and branch network were sold to the Nationwide Building Society. Previous nationalisations include Johnson Matthey Bankers, in 1984 and the Bank of England itself, in 1946. The government's shareholding in LBG and RBS is discussed in question 4.

In all these cases, depositors' interests were fully protected. As noted in question 4, on a bank insolvency, deposits protected by the Financial Services Compensation Scheme are 'super-preferred' in the creditor hierarchy. Employees may be protected under employment law where a business unit is transferred, or if redundancies are made. There are, however, no specific protections under BA 2009. Certain employee claims rank as preferred debts if a bank is wound up.

Under BA 2009, if the Treasury decides to take a bank or bank holding company into public ownership, it must pay compensation if shareholders suffer a loss compared to the position they would have been in had the failed bank been subject to insolvency proceedings (referred to as the 'no creditor worse off' safeguard). No account is taken of any financial assistance provided by the Bank of England or the Treasury in valuing the shares in the bank. The independent valuer appointed after the nationalisation of Northern Rock concluded that the value of the shares, after stripping out assistance provided by taxpayers, was nil and that no compensation was payable. An appeal to the Upper Tribunal was dismissed in 2011. An attempt to challenge the basis of compensation was dismissed by the European Court of Human Rights in 2012 as manifestly ill-founded, where it considered that it was entirely legitimate for the UK to decide that, had the Northern Rock shareholders been allowed to benefit from the value created through the provision of state support, this would encourage the managers and shareholders of other banks to seek and rely on similar support, to the detriment of the UK's economy. The independent valuer appointed in respect of Dunfermline Building Society concluded that the treatment of creditors whose claims were transferred to Nationwide, as well as those creditors whose claims remained behind, was no worse than it would have been had Dunfermline entered insolvency proceedings. Accordingly, no compensation was payable.

In March 2015, the Treasury published a Code of Practice on the use of tools under the SRR. This is supplemented by the Bank of England document referred to above.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

The PRA requires UK banks and banking groups to develop recovery and resolution plans (colloquially referred to as 'living wills').

A recovery plan comprises a series of measures that the bank or its group could take to turn the business around following adverse trading conditions, and postulates a range of options that the bank could take to return to adequate levels of liquidity and capital. Recovery options may include:

- disposals;
- raising new equity;
- elimination of dividends;
- liability management; or
- sale of the firm.

Recovery plans are developed by banks but their adequacy is evaluated by the PRA.

Banks are also required to produce a resolution pack, a document setting out information required by the appropriate resolution authorities to enable them to draw up a resolution plan and to resolve the firm if it fails. The resolution data and analysis provided by firms is intended to identify significant barriers to resolution, to facilitate the effective use of the powers under the BA 2009 and so reduce the risk that taxpayers' funds will be required to support the bank's resolution. An executive director of the bank must be nominated to have responsibility for the recovery plan and resolution pack and for overseeing the internal processes in relation to these documents.

The PRA expects a bank's recovery plan as well as the processes for producing resolution proposals to be subject to oversight and approval by the board or a senior governance committee and subject to review by the audit committee. Firms must nominate an executive director who has overall responsibility for the firm's recovery and resolution plan as well as overseeing governance arrangements.

As discussed in question 9, as a firm comes under increasing stress, the PRA will assess its 'proximity to failure', which is captured by the firm's position within the PRA's PIF, which is designed, in part, to guide the Bank of England's contingency planning as resolution authority. The PIF assessment is derived from a firm's ability to manage the following risks it may face:

- external context;
- business risk;
- management and governance;
- risk management and controls; and
- capital and liquidity.

There are five PIF stages denoting a different proximity to failure at a given point in time, and every bank will be allocated to a particular stage. If a firm migrates to a higher risk category (ie, the PRA determines that the firm's viability has deteriorated) the intensity of supervision will increase. The five PIF categories are:

- low risk;
- moderate risk;
- risk to viability absent action by the firm;
- imminent risk to viability of the firm; and
- the firm is in resolution or being wound up.

The firm's senior management will be expected to ensure appropriate remedial action is taken to reduce the likelihood of failure, while the PRA has stated that the regulatory authorities will ensure appropriate preparedness for resolution. The appropriate remedial actions that a firm may be required to take include drawing on the menu of options set out in the firm's approved recovery plan. The PRA has additional statutory powers to change the management or board composition, restrict capital distributions and leverage and set tight liquidity or capital requirements. When a firm is deemed to have entered resolution, the PRA may draw on a wide array of powers as set out in the SRR.

The PRA's framework for recovery and resolution plans is based on parts of Directive 2014/59/EU (BRRD) establishing a framework for the recovery and resolution of credit institutions and investment firms, which entered into force on 2 July 2014. The UK implemented the BRRD through a combination of changes to primary and secondary legislation, new PRA and FCA rules and amendments to the Treasury's SRR Code of Practice (see question 12).

14 Are managers or directors personally liable in the case of a bank failure?

Bank failure does not automatically result in liability for the directors. The personal liability of directors in the case of insolvency is discussed in question 25. In addition, depending on the circumstances, directors may be at risk of the following:

- disciplinary action: if the directors are responsible for breaches of the PRA or FCA rules they may be subject to regulatory sanctions in the normal way, which may include fines as well as banning orders;
- civil liability: directors owe fiduciary duties to the company. In particular, they are required to promote the success of the company, to exercise independent judgement and to exercise reasonable care, skill and diligence. Failure to comply with these duties exposes the directors to civil liability to the company;
- a range of criminal offences may be relevant to misconduct prior to or in the course of insolvency proceedings. These include theft, fraud, false accounting, fraudulent trading, transactions in fraud of creditors, conspiracy to defraud and misconduct in the course of winding-up and so on. Generally, these offences require proof of dishonesty; and
- disqualification: directors of an insolvent bank may be disqualified if their conduct makes them unfit to be concerned in the management of a company.

The failure of LBG and RBS demonstrates that errors of commercial judgement are not in themselves sanctionable, unless either the processes and controls that governed how those judgements were reached were clearly deficient, or the judgements were clearly outside the bounds of what might be considered reasonable. The FSA report into the failure of RBS considered options for change and concluded that there was a strong argument for new rules, which would ensure that bank executives and boards place greater weight on avoiding downside risks. In January 2016, the PRA fined and prohibited senior individuals who held positions at the Co-operative Bank from holding a significant influence function in a PRA-authorised firm for breaches related to the running of the Co-operative Bank and, in particular, for not exercising due skill, care and diligence in carrying out their roles. The regulator concluded that their actions posed an unacceptable threat to the safety and soundness of the Co-operative Bank.

As discussed in question 8, the new regulatory framework for senior individuals in UK banks and branches of foreign banks operating in the UK came into effect on 7 March 2016. One aspect of this framework is the senior managers regime, which replaced the approved persons regime in respect of individuals with key management responsibilities in banks and holds individuals performing a 'senior management function' to account for their areas of responsibility. A certification regime also applies to bank employees who could pose a risk of significant harm to the firm or any of its customers (eg, staff who give investment advice). The framework includes a code of conduct, which replaced the Statements of Principle and Code of Practice for Approved Persons, and apply to all individuals who are approved by the PRA or FCA as senior managers, or who fall within the PRA's certification regime.

Where a senior manager is found to have committed misconduct, the disciplinary powers available to the regulators include the power to impose an unlimited fine and to ban the person from performing particular types of function (or any function) in a regulated firm.

Of particular note is section 36 of the FS(BR)A 2013, which introduced a criminal offence relating to decisions taken by senior managers that cause a bank to fail. The offence is in relation to a decision that causes a financial institution to fail for conduct that takes place on or after 7 March 2016. It is committed when a senior manager takes a decision (or fails to prevent the taking of a decision) that leads to the failure of the bank or another firm in the same group, and at the time of taking the decision is aware that it may lead to failure, and his or her conduct falls far below what would have been reasonably expected of a person in his or her position. In order for liability to be established, the bank, or a firm in the group, must fail. Failure includes where the firm enters insolvency or the stabilisation options listed in question 12. The offence is punishable on indictment with up to seven years' imprisonment. It has been suggested by the PRA and the FCA that prosecution of this offence will likely be rare, as it requires (among other things) the financial institution to fail and for a senior manager's conduct to fall significantly below what could reasonably be expected of someone in the position.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

See question 13 on the requirement for banks to produce a resolution pack, a document setting out information required by the appropriate resolution authorities to enable them to draw up a resolution plan.

The Bank of England is required to develop a resolution plan for each UK bank setting out the actions that would be taken if a firm failed. It identifies a preferred resolution strategy for each firm, which depends on, among other things, the firm's systemic relevance and its structure. It completes resolvability assessments for each firm, which identify any barriers to implementing that firm's preferred resolution strategy and achieving its statutory objectives. If necessary, it can require firms to take action to remove these barriers to make them 'more resolvable'.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

Many of the regulatory capital requirements for UK-authorised banks on a solo and consolidated basis are determined according to CRD IV – comprising the CRR and the CRD, which entered into force on 1 January 2014 and is implemented in the UK mainly through the PRA and FCA rules. The CRD IV itself implements at the EU level Basel III, replacing the previous Basel Accord at EU level.

In short, the capital resources that a bank is required to maintain can be constituted by a mixture of common equity Tier 1 capital, additional Tier 1 capital and Tier 2 capital. With the exception of common equity Tier 1 capital, however, the proportions of each of these types of capital that the total capital can comprise are restricted. The CRR contains detailed legal and technical requirements for eligibility of capital instruments. Instruments categorised as additional Tier 1 capital are, broadly, perpetual subordinated debt instruments or preference shares with no incentive to redeem and that will automatically be written down or converted into common equity Tier 1 upon the bank's common equity Tier 1 ratio falling below a specified level.

Banks have a choice between a standardised approach to credit risk and advanced internal ratings-based approaches. Many of the smaller banks opt for, or are required to, use the standardised approach, which imposes capital charges on exposures falling into particular classes (eg, corporate, retail, mortgage, interbank and sovereign lending). The capital charge generally depends on the external credit rating of the borrower. The requirements also cover credit risk mitigation (collateral, guarantees and credit derivatives) and securitisation.

Banks may seek regulatory approval to use their own internal models to calculate capital requirements for credit risk, including credit risk mitigation and securitisation. Where a firm is to use an internal model in calculating its regulatory capital requirements, the PRA will expect the model to be 'appropriately conservative'.

Banks are required to assess themselves, the adequacy of their capital (a process known as the Internal Capital Adequacy Assessment Process, or ICAAP), which is then subject to review by the PRA (the Supervisory Review and Evaluation Process (SREP)). This usually results in the PRA providing individual capital guidance to the firm and setting a capital planning buffer. In addition, the PRA requires banks to carry out stress testing and scenario analysis, including 'reverse stress testing' identifying circumstances in which a bank would no longer be viable, to assess the UK banking system's capital adequacy. According to the Bank of England, the 2017 stress test showed that, for the first time since the launch of stress tests in 2014, no bank needed to strengthen its capital position and that the UK banking system is resilient to deep, simultaneous recessions in the UK and global economies, large falls in asset prices and a separate stress of misconduct costs.

The countercyclical capital buffer is a tool that enables the FPC to adjust the resilience of the banking system such that banks are required to have an additional cushion of capital with which to absorb potential losses. The UK rate will be 1 per cent with effect from 28 November 2018.

The quantitative capital requirements under the CRD and CRR are supplemented by the obligation, introduced by the BRRD, for banks to satisfy at all times a minimum requirement for own funds and eligible liabilities (MREL), as specified by the Bank of England on a case-by-case basis. The Bank of England has published its Statement of Policy, which sets out its approach to setting loss-absorbing capacity requirements for all financial firms. UK banks will be subject to interim MREL requirements from 1 January 2020, with final requirements coming into force in 2022.

As noted in question 8, the capital and prudential regime for banks continues to evolve, with reforms set out in the proposed regulation amending the CRR and the proposed directive amending CRD IV. A final package of rules comprising Basel IV was agreed in December 2017.

17 How are the capital adequacy guidelines enforced?

The PRA enforces compliance. Banks are required to submit periodic returns and must notify the PRA of any failure to hold adequate capital. The ICAAP and SREP are a continual process, although the PRA can require a bank to hold a specified amount of capital.

18 What happens in the event that a bank becomes undercapitalised?

The bank will need to notify and agree with the PRA a remedial programme to bring it back into compliance. The terms of such a programme will depend on the circumstances, and cannot be described in generic terms, but are likely to include raising new capital, a reduction of exposures (including divestment of assets or businesses), or both. If a bank is unable to agree with the PRA on how to remedy the situation, the PRA may revoke the bank's authorisation. Additional powers to deal with failing banks have been enacted in BA 2009, the Investment Bank Special Administration Regulations 2011 (SI 2011/245) (for banks carrying on investment banking business) and FS(BR)A 2013 (see question 19).

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

The SRR is described in question 12, having originally been put in place by the BA 2009 and enhanced subsequently.

The SRR consists of the following pre-insolvency stabilisation options for banks:

- the transfer of all or part of a bank to a private sector purchaser (PSP);
- the transfer of all or part of a bank to a bridge bank owned by the Bank of England;
- the transfer of a bank or a bank's holding company into temporary public ownership (TPO);
- the asset separation tool, which allows assets and liabilities of the failed bank to be transferred to a separate asset management vehicle, with a view to maximising their value through an eventual sale or orderly wind-down; and
- a bail-in to absorb the losses of the failed firm, and recapitalise that firm (or its successor) using the firm's own resources.

A stabilisation power may only be exercised if the PRA is satisfied that:

- the bank is failing, or is likely to fail, to satisfy the threshold conditions for authorisation under FSMA 2000; and
- having regard to timing and other relevant circumstances, it is not reasonably likely that action will be taken to satisfy those conditions.

In exercising any of the stabilisation powers, or the insolvency procedures, the authorities must have regard to a number of specified objectives. These are:

- continuity of banking services and critical functions in the UK;
- protection and enhancement of the stability of the UK financial systems;
- stability of the UK banking system;
- protecting depositors;
- protecting public funds and client assets; and
- avoiding unjustified interference with property rights.

These objectives are to be balanced as appropriate in each case. The Treasury has published a code of practice about the use of powers under the SRR, which is intended to be read alongside the Bank of England's approach document relating to bank resolution, most recently updated in October 2017.

The Bank of England can exercise the PSP or bridge bank powers if it is satisfied (after consultation with the Treasury and the PRA) that it is necessary having regard to the public interest in the stability of the UK financial systems, the maintenance of public confidence in the stability of the UK banking systems or the protection of depositors.

The Treasury may only exercise the TPO power if it is satisfied (after consultation with the Bank of England and the PRA) that either the exercise of the power is necessary to resolve or reduce a serious threat to the stability of the UK financial systems or that it is necessary to protect the public interest where the Treasury has previously provided financial assistance to a bank.

The stabilisation powers are supplemented by a broad range of powers to transfer shares or property (including foreign property) as well as overriding contractual rights that could interfere with the transfer.

In addition, there is a bank insolvency procedure providing for the orderly winding-up of a failed bank. It facilitates the Financial Services Compensation Scheme (the Scheme) in providing payout to depositors or transfer of their accounts to another institution. The Bank of England, the PRA or the Secretary of State may apply to the court to make a bank insolvency order. An order may be made if:

- the bank is unable, or is likely to be unable, to pay its debts;
- winding up the affairs of the bank would be in the public interest; or
- winding up the bank would be 'fair' (this has the same legal meaning as the phrase 'just and equitable' in the Insolvency Act 1986 (IA 1986)).

To be eligible for the bank insolvency procedure, the bank must have depositors eligible to be compensated under the Scheme. Once a bank insolvency order is made the liquidator has two objectives. The first is to work with the Scheme to ensure, as soon as is reasonably practicable, that accounts are transferred to another bank, or that eligible depositors receive compensation under the Scheme (see question 4). Once this objective has been accomplished, the task of the liquidator is to wind up the affairs of the bank. The general law of insolvency applies with some modifications to bank insolvency and the liquidator has similar powers to access the bank's assets and, once the eligible deposits have been transferred, or compensation paid, creditors will receive a distribution in accordance with their rights.

Other insolvency proceedings remain possible (eg, administration or liquidation), although no application can be determined until the PRA has decided not to apply for a bank insolvency order. A resolution for voluntary winding up has no effect without prior approval of the court.

The SRR also includes a bank administration regime, which puts the part of a failed bank that is not transferred to the bridge or private sector purchaser (known as the residual bank) into administration. The purpose of bank administration (which should not be confused with administration under the IA 1986) is principally to ensure that the non-sold or transferred part of the bank continues to provide services to enable the purchaser or bridge bank to operate effectively. Once the Bank of England notifies the bank administrator that the residual bank is no longer required, the bank will proceed to a normal administration where the objective is either to rescue the residual bank as a going concern or, if this is not possible, to achieve a better result for the bank's creditors as a whole than in a winding-up.

Insolvency procedures for banks carrying on an investment banking business are set out in SI 2011/245 (as amended by the Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017 (SI 2017/443)).

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

Yes. There has been a sequence of major reforms to the international prudential framework for capital requirements as set by the Basel Committee on Banking Supervision. Basel III reforms were finalised in December 2010 and aimed to address perceived weaknesses in Basel II and to reduce the probability and severity of future financial crises.

Basel III has been implemented into EU law by CRD IV, which came into force on 1 January 2014. The main prudential requirements are set out in the CRR, which is directly applicable in the United Kingdom.

The main changes included:

- improving the quality of capital through new definitions of core Tier I capital, non-core Tier 1 capital and Tier 2 capital;
- raising the minimum common equity Tier 1 capital ratio to 4.5 per cent and imposing a further capital conservation buffer of 2.5 per cent resulting in an effective minimum common Tier 1 ratio of 7 per cent;
- increasing the Tier 1 capital ratio (including the capital conservation buffer) from 4 to 8.5 per cent and the minimum total capital ratio (including the same buffer) to 10.5 per cent;
- abolishing innovative Tier 1 capital and Tier 3 capital. Tier 1 capital has been simplified with sub-categories removed;
- adopting a harmonised approach to deductions from capital, with most deductions being made from common equity;
- introducing new and more stringent requirements in respect of counterparty credit risk on derivatives, repos and securities financing transactions that will significantly increase the capital requirements for these transactions;
- adopting a leverage ratio as a non-risk-based measure to curtail excessive growth in banks' balance sheets;
- enabling regulators to impose an additional capital buffer in the case of excessive credit expansion where local conditions justify this;
- introducing two new liquidity standards: a liquidity coverage ratio designed to enable banks to withstand a short-term liquidity stress, as well as a net stable funding ratio requiring banks to have a minimum amount of stable funding based on the liquidity characteristics of their assets and activities over a one-year horizon; and
- addressing the risks posed by financial institutions that are systemically important.

As noted in question 8, a long, complex legislative procedure is now under way as the Council of the EU and the European Parliament broker an agreement on the final shape of the CRD V, adopted by the European Commission in November 2016. As the implementation of these rules by banks is still several years away, there is some uncertainty as to how and when the requirements will be applied. For UK banks, Brexit adds an additional layer of complexity when considering the impact of the proposals.

In December 2017, the Basel Committee published its final documents on the reform of Basel III, commonly referred to as Basel IV. These reforms comprise, among other things, changes to the standardised approach for credit risk, internal models, and the final calibration and design of the output floor that will be set at 72.5 per cent. The new rules will take effect in 2022 and have a five-year implementation period.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Much of the UK's controllers' regime reflects provisions that were originally introduced by the Acquisitions Directive (2007/44/EC), which imposes obligations on controllers, and potential controllers, of firms authorised under EU financial services legislation and is implemented in the UK through provisions of FSMA 2000.

In short, a person who decides to acquire or increase control over a UK-authorised bank must notify and obtain consent from the PRA in advance. Failure to do so is a criminal offence with the maximum penalty being an unlimited fine. The PRA must consult the FCA before coming to a decision on whether to approve a proposed change of control. The Acquisitions Directive tightened the assessment criteria for objections to a change of control (see question 28).

The PRA has 60 working days from receipt of the notice to approve the acquisition of control (with or without conditions), or to object. This period may be interrupted by up to 20 days where the PRA requires further information.

The thresholds for notifying the PRA of the acquisition of control are 10, 20, 30 and 50 per cent of the shares or voting power. The definition of 'control' is complex and a number of the terms used in that definition are extended beyond their normal meaning or are subject to

Update and trends

We expect regulatory policy for banks to continue to respond to developments in fintech. Banks have also shown themselves willing to adopt a range of strategies to collaborate in the fintech and emerging tech sphere, including by way of venture capital-style investment, incubator and accelerator programmes and the establishment of innovation centres. We do not envisage a decline in these efforts.

The Basel Committee's review programme continues to keep capital issues at the top of the regulatory agenda. Banks will need to assess and respond to the effect of the Basel IV reforms on their individual capital structures and prepare for amended capital calculations across all risk types. Reliance on internal models will need to be moderated.

Finally, the UK's withdrawal from the EU is preoccupying the UK's banking industry. Many UK banks are considering or accelerating restructuring plans for their EU business or seeking deposit-taking licences in multiple jurisdictions. Without agreements as to equivalence, Brexit will also affect elements of financial services infrastructure, such as access to clearing houses or payment services, or the provision of custody services to certain clients.

exceptions. For example, even if a person does not fall within the specific percentages of shares or voting power set out above, he or she may be deemed to be a controller, or to have increased his or her control, if his or her relationship with the firm amounts to 'acting in concert' with others.

A parallel regime exists in respect of the reduction of control, where a person is required to notify the PRA of any reduction in control to below 50, 30, 20 and 10 per cent of the shares or voting power. Failure to notify is an offence, although there is no requirement for PRA consent to the reduction of control.

The Acquisitions Directive was supplemented with Level 3 Guidelines published by the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors and the Committee of European Securities Regulators (together, the Level 3 Committees). The Level 3 Guidelines updated on 1 October 2017 contain guidance on important general concepts such as the meaning of the term 'acting in concert' and the process for determining acquisitions of indirect holdings. They also contain useful information in relation to the assessment criteria for a proposed acquisition.

22 Are there any restrictions on foreign ownership of banks?

No. Aside from sanctions imposed by the United Nations, the European Union and the United Kingdom on specified persons and countries.

23 What are the legal and regulatory implications for entities that control banks?

There are no restrictions on the business activities of a parent or acquirer of a UK bank, or on those of affiliates of a UK bank, although such activities will be taken into account as part of the PRA's assessment of the acquisition. A bank may be owned or acquired by a company whose business is wholly non-financial in nature. Directors, officers and employees of a holding company of a UK bank whose decisions or actions are regularly taken into account by that bank's governing body must be approved by the PRA.

The PRA carries out the consolidated supervision of banking groups. Consolidated supervision applies at the level of the highest EEA group company whose subsidiaries and participants (basically a 20 per cent holding) are banks or engage in broadly financial activities. The PRA will not normally undertake worldwide supervision of a group headed by a parent outside the EEA.

The practical effects of consolidated supervision applying will depend on the individual group's structure. However, the following points may be noted:

- the group will need to hold adequate capital to cover the exposures and off-balance-sheet liabilities of all members of the group (and not just regulated entities), including the parent and its subsidiaries and participations; and
- limits on large exposures will apply.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

Where a banking group is subject to consolidated supervision, the PRA will apply its prudential rules to the group as a whole (see question 23). It will not, however, directly regulate non-authorised entities in the group.

Each regulated firm (including banks) will need to meet the regulatory requirements applicable to it on a stand-alone basis. This includes, but is not limited to, capital adequacy and liquidity.

FSMA 2000 enables the PRA to give 'directions' to the UK parent of a UK bank or investment firm (a qualifying parent undertaking). A direction may require the parent undertaking to take specific action or to refrain from taking specified action. Before giving such a direction the PRA is obliged to consult the FCA. In April 2013 the PRA published a statement of policy with respect to the giving of directions which includes the following non-exhaustive list of possible directions that the PRA may give:

- a requirement to meet specific prudential rules applied at the consolidated level;
- a requirement to improve the system of governance or controls at group level or in relation to (UK or non-UK) subsidiary undertakings, or both;
- a restriction on dividend payments or other payments regarding capital instruments to conserve capital;
- a requirement to move funds or assets around the group to address risk more appropriately;
- a requirement for the group to be restructured;
- a requirement to block or impose restrictions on acquisitions or divestitures;
- a requirement to ensure continuity of service is provided between group entities;
- a requirement to include other entities within the scope of consolidated supervision (including shadow banking entities);
- a requirement to raise new capital;
- a requirement to take steps to remove from office directors of the parent that the PRA does not regard as fit and proper;
- a requirement to remove barriers to resolution; and
- a requirement to issue debt suitable for bail-in.

The exercise of the PRA's direction-making power may be appealed to the Upper Tribunal.

As discussed in question 13, banks are required by the PRA to draw up recovery and resolution plans. A recovery plan might include provision for group support in specified circumstances. Under BA 2009, the Treasury may bring the holding company of a bank into temporary public ownership if certain conditions are met.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

In question 19, we have referred to the pre-insolvency stabilisation powers as well as the bank insolvency procedure and bank administration procedure available to resolve banks under the SRR. A controlling entity or individual is not liable for the debts of an insolvent subsidiary, although it might be required (by PRA direction) to recapitalise an undercapitalised subsidiary before insolvency (see question 24). Liability depends on the application of general rules of insolvency law, which also apply in a bank insolvency or bank administration. The following are the main circumstances in which a shareholder or parent may incur liability. These powers are also relevant to proceedings under SI 2011/245 (as amended).

Transactions at an undervalue

If a company has entered into a transaction at an undervalue and at the time the company was unable to pay its debts, or became unable to do so as a result of the transaction, in the two years prior to the onset of insolvency, the court has wide powers to set aside the transaction. There is a presumption of insolvency if the transaction is with a controller or parent.

Preferences

If a company does anything that puts the controller or parent in a better position in the event that the company goes into insolvent liquidation in the two years prior to the onset of insolvency, the court may set aside the preference if the company was insolvent or became insolvent as a result.

Fraud on creditors
The court has broad powers to set aside transactions entered into for the purpose of putting assets beyond the reach of creditors or otherwise prejudicing the company's creditors.

Shadow directorship
A controller or parent may be a shadow director if the directors of the company are accustomed to act in accordance with its directions. A shadow director may incur personal liability for fraudulent trading and wrongful trading. Fraudulent trading requires proof of dishonesty and is also a criminal offence.

A director is responsible for wrongful trading if a company goes into insolvent liquidation and at some time before the commencement of the winding-up the director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation, and the director failed to take every step with a view to minimising the potential loss to the company's creditors as he or she ought to have taken. A director that is guilty of wrongful or fraudulent trading may be ordered to contribute such amount to the company's assets as the court thinks proper.

Disqualification
The court has powers to disqualify company directors (including shadow directors) found guilty of misconduct for up to 15 years. In particular, a director of an insolvent company may be disqualified if his or her conduct makes him or her unfit to be concerned in the management of a company. See also question 14 for the criminal offence in FS(BR)A 2013 relating to decisions taken by senior managers that cause a bank to fail.

Piercing the corporate veil
The courts may pierce the corporate veil, so as to impose liability on a parent company for the debts of its insolvent subsidiary in limited circumstances. These include where the subsidiary was used as a device or façade, thereby avoiding or concealing any liability of the company's controllers. In *Ben Hashem v Ali Shayif* [2009] 1 FLR 115, Munby J said: 'The common theme running through all the cases in which the court has been willing to pierce the veil is that the company was being used by its controller in an attempt to immunise himself from liability for some wrongdoing which existed entirely dehors the company.' The Court of Appeal emphasised that '[t]he rationale is that a wrongdoer cannot benefit from his dishonest misuse of a corporate structure for improper purposes' (*Petrodel Resources Ltd & Ors v Prest & Ors* [2012] 3 FCR 588).

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

See question 20. Approval may also be required under UK or EU competition law. Where a bank's shares have been admitted to trading on a regulated market (eg, the main market of the London Stock Exchange), a person whose holding of voting rights in the bank reaches, exceeds or falls below every 1 per cent above 3 per cent must notify that bank.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The place of incorporation or nationality of an acquirer is not relevant. There is no difference in the process for approval.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

See question 21. The PRA may only object to an acquisition on the basis of the following matters (or the submission of incomplete information):

- the reputation of the acquirer;
- the reputation and experience of any person who will direct the business of the UK bank;
- the financial soundness of the acquirer, in particular in relation to the type of business that the bank pursues;
- whether the bank will be able to comply with applicable prudential requirements;
- whether the PRA and FCA can effectively supervise the group including the target; or
- whether there are reasonable grounds to suspect money laundering or terrorist financing in connection with the proposed acquisition.

The Level 3 Guidelines, referred to in question 21, provide detail on the interpretation of these assessment criteria. The PRA must also take into consideration any representations made to it by the FCA in relation to the above matters. The FCA can, however, only direct the PRA not to approve the acquisition if it has reasonable grounds to suspect money laundering or terrorist financing in connection with it.

29 Describe the required filings for an acquisition of control of a bank.

The first step is normally an informal approach to the PRA. This is followed by submission of the required information. A prospective controller is recommended to use the PRA prescribed forms.

Completion of the forms can be time-consuming and requires supporting documentation such as group structure charts, CVs for individual controllers, proof of funding and a business plan. The business plan is required to contain at least the following:

- a strategic developmental plan;
- estimated financial statements for the target firm or firms for three years; and
- information about the anticipated impact of the acquisition on the target firm.

Having received the notice, the PRA can require additional information or documents if it considers this necessary and may carry out interviews. Where a proposed new or increased controller is regulated elsewhere in the EU or European Economic Area (EEA) the PRA must consult the relevant home-state regulator. The same applies if a UK bank is controlled by a parent company located in another EU or EEA state. It should be emphasised that 'control' does not stop at the level of the acquirer and can pass all the way up the corporate chain to the ultimate beneficial owners.

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30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

The PRA has 60 working days from the date on which the regulator deems the application for approval to be complete to approve an acquisition, although the process may be shortened where the controllers are already known to the PRA. It facilitates approval for the acquirer to discuss a proposed acquisition with the PRA informally in advance. This enables the PRA to identify potential issues and request any further information before the formal notification is submitted. Up to the 50th working day of the assessment period, the PRA may pause the assessment period for up to 20 working days (or 30 working days in certain circumstances) in order to seek further information from the applicant. If approval is granted, the prospective controller must complete the acquisition within one year, or such shorter period as the PRA specifies. The PRA will consider requests for extension of the approval if required.

United States

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

Because the deposits held by US banks are insured by the federal government, many governmental and regulatory policies are aimed at protecting these deposits by requiring safe and sound banking practices. This is accomplished through regulatory capital adequacy requirements and regulations relating to appropriate lending, investment and other business practices. In general, a US banking organisation's obligations to its depositors takes precedence over its obligations to its shareholders. Following the global financial crisis of 2008, US bank regulatory policy has also been focused on reducing systemic risk, the risk that the failure of one or more large financial institutions will jeopardise the stability of the financial system. Financial stability considerations have led to capital requirements that increase as a bank grows in size and complexity. The pendulum now appears to be swinging in the opposite direction and US bank regulators are considering how to make bank regulation less burdensome without exposing the financial system to increased risk.

2 Summarise the primary statutes and regulations that govern the banking industry.

The principal statutes governing the US banking industry are:
- the Federal Deposit Insurance Act (FDIA), which provides for federal deposit insurance and vests the Federal Deposit Insurance Corporation (FDIC) with regulatory authority over FDIC-insured banks;
- the Bank Holding Company Act of 1956, as amended (the BHC Act), which subjects companies that control banks, called 'bank holding companies', to supervision and regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve);
- the National Bank Act, which provided for the establishment of national banks (ie, banks with charters issued by the federal government) and vested the Office of the Comptroller of the Currency (OCC) with regulatory authority over them;
- the Federal Reserve Act, which established the Federal Reserve System and contains restrictions applicable to banks, such as section 23A of the Federal Reserve Act, which limits transactions between a bank and its affiliates; and
- the Home Owners' Loan Act (HOLA), which provided for the establishment of federal savings banks.

3 Which regulatory authorities are primarily responsible for overseeing banks?

There are three federal bank regulators as well as a multitude of state banking authorities. The three federal bank regulators are:
- the Federal Reserve System, which has primary supervisory authority over bank holding companies, savings and loan holding companies and state-chartered banks that have elected to become members of the Federal Reserve System;
- the FDIC, which, in addition to administering the Deposit Insurance Fund, also has primary supervisory authority over state-chartered banks that have opted not to become members of the Federal Reserve System (commonly referred to as 'non-member banks'). The FDIC also has oversight authority at a secondary level over all other types of FDIC-insured banks; and
- the Office of the Comptroller of the Currency, which has primary supervisory authority over national banks and federal savings banks.

In addition, the National Credit Union Administration has oversight over federal credit unions and insures deposits held by both federal and state-chartered credit unions through the National Credit Union Share Insurance Fund, a federal fund backed by the full faith and credit of the US government.

The Consumer Financial Protection Bureau, formed in 2011, has broad responsibilities to enforce federal consumer protection laws over both banks and non-banks engaged in financial services activities.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The FDIC protects depositors against the loss of their insured deposits if an FDIC-insured institution fails. FDIC insurance is backed by the full faith and credit of the US government. The basic limit on federal deposit insurance coverage is $250,000 per depositor. As a temporary measure in response to the financial crisis, from 31 December 2010 to 31 December 2012 all non-interest-bearing transaction accounts were fully insured, regardless of the balance of the account, at all FDIC-insured institutions. This was an unprecedented action by the FDIC and the unlimited insurance coverage has now expired.

A non-interest-bearing transaction account is essentially a checking account, a deposit account where interest is neither accrued nor paid; depositors are permitted to make an unlimited number of transfers and withdrawals; and the bank does not reserve the right to require advance notice of an intended withdrawal.

Beginning during the global financial crisis in 2008 and continuing through 2009, financial institutions of all sizes sought to increase their capital levels for a variety of reasons, including to help absorb current and future losses, to ensure that capital ratios stayed above regulatory minimums and also to convey a sense of financial strength and confidence to investors, customers, counterparties and competitors. Capital raising in 2008 was significantly aided by the implementation of the Capital Purchase Program (CPP) under the Troubled Asset Relief Program (TARP) in which financial institutions sold senior preferred shares and warrants exercisable for common stock to the Treasury. By 31 December 2008 the Treasury had invested approximately $178 billion in 214 financial institutions through the CPP, and by 31 March 2009 this amount had grown to nearly $199 billion in 532 financial institutions. By year-end 2009, the Treasury had invested in nearly 700 banks with over $200 billion in TARP funds. Since that time, as the US banking industry has returned to health, virtually all banks have repaid their TARP funds.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Transactions between an FDIC-insured bank or thrift are subject to sections 23A and 23B of the Federal Reserve Act. The Federal Reserve's

Regulation W (12 CFR Part 223) is the implementing regulation. These restrictions effectively make it impracticable for the FDIC-insured institution to lend to its affiliates or purchase assets from them. In addition, all other transactions between the FDIC-insured institution and its affiliates must be at fair market value. For this purpose, an 'affiliate' is any company:

- that controls the bank or thrift;
- that is under common control with the bank or thrift;
- with a majority of interlocking directors with a bank or thrift; or
- that is sponsored or advised by a bank or thrift.

'Control' for this purpose is ownership of 25 per cent or more of any class of voting securities, but also includes control in any other manner. Note that a controlling relationship can exist for the purposes of section 23A even at an ownership level of less than 25 per cent of voting securities.

Companies that control a US bank or thrift are generally limited in the types of activities in which they can engage to financial services activities including securities underwriting, insurance (both agency and underwriting) and merchant banking. While there are certain exceptions to this rule, over the past several years US regulators and Congress have gradually eliminated or scaled back these exceptions.

6 What are the principal regulatory challenges facing the banking industry?

Much of the focus of the US banking industry has been to adjust to heightened supervision by the bank regulators in the aftermath of the global financial crisis that occurred in 2008 and 2009. Pre-crisis, bank regulators focused on ensuring that individual banks had sufficient capital to avoid failure but did not consider systemic implications. Consequently, the same capital requirements applied to both small and large banks. Post-crisis, the US bank regulators adopted a 'macro-prudential' perspective and expanded their focus to ensuring that the financial system avoids failure. For this reason, capital requirements now increase the larger and more complex that a bank grows. In addition, activities deemed overly risky, such as proprietary trading, are being limited or banned altogether. The regulators have also instituted annual stress tests in which banks are required to demonstrate to their regulators that they would retain an adequate amount of capital even under extremely adverse hypothetical economic scenarios. In addition, a broad spectrum of legislators attributed part of the blame for the financial crisis to a lack of comprehensive and rigorous regulatory supervision and a breakdown in culture, ethics and risk management on the part of the affected financial institutions. A net effect was a wave of sweeping enforcement actions that continued through 2017, including enormous financial penalties, primarily focused on the largest banks. More broadly, the policy debate whether to 'break up' the largest banks in order to prevent another financial crisis continues to this day. Ironically, at the same time, the heavier compliance burden resulting from the increase in regulation has incentivised banks to expand their revenue base via acquisitions to bear the incremental costs.

The Trump Administration has pledged to roll back a significant portion of the regulations adopted post-crisis. The US Treasury has issued policy papers detailing how the regulation should be reformed. As Trump appointees assume control of federal bank regulatory agencies, they are expected to begin to implement this reform. In Congress, there are several bills pending that would attempt to reduce the regulatory burden on banks and it appears likely that we will see some legislative action along these lines in 2018.

7 Are banks subject to consumer protection rules?

US banks are subject to extensive consumer protection rules at both the federal and state level. At the federal level, they are primarily enforced by the CFPB. The CFPB has rapidly become a powerful regulator and has been notably active both in issuing regulations and in bringing investigations and enforcement actions against a wide variety of financial companies including:

- banks;
- credit card companies;
- credit reporting companies;
- debt collection agencies;
- mortgage brokers;
- mortgage lenders;
- mortgage insurers;
- debt relief companies (including law firms); and
- student loan companies.

Banks with assets of $10 billion or less are examined by their primary bank regulators but need to comply with CFPB rules. Banks with assets in excess of $10 billion are subject to examination by the CFPB.

Although auto dealers are exempt by statute from CFPB regulation, the CFPB has used its authority over banks engaged in indirect auto lending to address alleged discriminatory mark-ups and similar dealer practices through enforcement activity and by imposing monitoring requirements on the banks conducting the indirect lending. Much of the CFPB's early rulemaking has focused on mortgage lending and servicing, including an important rule, issued in early 2013, requiring lenders to ensure that prospective buyers have the ability to repay their mortgages. Other areas of current CFPB focus include consumer protections for:

- prepaid cards;
- payday lending;
- debt collection;
- overdraft protection services; and
- privacy notices.

Virtually all consumer protection functions of the Federal Trade Commission, the Department of Housing and Urban Development, the Federal Reserve and other federal banking regulators have been moved to the CFPB in connection with its formation. Accordingly, the CFPB has the authority to enforce numerous FTC regulations as well as more than a dozen federal consumer protection statutes, including:

- the Home Owners Protection Act;
- the Fair Debt Collection Practices Act;
- the Home Mortgage Disclosure Act;
- the Real Estate Settlement Procedures Act;
- the Truth in Lending Act; and
- the privacy protections of Gramm-Leach-Bliley.

States may also enact their own consumer protection law; the CFPB's position is that federal consumer protection statutes set the floor and do not pre-empt more rigorous state laws.

As we enter 2018, the CFPB is very much in a state of flux. Now under new leadership, the agency appears to be in the midst of softening it approach to the industry. As time progresses and the senior staff changes over, we expect to see the CFPB continue to moderate its approach to supervision and enforcement.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

In addition to the reform mandated by Dodd-Frank, the difficulties experienced by the US financial services industry during the financial crisis have resulted in more rigorous regulation that has cut across the industry. Post-crisis, the regulatory pendulum has swung sharply to more extensive and burdensome regulation as well as more frequent and severe enforcement actions. Increased capital requirements have been accompanied by a greater emphasis on higher quality forms of capital, with a focus on common equity and the Tier I common equity ratio. It is the federal banking regulators' position that common equity should constitute a majority of a banking firm's Tier I capital because it is permanent, deeply subordinated and does not oblige the issuer to make any payments to investors. Capital must absorb losses and permit the issuer to continue operating as a going concern, as opposed to just serving as a buffer against losses in the event of a liquidation. At the same time, the regulators have been pressuring the banking industry to decrease its level of risk. The combination of more extensive regulation, higher capital requirements and lower risk has deeply impaired the profitability of the industry.

The Trump Administration has pledged to roll back a significant portion of the regulations adopted post-crisis and the pendulum has begun to slowly swing in the other direction. As 2018 progresses, we expect a rollback of regulation to continue in two ways. First, the Administration has almost completed its process of appointing a new slate of senior-most bank regulators who will have a profound impact on the regulatory environment. Second, in Congress, there are several bills pending that would further reduce the regulatory burden on banks and we expect to see legislative action this year in some form.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Banks are subject to extensive statutes and regulations. In addition, the applicable banking authorities conduct periodic on-site examinations. Large banks have teams of regulators resident in their offices in order to facilitate continuous monitoring. Based on these examinations, the authorities issue detailed confidential written reports articulating their concerns.

10 How do the regulatory authorities enforce banking laws and regulations?

Federal bank regulators have a formidable array of enforcement mechanisms. Set out below is a brief overview of the types of enforcement actions generally used by the federal bank regulators in order of increasing severity, including whether the actions are made public by the regulators. In general, enforcement actions can be divided into two categories: informal and formal. Usually less severe in scope, informal actions are generally not made public by the regulators and often remain undisclosed by the target, while formal actions are in all but a few rare instances made public.

Informal actions

Informal supervisory directives

All banks maintain a close supervisory relationship with their primary regulators. When that relationship is functioning at its best, all material transactions and plans are shared and discussed with the bank's regulators, and a good deal of informal supervisory direction is provided by the regulators to the bank. All banks receive informal advice and direction from their regulators and often make significant adjustments to their operations and capital, liquidity and controls as a result of that informal input.

Supervisory criticisms within examination reports

Bank regulators deliver formal examination reports to their regulated institutions on a regular periodic basis. These examination reports often contain express criticisms or concerns regarding a bank's operations or controls and directives from the regulators concerning the steps that need to be taken to correct such deficiencies or address such concerns. Examination materials are strictly confidential and may not be publicly disclosed by the institution.

Supervisory letter

A supervisory letter is an informal communication from a regulator to a bank either requesting information with respect to a targeted area or specific transaction or requesting that the bank take, or refrain from taking, certain actions. Supervisory letters are generally not publicly disclosed by the regulators and are used to call attention to specific areas of concern.

Commitment letter

A commitment letter is an informal written agreement between a bank and its regulator in which the bank commits to take certain corrective actions. Commitment letters often are entered into in connection with an approval request for a specific transaction or an expansion of powers. Commitment letters are generally not publicly disclosed by the regulators. The regulators also sometimes seek board level commitments through the adoption by the board of formal resolutions on a given matter.

Memorandum of understanding

A memorandum of understanding is also considered an informal enforcement action and is typically executed by the full board of a banking organisation and the regulator. Memoranda of understanding are generally not publicly disclosed by the regulators.

Formal actions

Formal written agreement

A formal written agreement is an agreement typically signed by the board of directors of a bank and the regulator. Formal written agreements are generally publicly disclosed by the regulators in the absence of a compelling reason to maintain confidentiality.

Cease-and-desist order

A cease-and-desist order is imposed after the issuance of a notice of charges, a hearing before an administrative law judge and a final decision by the regulator. More often, banks consent to a cease-and-desist order in order to expedite resolution by dispensing with the need for the notice and administrative hearing, these are often referred to as 'consent orders'. Temporary cease-and-desist orders can be issued on an interim basis pending completion of the steps necessary to issue a final cease-and-desist order. The regulators are required by law to publicly disclose cease-and-desist orders.

Troubled condition

The federal bank regulators also have the ability to declare a bank or bank holding company to be in 'troubled condition', which then subjects the bank or bank holding company to heightened scrutiny, including a requirement that any addition or change of directors or senior executive officers be subject to prior regulatory approval. A troubled bank or bank holding company also becomes subject to the FDIC's 'golden parachute' regulations, which require prior regulatory approval in order to enter into an agreement to make, or to actually make, a broad range of payments to any officers, directors, employees or controlling shareholders that are contingent on the termination of that person's employment.

In addition, federal bank regulators may impose civil money penalties in a number of circumstances, including: violations of law, formal written agreements, final orders or conditions imposed in writing; unsafe or unsound banking practices; or breaches of fiduciary duty.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

The years following the financial crisis have witnessed some of the largest ever enforcement actions in the US. Remarkably, in 2014, two of the world's biggest banks took the almost unprecedented step of pleading guilty to criminal violations in the US and agreed to pay staggering fines: BNP paid $8.9 billion to resolve criminal and civil investigations into violations of US sanctions law and Credit Suisse paid $2.6 billion to resolve a criminal federal income tax investigation. Separately, a number of large financial institutions have paid billions in fines, penalties and disgorgement in connection with alleged attempted manipulation of foreign exchange benchmark rates. Governmental settlements have continued to arise out of the financial crisis, notably in connection with mortgage-backed securities, with a number of financial institutions agreeing to pay tens of billions of dollars.

For regional and community banks, the most common enforcement issue has been Bank Secrecy Act (BSA) anti-money laundering (AML) compliance. Following the terrorist attacks on 11 September 2001, enforcement actions requiring that banks strengthen their BSA and AML compliance programmes became particularly widespread. Then, during the financial crisis, BSA and AML concerns took a back seat to more fundamental concerns by the US bank regulators centring on capital adequacy, asset quality, managerial competence and risk management. Post-crisis, regulatory enforcement actions have focused again on BSA and AML. Enforcement actions often have a direct impact on a bank's ability to expand via acquisitions and often result in them being put into a 'penalty box' while the enforcement action is pending. The enforcement actions are typically very lengthy and it can take years to complete the work required to the satisfaction of the regulators. During that time, the bank is not permitted to make any acquisitions. Consumer compliance has also emerged as a common area of enforcement.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

The FDIC may acquire control of a bank if the bank becomes insolvent or is in danger of becoming so. The primary regulator of the bank (for example, the OCC in the case of national banks) has the formal responsibility of closing the bank and appointing the FDIC as receiver. Once appointed, the FDIC is charged with selling or liquidating the bank while at the same time minimising the cost of the failure to the Deposit Insurance Fund. Depositors are paid by the FDIC up to the maximum amount of deposit insurance coverage. The FDIC then uses the remaining proceeds of the receivership, if any, to repay creditors. Shareholders do not receive any payments from the FDIC in return for their equity stock in the bank.

Prior to the passage of the Dodd-Frank Act, the FDIC's resolution authority was limited to banks or thrifts whose deposits were insured by the FDIC. The FDIC's resolution authority did not extend to the parent holding company or other non-bank affiliates of an insured depository institution. Now, the Federal Reserve and the FDIC may recommend that, based on an assessment of systemic risk, the Secretary of the Treasury appoint the FDIC as receiver for a 'financial company'. Covered companies include domestic bank holding companies, non-bank financial companies supervised by the Federal Reserve, companies predominantly engaged in activities that the Federal Reserve determines are financial in nature or incidental thereto, and any subsidiary of the foregoing. The Secretary can appoint the FDIC as receiver if the Secretary determines that:

- the financial company is in default or in danger of default;
- the company's failure and resolution through other means would have a serious adverse effect on the financial stability of the US;
- no viable private sector alternative is available;
- any effect on the claims or interests of creditors, counterparties, shareholders and other market participants is appropriate given the impact of a receivership on the financial stability of the US;
- any liquidation would avoid or mitigate such effects; and
- a federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order.

Any financial company put into receivership must be liquidated. No taxpayer funds may be used to prevent liquidation, which will limit the alternatives to FDIC receivership and may make it more challenging for a company to arrange private investment once it is within the 'zone of danger'. The FDIC issued a final rule with respect to its orderly liquidation authority in July 2011. Among other things, the final rule provides that compensation paid to a senior executive or director deemed by the FDIC as 'substantially responsible' for a financial company's failure may be clawed back if the executive or director acted negligently.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

In the event of a bank failure, bank management and directors typically have very little involvement. Members of management may be employed by the acquirer of the failed bank but do not play a meaningful role in the seizure of the bank. US banking regulations require that large banks and bank holding companies have a resolution plan in place.

14 Are managers or directors personally liable in the case of a bank failure?

Bank failures are often followed by lawsuits by the FDIC against the bank's managers and directors alleging mismanagement and seeking money damages. The FDIC has filed a large number of these lawsuits following the wave of bank failures that occurred in 2008 and 2009.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

All bank holding companies and insured depository institutions with $50 billion or more in assets and non-bank financial companies supervised by the Federal Reserve must submit periodically to the Federal Reserve and the FDIC a 'living will' for the company's rapid and orderly resolution in the event of material financial distress or failure. Living wills are highly elaborate, lengthy documents that contain a great amount of detail about a company's legal structure, the legal regimes to which it is subject around the world, how its business operations map to its legal entities, internal and external contractual relationships and dependencies and a good deal more. Enhanced reporting is required, including periodic reports about credit exposure to other significant financial institutions.

The Federal Reserve and the FDIC may determine that a living will is not credible or would not facilitate an orderly resolution of the company. If they do, they are empowered to jointly impose enhanced prudential standards or require divestitures. Development of these documents is an iterative process and institutions may be encouraged by the regulators to rearrange existing contractual and other arrangements that might complicate the separation of the institutions' various business and legal entities in the event of financial distress. In orders involving bank acquisitions by larger institutions, the Federal Reserve has made it clear that the quality of an institution's living will, and the resulting view of how difficult a company may be to resolve in the case of financial distress, is a significant factor in assessing the potential impact on risks to the stability of the US financial system posed by the transaction.

Under FDIC living will guidance, a covered institution must provide a fully developed discussion and analysis of a range of realistic resolution strategies. Each institution should include in the discussion and analysis at least one strategy that primarily involves the separation and sale of the covered institution's deposit franchise, core business lines and or major assets to multiple acquirers, as well as an alternative strategy involving the liquidation of the firm, including a payout of insured deposits.

Capital requirements

16 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

In July 2013, the US federal bank regulators adopted final capital regulations implementing the Basel III capital framework established by the Basel Committee on Banking Supervision. The new capital regulations became effective on 1 January 2015 and will be fully phased in on 1 January 2019. Today, many US banking institutions publicly report their Basel III capital ratios on a 'fully phased in' basis. The regulations require that US banks and bank holding companies maintain capital sufficient to meet both a risk-based asset ratio test and a leverage ratio test on a consolidated basis. The risk-based ratio is determined by allocating assets and certain types of off-balance sheet commitments into risk-weighted categories, with higher weighting assigned to categories with greater risk. The risk-based ratio represents total capital divided by total risk-weighted assets. The leverage ratio is Tier 1 capital (which includes common equity, certain types of perpetual preferred and other instruments) divided by total assets which are subject to adjustment but are not risk weighted. In addition, the regulations include a new minimum ratio of common equity tier 1 capital called 'Tier 1 common' to risk-weighted assets and a Tier 1 common capital conservation buffer of 2.5 per cent of risk-weighted assets. The regulations also include a minimum leverage ratio of 4 per cent. The following are the minimum Basel III regulatory capital levels in order to avoid limitations on capital distributions and discretionary bonus payments during the transition period until 1 January 2019:

Basel III regulatory capital levels

	1 January 2015 (per cent)	1 January 2016 (per cent)	1 January 2017 (per cent)	1 January 2018 (per cent)	1 January 2019 (per cent)
Tier 1 common	4.5	5.125	5.75	6.375	7
Tier 1 risk-based capital ratio	6	6.625	7.25	7.875	8.5
Total risk-based capital ratio	8	8.625	9.25	9.875	10.5

17 How are the capital adequacy guidelines enforced?

For US banks, meeting the regulatory requirements to be deemed 'well capitalised' is critical to maintaining an institution's status and privileges as a financial holding company, making capital distributions that deviate from the institution's capital plan, engaging in interstate acquisitions, and receiving approval from a federal bank regulator to engage in a merger or acquisition. The well-capitalised percentages discussed below should be considered a starting point. The federal banking agencies have advised that institutions and their holding companies should maintain capital ratios well above the minimums for well-capitalised status. In addition, an institution's or its holding company's primary regulator may require additional capital based on the institution's size, complexity and risk profile. Weaker institutions are required to address their capital and operating deficiencies promptly or face regulatory-driven corrective actions, including a possible forced recapitalisation or merger.

Under the FDIA, the US federal banking regulators must take 'prompt corrective action' to resolve the problems of insured depository institutions. The prompt corrective action regulations establish five categories based on a depository institution's capital position:

- well capitalised institutions have a total risk-based capital ratio of more than 10 per cent, a Tier 1 risk-based capital ratio of more than 8 per cent, a leverage ratio of more than 5 per cent, a common equity Tier 1 ratio of more than 6.5 per cent, and may not be subject to an order, written agreement or directive relating to capital;
- adequately capitalised institutions have a total risk-based capital ratio of more than 8 per cent, a Tier 1 risk-based capital ratio of more than 6 per cent and a leverage ratio of more than 4 per cent and a common equity Tier 1 ratio of more than 4.5 per cent;
- undercapitalised institutions are those which fail to meet the requirements of an adequately capitalised institution;
- significantly undercapitalised institutions are those with a total risk-based capital ratio of less than 6 per cent, a Tier 1 risk-based capital ratio of less than 4 per cent or a leverage ratio of less than 3 per cent or a common equity Tier 1 ratio of less than 3 per cent; and
- critically undercapitalised institutions are those with less than 2 per cent tangible equity to total asset ratio.

If an agency determines that an institution is in an unsafe or unsound condition or engaging in an unsafe or unsound activity, it may impose more stringent treatment than would otherwise apply, based upon the category of capitalisation into which the institution falls. An institution may be deemed to be engaging in an unsafe or unsound practice if it has received a less than satisfactory rating for asset quality, management, earnings or liquidity in its most recent report on examination. Dodd-Frank mandates enhanced prudential standards for bank holding companies with $50 billion or more in assets that become stricter as companies grow in size and complexity, and the federal supervisors' Basel III implementing rules adopted in 2013 require enhanced regulatory capital requirements for banking organisations of all sizes.

18 What happens in the event that a bank becomes undercapitalised?

Once an institution becomes undercapitalised (whether by failure to meet capital ratios or by regulatory determination), a host of significant restrictions and regulations come into play. The federal agencies are required to closely monitor all undercapitalised institutions and their compliance with FDICIA capital restoration plans.

All undercapitalised institutions are required to submit an acceptable capital restoration plan to the appropriate federal agencies pursuant to a deadline to be established by the agencies. The capital restoration plan must specify:

- the steps that the institution will take to become adequately capitalised;
- the levels of capital to be obtained during each year that the plan is in effect;
- how the institution will comply with the restrictions applicable to the institution; and
- the types and levels of activities in which the institution will engage.

In addition, before a plan can be accepted, each company having control of the institution must guarantee that the institution will comply with the plan until said institution has been adequately capitalised on average during four consecutive quarters and provide appropriate assurances of performance. 'Control' for this purpose is defined as it is under the BHC Act.

The aggregate liability of controlling companies under such guarantees is limited to the lesser of 5 per cent of the depository institution's total assets at the time it becomes undercapitalised and the amount necessary to bring the institution into compliance with all applicable capital standards as of the time that the institution fails to comply with the plan. The provision requiring a holding company to guarantee the performance of its subsidiary depository institutions can raise significant creditors' rights issues that should be carefully examined before any such guarantee is granted.

In addition, the asset growth of undercapitalised institutions is restricted. An undercapitalised institution may not increase its quarterly average total assets unless:

- its capital restoration plan has been accepted by the appropriate agency;
- any increase is consistent with the plan; and
- the institution's ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the institution to become adequately capitalised within a reasonable period.

Likewise, an undercapitalised institution may not acquire any interest in any company, establish any additional branch office or engage in any new line of business unless its capital restoration plan has been accepted and the board of the FDIC determines that the proposed action will further the purposes of FDIA. These requirements make significant expansion by undercapitalised institutions generally unfeasible.

Significantly undercapitalised institutions

Once an institution becomes significantly undercapitalised (or if it fails to take steps to become adequately capitalised) it becomes potentially subject to a series of draconian measures, within the discretion of the regulatory agencies. In addition, as described below, companies controlling such institutions also become potentially subject to several significant restrictions.

The following may be imposed by statute or by appropriate agency action:

- requiring the institution to recapitalise by selling enough shares (including voting stock) or obligations to adequately capitalise the institution and, if grounds for appointment of a receiver or conservator exist, requiring that the institution be sold or merged;
- requiring any company having control of the institution to divest the institution if the appropriate agency determines that divestiture would improve the institution's financial condition and future prospects;
- requiring the institution to comply with section 23A of the Federal Reserve Act if the provision exempting transactions with certain affiliated institutions did not apply, or otherwise restricting transactions with affiliates;
- restricting interest rates paid on new deposits, including renewals and rollovers, substantially to the prevailing rates of interest on deposits of comparable amounts and maturities in the region where the institution is located;
- restricting asset growth even more stringently than for undercapitalised institutions, or requiring asset shrinkage;
- requiring the institution to alter, reduce or terminate any activity the agency determines poses excessive risk;
- ordering a new election of the board; dismissing any director or senior executive officer who held office for more than 180 days immediately before the institution became undercapitalised; or requiring the institution to employ qualified senior executive officers who, if the agency so specifies, shall be subject to agency approval. While directors and senior executive officers that have been dismissed have the right to petition the agency for reinstatement, they bear the burden of proving that their continued employment would materially strengthen the institution;
- prohibiting the acceptance of deposits, including renewals and rollovers, from deposit brokers;
- prohibiting any bank holding company having control of the institution from making any capital distribution without prior approval of the Federal Reserve;
- requiring the institution to divest or liquidate any subsidiary the agency determines to be in danger of becoming insolvent and a significant risk to the institution or likely to cause a significant dissipation of the institution's assets or earnings;
- requiring any company having control of the institution to divest or liquidate any affiliate other than an insured depository institution the appropriate agency for such company determines to be in

danger of becoming insolvent and a significant risk to the institution or likely to cause a significant dissipation of the institution's assets or earnings; or
- requiring the institution to take any other action the agency determines to be more appropriate.

The FDIA sets out a presumption that the following actions will be taken unless the agency determines such actions would not be appropriate:
- requiring the sale of shares or obligations or requiring the institution to be sold or merged;
- restrictions on affiliate transactions; and
- restrictions on interest rates.

All significantly undercapitalised institutions and all undercapitalised institutions that fail to submit an acceptable capital restoration plan in a timely manner or that fail in any material respect to implement a plan accepted by the agency are required to obtain prior agency approval before paying any bonus to any senior executive officer or providing compensation to any senior executive officer at a rate that exceeds the officer's rate of compensation (excluding bonuses, stock options and profit sharing) during the 12 months prior to the month in which the institution became undercapitalised. Agency approval may not be granted if the institution has failed to submit an acceptable capital restoration plan.

Critically undercapitalised institutions

The FDIC is required to act by regulation or order to restrict the activities of critically undercapitalised institutions. At a minimum, the FDIC is required to prohibit critically undercapitalised institutions from doing any of the following without the FDIC's prior written approval:
- entering into any material transaction other than in the ordinary course of business;
- extending credit for any highly leveraged transaction;
- amending the institution's charter or by-laws;
- making any material change in accounting methods;
- engaging in certain types of affiliate transactions;
- paying excessive compensation or bonuses; and
- paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a rate significantly exceeding the prevailing market rate on insured deposits.

The FDIA calls for the appropriate federal agency within 90 days after an institution becomes critically undercapitalised to either:
- appoint a receiver, or with the concurrence of the FDIC, a conservator, for the institution; or
- take such other action as the agency determines with the concurrence of the FDIC would be more appropriate (after documenting why such action would be better).

19 What are the legal and regulatory processes in the event that a bank becomes insolvent?

When confronted with an insured depository institution on the brink of failure, the FDIC is required by law to guarantee insured deposits and dispose of the failed institution's assets in the 'least costly' manner to the FDIC's bank insurance fund (with surplus funds after repaying the FDIC, if any, flowing to uninsured depositors, creditors and then shareholders of the failed institution). This disposition process is referred to as a 'resolution'. The FDIA expressly requires the affirmative, documented determination by the FDIC that its exercise of authority with respect to a resolution of a troubled institution is necessary to meet the FDIC's insurance obligations on insured deposits and provides for a resolution that when measured in terms of the total amount of expenditures (immediate or long-term, direct or contingent) is the 'least costly to the [FDIC] of all possible methods'. The statute clarifies that the cost of any efforts at a resolution must be less than the value of insured deposits minus the present value of reasonably expected recoveries in a liquidation of the troubled bank. This exacting 'least cost' standard may only be waived if, upon the written recommendation of and approval by two-thirds of the members of the board of directors of the FDIC and two-thirds of the board of governors of the Federal Reserve System, the secretary of the Treasury (in consultation with the president) determines that:
- the least cost approach would pose systemic risks (ie, have serious adverse effects on economic conditions or financial stability); and
- the proposed resolution would mitigate these adverse effects.

FDIC-orchestrated dispositions of failed or failing federally insured depository institutions are most commonly structured as a purchase and assumption (P&A) transaction whereby the FDIC oversees the assumption of all insured deposits of the failed bank by one or more acquiring banks and the transfer of some or all assets of, and the assumption of some or all other liabilities of, the failing bank by the acquiring banks. A number of variations of P&A transactions exist and features of different variations may be combined in a particular case. The two most prevalent variants are bridge bank arrangements and loss-sharing agreements. Each of these two variants has proven particularly useful in large, complex resolutions. A P&A transaction affords the opportunity for the acquiring bank to pay a premium for the going-concern value of the failed bank, thereby reducing the FDIC's total cost of resolution and increasing the probability that the FDIC may avoid a loss in guaranteeing insured deposits. A P&A transaction may also provide for assistance to the acquiring bank in capitalising or supporting the credit risk of the acquired assets and liabilities. The terms of the transaction may be highly customised based on the intentions of the ultimate acquirer and may exclude certain assets or categories of assets that are carved out by the FDIC into a segregated fund to be professionally managed and liquidated over time (whether by the acquirer or by some other third party).

Two less common structures are an open bank assistance transaction and a deposit payoff. In an open bank assistance transaction, the FDIC provides ongoing support to the troubled institution to facilitate a turnaround plan as it works through its capital issues. In order to provide open bank assistance, the board of directors of the FDIC, the Federal Reserve and the secretary of the Treasury must all determine that not to do so would cause systemic risks. In a deposit payoff, the FDIC assumes and honours insured deposits (and possibly uninsured deposits) and liquidates the troubled institutions assets through receivership.

20 Have capital adequacy guidelines changed, or are they expected to change in the near future?

As noted in question 16, the US bank regulators adopted new Basel III capital guidelines in July 2013 that became effective in January 2015. In addition, Dodd-Frank requires the Federal Reserve to increase capital requirements the larger and more complex a banking organisation becomes.

Ownership restrictions and implications

21 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Both individuals and companies, regardless of whether they are foreign or domestic, may acquire controlling interests in US banks, provided they meet the applicable statutory and regulatory requirements discussed in question 26 and obtain prior approval from the appropriate regulators. As discussed in question 26, the need for prior approval can be triggered by an acquisition of as little as 10 per cent of the voting stock of a bank or a company that controls a bank or even by the acquisition of non-voting equity securities.

22 Are there any restrictions on foreign ownership of banks?

Foreign acquirers of US banks are generally subject to the same limitations and processes as US acquirers. The principal difference is that the US regulators will first ensure that the foreign acquirer is subject to comprehensive consolidated supervision in its home country. This is discussed in more detail in question 27. Foreign acquirers should also be aware of filing requirements with the Committee on Foreign Investment in the US (CFIUS).

In February 2014, the Federal Reserve issued final regulations that substantially tightened the regulation of foreign banks operating in the US. Foreign banks with $50 billion or more in US assets (excluding assets held in US branches and agencies) must form a US intermediate holding company (IHC) to act as the parent company of substantially all of the foreign bank's US subsidiaries. The IHC will be regulated by the Federal Reserve as if it were a domestic bank holding company and must comply with US regulatory capital requirements, stress testing, liquidity management requirements and a host of other regulatory requirements. Foreign banks were required to establish an IHC that is fully compliant with these regulations by 1 July 2016.

23 What are the legal and regulatory implications for entities that control banks?

With certain exceptions, companies (but not individuals) that acquire control of a US bank will be limited to engaging in financial services activities. For example, an automobile manufacturer is generally precluded from acquiring a US bank. Non-financial companies are not, however, precluded by law from acquiring or establishing an FDIC-insured 'industrial bank', a special type of bank, although the ownership by non-financial companies of industrial banks has generated significant controversy in recent years and there was a moratorium on the ability of non-financial companies to acquire or establish industrial banks, which was imposed by Dodd-Frank in July 2010 and expired in July 2013. Although the moratorium has expired, no non-financial company has successfully acquired or established an industrial bank since that time. Recently, a few fintech companies have expressed interest in forming a bank or industrial bank and filed formal applications to do so.

24 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

An investment that constitutes 'control' under the BHC Act by a company in a bank has several implications. From a bank regulatory perspective, the company would be deemed to be the parent bank holding company of the bank. Consequently, the company would be subject to the Federal Reserve's 'source of strength' doctrine, which provides that a bank holding company must serve as a source of financial and managerial strength to its subsidiary banks. Under this doctrine, the Federal Reserve may require the company to provide additional capital to the bank in the event that the bank was under financial stress. Note that there is no cap on the amount of capital that the Federal Reserve can require that the company provide to the bank. By its terms, the source-of-strength doctrine only applies to companies and not to individuals that control banks because, under the BHC Act, individuals cannot be deemed to be bank holding companies.

In addition, a finding of control under the BHC Act would mean that the company would control the bank for purposes of the prompt corrective action regulations issued by the federal bank regulators, which are discussed in greater detail in question 18. Under these regulations, an FDIC insured bank is required to file a capital restoration plan with its primary federal bank regulator within 45 days of becoming 'undercapitalised', 'significantly undercapitalised' or 'critically undercapitalised'. The regulations further require that the capital plan include a performance guarantee by each company that 'controls' the bank; control for this purpose is identical to control under the BHC Act. The prompt corrective action regulations limit the aggregate liability under performance guarantees, which are joint and several obligations, for all companies that control a bank to the lesser of:

- an amount equal to 5 per cent of the bank's total assets at the time that the bank was notified that it was undercapitalised; or
- the amount necessary to restore the bank to adequately capitalised status (ie, a total risk-based capital ratio of 8 per cent or greater, a Tier 1 capital ratio of 4 per cent or greater and a leverage ratio of 4 per cent or greater).

A finding of control would have other regulatory implications as well. Sections 23A and 23B of the Federal Reserve Act would place restrictions on transactions between the company (including its affiliates) and the bank. Hence, any loan, asset transfer or other transactions between the company and the bank would be subject to a number of stringent limitations and an overall requirement that they be at arm's length. Moreover, if the Federal Reserve were to commence an enforcement action against the bank, its controlling shareholders may become parties to the proceeding, depending on the particular facts and circumstances.

25 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

In the event that a bank is declared insolvent, the US bank regulators may assume control of the bank and ultimately offer it for sale to third parties. If the regulators determine that the bank failed because of mismanagement by the parent company or controlling individual, they typically pursue enforcement actions against members of management as well as lawsuits seeking reimbursement to the Deposit Insurance Fund.

Changes in control

26 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The statutory authority for federal regulation of acquisitions of banks, other insured depository institutions, bank holding companies and other insured depository institution holding companies, and their respective subsidiaries, emanates primarily from:

- the BHC Act, which regulates acquisitions of control of a bank or bank holding company by a 'company', as well as the acquisition of foreign subsidiaries and the commencement or acquisition of companies engaged in non-bank activities by a holding company or non-bank subsidiary;
- the Bank Merger Act, which regulates mergers between insured depository institutions and acquisitions of assets and assumptions of liabilities of one insured depository institution by another;
- HOLA, which regulates acquisitions of control of thrifts and thrift holding companies; and
- the Change in Bank Control Act of 1978 (the Control Act), which governs all acquisitions of control of a bank, thrift or holding company by a 'company' other than those covered by the BHC Act, HOLA and the Bank Merger Act as well as by individuals. The Control Act provides that if a proposed acquisition is subject to the provisions of the BHC Act, HOLA or the Bank Merger Act, then the acquiring person need not comply with the Control Act.

Frequently, a particular bank acquisition involves the acquisition by one bank holding company of shares of another bank holding company followed by a merger between the two subsidiary banks. Such transactions are subject to prior regulatory approval under the BHC Act, on the one hand, and the Bank Merger Act, on the other.

BHC Act

Under the BHC Act, prior approval by the Federal Reserve is required for the acquisition by a 'company' of 'control' of a bank or of substantially all of the assets of a bank. Prior Federal Reserve approval also is required under the BHC Act for an existing bank holding company to acquire direct or indirect ownership or control of voting shares of a bank or bank holding company if it will own or control more than 5 per cent of the voting shares after such acquisition and merge with another bank holding company. Such approval is not required for the acquisition of additional shares in a bank or bank holding company by a company that already owns or controls a majority of the voting shares prior to such acquisition.

A company is deemed to 'control' a bank or bank holding company under the BHC Act if:

- it has the power to vote 25 per cent or more of any class of 'voting securities' of the bank or holding company;
- it has the power to control 'in any manner' the election of a majority of the board of the bank or holding company; or
- the Federal Reserve determines, after notice and an opportunity for hearing, that the company has the power to directly or indirectly exercise a controlling influence over the management or policies of the bank or holding company.

The BHC Act contains a statutory presumption that a company that owns, controls or has the power to vote less than 5 per cent of the voting securities of a bank or bank holding company does not have 'control' for purposes of the BHC Act.

The Federal Reserve's regulations provide that the term 'voting securities' includes any securities giving the holder power to vote for directors or to direct the conduct of operations or other significant policies of the issuer. Preferred stock is deemed not to be a class of voting securities if it does not carry the right to vote for directors, its voting rights are limited solely to the type customarily provided by statute with regard to matters that significantly and adversely affect the rights or preferences of the preferred stock and it represents an essentially passive investment or financing device.

In addition to acquisitions of voting securities, Federal Reserve regulations identify a number of situations in which there is a rebuttable presumption that a company controls a bank or bank holding company for purposes of the BHC Act. This presumption will apply if:

- a company enters into a contract with a bank or bank holding company pursuant to which the first company directs or exercises significant influence over the management of the bank;
- a company and its management and principal shareholders own, control or hold with the power to vote, 25 per cent or more of any class of voting securities of a bank or bank holding company and the first company itself owns, controls or holds, with the power to vote, more than 5 per cent of any class of voting securities of the bank or bank holding company; or
- the two companies have one or more management officials in common, the first company owns, controls or holds, with the power to vote, more than 5 per cent of any class of voting securities of the other company and no other person controls as much as 5 per cent of any class of voting securities of the other company.

The Federal Reserve has also identified a number of circumstances that may indicate the existence of a control relationship under the BHC Act. Such indicia of control include:

- agreements that substantially limit the discretion of a bank holding company's management over major policies of the company, including restrictions on entering into new banking activities without approval of another company or requirements for extensive consultation with the other company regarding financial matters;
- agreements that restrict a bank holding company from selling a majority of the voting shares of its subsidiary banks;
- agreements that give another company the ability to control the ultimate disposition of voting securities to a person of the other company's choice and to secure the economic benefits therefrom;
- an investment of substantial size, even if in non-voting securities;
- agreements that require that one holder's voting securities be redeemed at a premium upon transfer of shares held by another holder; and
- agreements giving a company the ability to direct a bank holding company's use of the proceeds of the first company's investment.

The Federal Reserve has stated that provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control of the acquiree by the acquiring company. Such mitigating provisions may include:

- covenants that leave management free to conduct banking and permissible non-banking activities;
- a 'call' right that permits the acquiree to repurchase the acquiring company's equity investment;
- a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of these rights if the right of first refusal is not exercised;
- agreements involving rights with respect to less than 25 per cent of the acquiree's voting shares; and
- holding down the size of any non-voting equity investment in the acquiree below the 25 per cent level.

With respect to the last point, the Federal Reserve has generally taken the view (except in certain circumstances) that non-voting equity investments by bank holding companies may not be equal to 25 per cent or more of a target's total equity. In addition, the Federal Reserve has viewed subordinated debt as equity for purposes of this limitation.

Change in the Bank Control Act

The Control Act provides that a 'person' seeking to effect an acquisition of 'control' of a bank holding company or a federally insured depository institution must give prior written notice to the 'appropriate federal banking agency'. The agency then has a specified period to disapprove the acquisition. If not disapproved within that period, the acquisition may be consummated. An acquisition may be made prior to expiry of the period if the agency issues written notice of its intent not to disapprove the acquisition.

The concept of control used in the Control Act differs somewhat from that used in the BHC Act. The Control Act defines 'control' as the power, directly or indirectly, to direct the management or policies, or to vote 25 per cent or more of any class of voting securities, of an insured bank. In addition, Federal Reserve regulations provide that a person is rebuttably presumed to 'control' a bank under the Control Act if the person:

- 'owns, controls, or holds with the power to vote 25 per cent or more of any class of voting securities of the institution'; or
- 'owns, controls or holds with power to vote 10 per cent or more [...] of any class of voting securities of the institution'; and if
  - the institution's shares are registered pursuant to section 12 of the Exchange Act; or
  - no other person would own a greater percentage of the institution's outstanding shares.

Bank Merger Act

The Bank Merger Act provides that no insured bank or other insured depository institution may merge with, or acquire the assets or assume the liabilities of, another insured depository institution without the prior written approval of the 'responsible agency' and prescribes certain procedures (including procedures for obtaining shareholder approval and for appraisal of shares held by dissenting holders) for such mergers.

Where the acquiring or resulting bank is to be a national bank or a bank chartered in the District of Columbia, the OCC is the responsible agency. Where the acquiring or resulting bank is to be a state-chartered bank that is a member of the Federal Reserve System, the Federal Reserve is the responsible agency. Where the acquiring or resulting bank will be a state-chartered bank (other than a savings bank) that is not a member of the Federal Reserve System, the FDIC is the responsible agency.

Where the acquiring or resulting institution is to be a thrift, the OCC is the responsible agency. In addition, a 'deposit transfer' application to the OCC may be required where the transferring or disappearing institution is a thrift.

HOLA

HOLA governs acquisitions of control of insured federal or state thrifts (including savings associations, savings and loan associations, building and loan associations and federal savings banks) and holding companies of such thrifts.

Thrift regulations provide that a company generally cannot acquire control of a thrift, directly or indirectly, unless it first receives written approval from the Federal Reserve. The regulations create two thresholds for determining 'control': conclusive control and control subject to rebuttal. The regulations also establish presumptions of concerted action for purposes of determining the circumstances under which it might be appropriate to aggregate the holdings of different investors.

A company will be deemed to conclusively control a thrift if an acquirer directly or indirectly, or acting in concert with one or more persons or companies:

- acquires more than 25 per cent of any class of voting stock;
- acquires irrevocable proxies representing more than 25 per cent of any class of voting stock;
- acquires any combination of voting stock and irrevocable proxies representing more than 25 per cent of any class of voting stock;
- controls in any manner the election of a majority of the directors of the thrift; or
- can exercise a controlling influence over the management or policies of the thrift.

Subject to rebuttal, an acquirer will be deemed to control a thrift if the acquirer directly or indirectly, or acting in concert with one or more persons or companies:

- acquires more than 10 per cent of any class of voting stock and one or more additional 'control factors' are present, including:
- being one of the two largest holders of any class of voting stock;
- holding more than 25 per cent of total equity;
- holding more than 35 per cent of combined debt securities and equity; or
- being party to agreements that give an investor a material economic stake in a thrift or thrift holding company or that give an investor the power to influence a material aspect of management or policy;

- acquires more than 25 per cent of any class of stock and one or more of the above control factors are present; or
- holds any combination of voting stock and proxies, representing more than 25 per cent of any class of voting stock, that enables an acquirer to:
- elect one-third of the board of directors;
- cause the shareholders of the thrift to approve its acquisition or reorganisation; or
- exert a controlling influence on a material aspect of its business operations.

To satisfy the thrift regulations, an investor should, prior to an acquisition of equity securities, debt securities, or both, of a thrift or thrift holding company that could subject the investor to a finding of control subject to rebuttal, submit to and have approved by the Federal Reserve a rebuttal of control agreement. Rebuttals of control contain a series of passivity commitments.

27 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The receptivity of the US regulatory authorities to foreign acquirers of US banks depends in large part on whether the acquirer is subject to comprehensive consolidated supervision by its home country supervisor as discussed below. The filings are essentially the same for a foreign acquirer of a US bank; a foreign acquirer, however, raises some different considerations. Also, as noted in question 20, foreign acquirers need to be mindful of CFIUS filing requirements.

Capital

In considering applications by foreign banks to acquire US banks, the Federal Reserve has looked to whether the capital levels of a foreign bank exceed the minimum levels that would be required under the Basel Capital Accord both before and after the merger. The Federal Reserve also looks to whether a foreign bank's capital levels are considered to be equivalent to the capital levels that would be required of a US banking organisation. In doing so, the Federal Reserve will typically consult a foreign bank's home country supervisor. Another important factor is that the US-insured depository institutions controlled by the foreign bank both before and after the merger meet the requirements to be deemed well capitalised. As discussed in question 22, in February 2014, the Federal Reserve issued regulations that substantially tightened the regulation of foreign banks operating in the US and required the formation of US intermediate holding companies if certain size thresholds are met.

Requirement of comprehensive supervision

Under the BHC Act, the Federal Reserve is precluded from approving an application by a foreign bank to acquire a US bank unless the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. In essence, the Federal Reserve must determine that the bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the bank, including its relationships to any affiliate, to assess the bank's overall financial condition and its compliance with laws and regulations. If the Federal Reserve has previously determined that a particular home country supervisor practices comprehensive consolidated supervision, the finding is relatively easy for the Federal Reserve to make in the context of subsequent acquisitions by other banks from the same home country. Conversely, if the Federal Reserve has not previously made such a determination with respect to particular home country supervisor, the determination process can take months and even years.

Similarly, the Federal Reserve must also determine that a foreign bank that is applying to acquire a US bank provide adequate assurances that it will make available such information on its operations and activities and those of its affiliates as the Federal Reserve deems appropriate to determine and enforce compliance with the BHC Act. To make this determination, the Federal Reserve reviews the restrictions on disclosures in jurisdictions where the foreign bank has material operations and consults with the relevant non-US governmental authorities concerning access to information. The Federal Reserve also expects that the foreign bank commit to making available such information on its operations and those of its affiliates that the Federal Reserve deems necessary.

Update and trends

With the change in Administration in November 2017, US banking regulation appears to be entering a more industry-friendly period. Following the global financial crisis of 2008 to 2009, the regulatory environment for banks in the US became extremely harsh. The regulatory environment again appears to be in a state of flux as the pendulum seems to be changing direction.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank?

Section 3(c) of the BHC Act sets out the criteria that the Federal Reserve must apply in acting upon BHC Act applications. The criteria are:

- antitrust;
- financial condition and future prospects;
- management resources;
- convenience and needs of the community; and
- impact on systemic risk.

In every case, the Federal Reserve must also take into consideration the effectiveness of the company or companies in combating money laundering activities, including in overseas branches.

Antitrust

The BHC Act provides that the Federal Reserve may not approve an acquisition that would result in a monopoly in or furtherance of a combination or conspiracy to monopolise or to attempt to monopolise the business of banking in any part of the US or might have the effect in any section of the country of substantially lessening competition, unless the board finds that the anticompetitive effects of the transaction are clearly outweighed by the convenience and needs of the communities to be served.

During the Federal Reserve's review of an acquisition under the BHC Act, the Antitrust Division of the Department of Justice (DOJ) also has an opportunity to evaluate the competitive issues raised by the proposed transaction and may submit its comments to the Federal Reserve. If the Federal Reserve approves the acquisition, the BHC Act provides that the transaction may not be consummated for 30 days (or 15 days if the DOJ has not submitted adverse comments with respect to competitive factors), during which time the DOJ may challenge the transaction in a federal district court.

Evaluating the antitrust implications raised by in-market bank acquisitions can be a complex task owing to the fact that the Federal Reserve and the DOJ apply different methodologies and focus on different competitive concerns. Most notable among those differences is the relevant product market defined by the two agencies. The Federal Reserve continues to invoke the 'cluster' of banking services market definition adopted by the US Supreme Court more than 50 years ago. The Federal Reserve's primary tool for evaluating the antitrust implications raised by a bank merger is to measure the effect of the proposed merger on the concentration levels within locally limited geographic markets. In contrast, the DOJ evaluates disaggregated product markets, including small-business lending and middle-market lending, in addition to retail banking services. At times, these differences can lead to conflicting outcomes at the two agencies with respect to whether a particular transaction raises antitrust concerns, and, if so, the level of divestiture required to resolve those concerns.

Financial condition and future prospects

The BHC Act provides that, in considering proposed acquisitions of bank shares or assets, '[i]n every case, the Federal Reserve Board shall take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned'. The Federal Reserve's consideration of this factor generally centres round the adequacy of the resulting company's capital. This analysis turns on the following three measures of capital adequacy:

- whether the resulting company will satisfy the Federal Reserve's published risk-based capital adequacy guidelines, which establish minimum levels of capital that bank holding companies are expected to meet;
- how the resulting company's capitalisation compares to the capitalisation of the two combining companies; and

- how the resulting company's capitalisation compares to the capitalisation of its peers.

Management resources

The BHC Act requires the Federal Reserve to take 'managerial resources' into account in considering applications for acquisitions. Applications that have been denied on the grounds of inadequate managerial resources have generally involved attempted acquisitions of relatively small banks by persons with little or no experience in managing a banking business.

Such managerial concerns are not limited to these circumstances, however. As part of the application process, the Federal Reserve staff frequently seeks and obtains detailed information to document an acquirer's managerial resources. Such information often takes the form of strategic business plans for the combined company, integration plans and staffing and cost savings projections. In addition, the federal regulators also scrutinise the larger bank holding companies' management, staffing, planning and implementation of acquisitions as part of the examination process. Any adverse examination reports in this area can be expected to affect applicant during the application process.

Convenience and needs of the community

The Federal Reserve is required to take into consideration the 'convenience and needs of the community to be served' in approving or rejecting an application under section 3 of the BHC Act. This consideration generally relates to the nature, quality and availability of the applicant's actual or planned products and services, including, for example, the hours and locations of operation, interest rates on deposits and size of available loans.

As a practical matter, the Federal Reserve has almost always determined that the general convenience and needs aspects of an application are consistent with approval of the application, even if the applicant plans to offer no new services or products. On the other hand, the Federal Reserve has found increases in services, greater loan limits, increased hours and, in particular, the reopening, or the assumption of the deposits, of a closed institution to be positive factors weighing in favour of approval of an application because of more effective service to the community.

Systemic risk

Under Dodd-Frank, the Federal Reserve is also required to consider the impact of a bank acquisition on systemic risk. In assessing this factor, the Federal Reserve looks at five factors:
- the size of the combined company;
- the availability of substitute providers for the critical services offered by the combined company;
- the combined company's interconnectedness with the rest of the US financial system;
- the degree to which the combined company contributes to the complexity of the US financial system; and
- the extent of the combined company's cross-border activities.

The Community Reinvestment Act

In considering the convenience and needs of the community, the Federal Reserve is required under the Community Reinvestment Act (CRA) to consider an applicant's record of serving the credit needs of its entire community, including low and moderate-income neighbourhoods, consistent with the safe and sound operation of the applicant. The CRA requires the federal banking regulators to 'encourage financial institutions to help meet the credit needs of the local communities in which they are chartered' and, to that end, the Federal Reserve is required to take an applicant's CRA record into account under section 3 of the BHC Act.

The CRA provides a four-tier system for rating an institution's record of meeting community credit needs: 'outstanding', 'satisfactory', 'needs to improve' and 'substantial non-compliance'. Each bank's primary regulator performs periodic examinations of, and assigns a rating to, the bank's CRA performance.

An applicant's CRA record may be the basis for the denial of an application, although denials solely on CRA grounds are rare. The Federal Reserve takes into account both an institution's CRA rating and CRA evaluations in making its CRA determination in connection with an application. Of the few CRA-based denials of applications, most, if not all, have involved applicants having subsidiaries with low CRA ratings.

Control Act criteria

The appropriate agency may disapprove a proposed acquisition under the Control Act:
- if the acquisition would result in a monopoly or would be in furtherance of any combination or conspiracy to monopolise or to attempt to monopolise the business of banking in any part of the United States;
- if the acquisition may have the effect in any section of the country of substantially lessening competition, unless the responsible agency finds that the anticompetitive effects of the proposed transaction are clearly outweighed by the convenience and needs of the community to be served;
- if the financial condition of any acquiring person is inadequate;
- based upon the competence, experience or integrity of any acquiring person or of any of the proposed management personnel;
- if any acquiring person neglects, fails or refuses to furnish the appropriate agency all the information required by it; or
- if the acquisition would adversely affect the Deposit Insurance Fund.

Bank Merger Act criteria

The Bank Merger Act provides that the responsible agency may not approve any proposed merger that:
- would result in a monopoly or would be in furtherance of any combination or conspiracy to monopolise or to attempt to monopolise the business of banking in any part of the United States; or
- might have the effect in any section of the country of substantially lessening competition, unless the responsible agency finds that

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the anticompetitive effects of the proposed transaction are clearly outweighed by the convenience and needs of the community to be served.

In addition, the responsible agency is required to take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the communities to be served and the impact of the merger on systemic risk. The responsible agency must also take into consideration the effectiveness of any insured depository institution involved in the proposed merger in combating money laundering activities, including in overseas branches.

29 Describe the required filings for an acquisition of control of a bank.

In order to acquire a US bank, an application must be filed under the appropriate statute set out in question 26. In general, the filings require detailed information regarding the acquirer, including all individuals who have the authority to participate in major policy-making functions. In addition, detailed personal information of individuals with the most senior decision-making authority must often be provided for the acquirer.

30 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

An acquisition of a bank or bank holding company differs from most other types of acquisitions by virtue of the often elaborate and extended regulatory approval process. In general, when a bank holding company or a financial holding company acquires more than 5 per cent of the voting shares of another bank or bank holding company, it must first receive Federal Reserve approval. Depending on the size and complexity of the proposal, the approval process can be as short as 45 days or longer than six months.

Getting the Deal Through

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