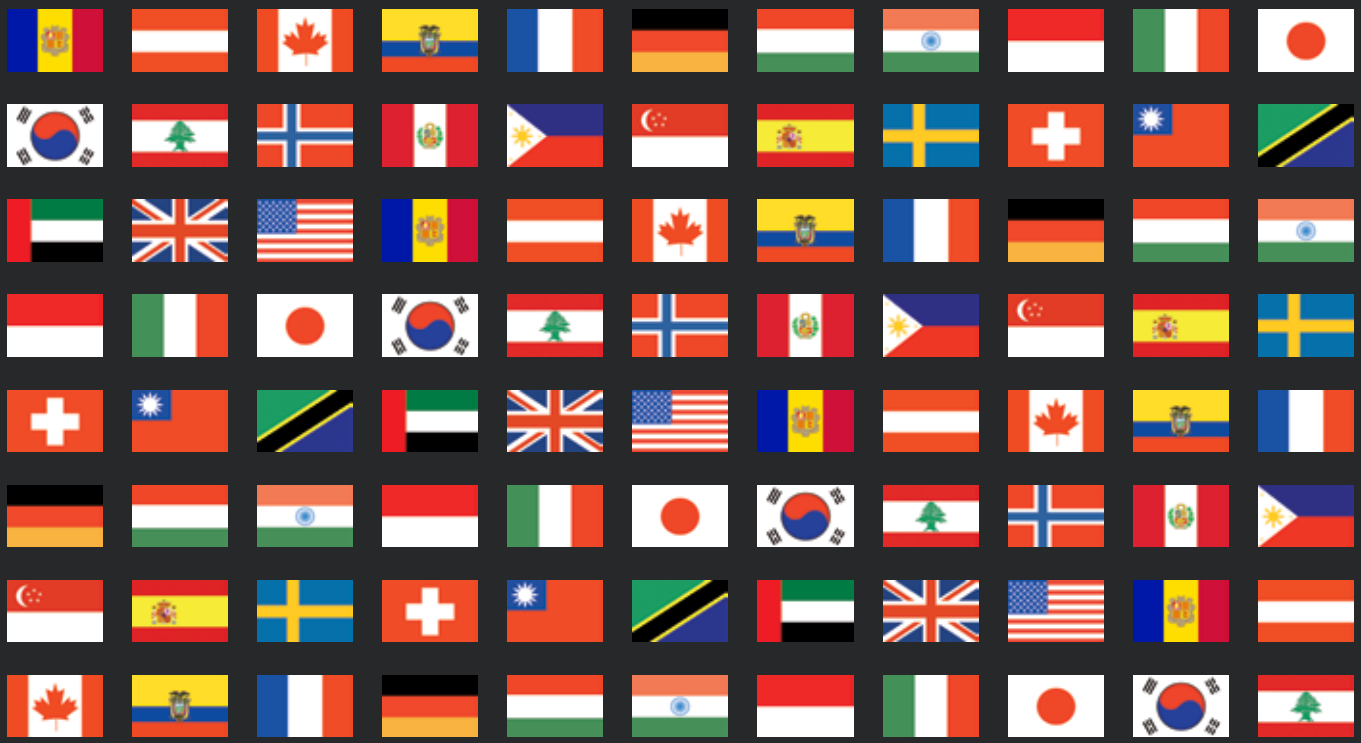
Banking Regulation

Contributing editor
David E Shapiro



2017

GETTING THE DEAL THROUGH

GETTING THE DEAL THROUGH

Banking Regulation 2017

Contributing editor
David E Shapiro
Wachtell, Lipton, Rosen & Katz

Publisher
Gideon Roberton
gideon.roberton@lbresearch.com

Subscriptions
Sophie Pallier
subscriptions@gettingthedealthrough.com

Senior business development managers
Alan Lee
alan.lee@gettingthedealthrough.com

Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan White
dan.white@gettingthedealthrough.com

Law Business Research

THE QUEEN'S AWARDS FOR ENTERPRISE: 2012

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3708 4199
Fax: +44 20 7229 6910

First published 2008
Tenth edition
ISSN 1757-4730

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

CONTENTS

Preface

Banking Regulation 2017

Tenth edition

Getting the Deal Through is delighted to publish the tenth 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 new chapters on Andorra, Ecuador and Korea.

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, David E Shapiro of Wachtell, Lipton, Rosen & Katz, for his continued assistance with this volume.

GETTING THE DEAL THROUGH

London
April 2017

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.

Although the financial crisis has had a reduced impact in Andorra in comparison with other neighbouring jurisdictions, it has highlighted the compelling need to strengthen regulation over the banking sector, aimed at enhancing financial supervision and maintaining a close focus on the banking solvency and capital requirements regime.

Andorran banking regulation is being increasingly influenced by international standards in financial regulation (ie, European 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 Monetary Agreement with the European Union in 2011 (the Monetary Agreement), which obliged the Andorran government to implement several banking and anti-money laundering European Directives and Regulations before 2019.

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

Overall, the primary statutes governing the banking sector are Act 7/2013, 9 May, on the regime for the operating entities in the Andorran financial system and other provisions that govern financial services in the Principality of Andorra and Act 8/2013, 9 May, 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 acts 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 European regulations.

Specifically, certain areas of the banking sector are governed by concrete rules, including Act 35/2010 on the legal regime for authorising the creation of new operating entities within the Andorran financial system; Act 10/2008 regulating Andorra collective investment schemes undertakings; Act 8/2015 on urgent measures to introduce mechanisms for the recovery and resolution of banking entities; Act 10/2013 of the INAF; the financial system disciplinary Act, dated 27 November 1997; the capital adequacy and liquidity criteria of financial institutions Act, dated 29 February 1996; the insurance companies Act, and the international cooperation in criminal matters and the fight against money laundering or securities arising from the international crime Act, dated 29 December 2000.

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 Andorran entities, due to the coming into force of the draft legislation on the organisation and supervision of insurance and reinsurance within the Principality of 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 Act 1/2011, of 2 February, 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 the European standards. Act 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 shall 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 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, although its intervention could have been relevant in recent events (eg, intervention in Banca Privada d'Andorra, SA). 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 as a consequence of the resolution of Banca Privada d'Andorra, 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 transactions that banks may carry out with their affiliates is basically made up of the capital adequacy and liquidity criteria of financial institutions Act, 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 abovementioned Act under a consolidated basis.

Under Andorran law an 'affiliate' relationship applies when there are dominant and a 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 as well as 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 legislature has made significant efforts in recent years in order to adapt and modernise the Andorran banking industry to international standards.

In this sense, areas such as investor protection, market abuse regulation, the general regulatory regime for Andorran financial entities and regulation of financial guarantees have been set up and strengthened, as well as the regulation for banking resolution and restructuring.

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

Insurance and reinsurance regulation

The current draft bill regulating the insurance and reinsurance market in Andorra will serve as a cornerstone for the insurance market. In particular, the main challenges in this respect are the adaptation of Andorran insurance entities to the capital requirements imposed by the draft bill, 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 (INAAF).

Banking industry framework

One of the main challenges for the banking industry is to continue to open up to foreign investment and, at the same time, to maintain its independence and remain 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 the incorporation of the Andorran legal framework to the Common Reporting Standard of the Organisation for Economic Co-operation and Development (OECD). This commitment came into force by the enactment of Act 19/2016 of 30 November on the automatic exchange of tax information.

Bank resolution and restructuring regulation

The main challenges in this matter refer both to the modernisation of the Insolvency Decree dated 4 October 1969, which governs the general bankruptcy regime, and its alignment with Act 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's 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 Act 13/2013, 13 June, 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 are the keystones of this 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 saftey; 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 modalities for sale; and
  - information and diffusion on consumption through mass media.
- Unfair terms: this act 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 all 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 Act 8/2013, which is in line with 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 Act 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, 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) 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). Furthermore, the Andorran government is working to enact several laws to permit Andorran banks to gain access to capital markets and issue financial instruments.

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 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.

Supervision performed by the INAF has as an essential aim 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 authorisation by the INAF 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 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 services of treasury 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 the case of breach of the obligations imposed by the Andorran financial legislation. These on-site inspections carried out by the INAF are frequent and are thorough.

In spite of not being a member state of the EU, article 20 of Law 10/2013 foresees the international cooperation with other regulators, in addition to the INAF condition as a member of IOSCO. In this sense, there is a Memorandum of Understanding (MoU) in force between Andorra and Spain, signed on 4 April 2011. The MoU: (i) constitutes an agreement for consolidated cooperation in the supervisory framework between the INAF and the Bank of Spain; (ii) establishes the terms of the protocol for the relationship and collaboration between both authorities; and (iii) enables 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.

The enforcement powers of the INAF comprehend, among others:

- 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; 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 the Andorran banks; compliance with the anti-money laundering Act; and the judicial proceedings issued against unfair terms incorporated in consumer contracts.

Nevertheless, the volume and intensity of the two 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?

Act 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 such 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 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 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 Act 8/2015 a bank's management must draft an action plan in the case where the bank is already or is foreseeably going to enter an insolvency situation. The objective of the plan is to provide measures to restore the bank 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 a part or the totality of 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 of the totality 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 thereof.

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 the functions of the AREB and the INAF with respect to analysis of the bank's situation;
- removal from the position of director and disqualification from exercising management or direction activities in the failed entity for five years;
- disqualification from exercising management or direction activities in any financial or banking entity, and removal, as the case may be, from his or her position as director, for a period less than 10 years;
- an order for the directors to cease and desist from the prejudicial activity performed against the entity; and
- public reprimand in the Andorran official journal or the website of the sanctioning organisation or private reprimand.

Capital requirements

15 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 shall have solid, effective and exhaustive strategies and procedures to evaluate and maintain, permanently, the amount, type and distribution of share capital that is adequate to cover the nature and the level of risk to which the 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 shareholders of the entity. The INAF has competence to adopt all measures necessary if a bank has insufficient own funds.

16 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 date of submission of the correspondent 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.

17 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 the 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 to 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.

18 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 17:

- 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 the 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 Act 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.

19 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 the Basel III framework, by implementing them into Andorran legislation. However, although the INAF has been anticipating provisions of Basel III by means of personalised direct recommendations and communications (note that the regulator has the ability to set as applicable what he deems to be an international standard) the provisions of Basel III and its correspondent EU capital requirements regulations 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 are also applicable to 2017 financial statement, the impact on the regulatory Andorran framework should not be particularly relevant.

Ownership restrictions and implications

20 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, a percentage of 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, 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 AML authority (UIFAND), which will also examine the transaction and the acquirer.

21 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 the authorisation. However, if the authorisation is not resolved in that period, it is deemed granted.

However, the Andorran government has a safeguard clause to deny such authorisation to protect the sovereignty, public and economic order, national security, public health or general interest of the Principality of Andorra.

Update and trends

Although not strictly related to banking regulation, on 1 January 2017 Act 19/2016 on the automatic exchange of tax information, which comprises the provisions of the Common Reporting Standard of the OECD, came into force in Andorra.

On the other hand, the Andorran government is negotiating an association agreement with the European Union in order to bring the country into line with European member states, which will allow it to, for example, benefit from a (soft) passport to perform financial services on a cross-border basis.

Furthermore, over the following years Andorra has to implement all the European regulations within the Monetary Agreement.

22 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 23.

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.

23 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 Act 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: (i) 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 (ii) demanding the home state regulator to perform on-site inspections in relation to entities supervised by the INAF and vice versa.

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

Act 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

25 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 associated parties thereof; or
- a natural or legal person may exercise or actually exercises a dominant influence or an influence of control.

26 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.

27 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 the bank to comply with the applicable regulatory and disciplinary rules stated in Andorran legislation;
- the directors and senior officers of the 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 of which the control is acquired;
- absence of breach of the 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.

28 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. In brief:

- information about the transaction: purpose, price and payment terms, identification of the entity, impact on the distribution of voting rights, financing of the transaction and existence of agreements with third parties or other shareholders in relation to the transaction, documentation stating that there is no affection to the technical, economic and professional guarantees of the Andorran bank and, in the case of qualified stakes, that there is no breach of Andorran legislation;
- information about the acquirer and its controlling persons: certificate of the general meeting of the foreign entity according the acquisition, identity of the acquirer and its controlling persons, group structure, structure and members of the management bodies as well as their reputation and experience, economic and financial situation, verification or previous links with the acquired bank and evaluations performed by AML bodies; and
- 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.

29 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 shall hand down 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.

CASES & LACAMBRA

Miguel Cases **miguel.cases@caseslacambra.com**
Marc Ambrós **marc.ambros@caseslacambra.com**

Manel Cerqueda i Escaler 3–5
AD700 Escaldes-Engordany
Andorra

Tel: +376 728 001
www.caseslacambra.com

Austria

Christoph Moser and Stefan Weber
Weber & Co

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, financial stability and the financial institutions' loss-bearing capacity;
- ensuring the efficient supply of credit to businesses and individuals;
- strengthening and harmonisation of the supervision of banks, securities, insurance and financial conglomerates; and
- requiring institutions to develop better internal control systems and more effective 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 developments of Austria's banking regulations are extensively connected with European measures. The key Austrian legislation applicable to credit institutions includes the following:

- 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 has to be implemented in national laws by 13 January 2018. In addition, the Interchange Fee Regulation (Regulation 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 European Union level required a revision of the BaSAG in 2015. The bulk of the amendments entered into force in January 2016 and strengthen the rights and duties of the Austrian Financial Markets Authority (FMA) as 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 Capital Markets Act, which primarily implements the Prospectus Directive (Directive 2003/71/EC), provides in particular for the prospectus framework relevant to securities offerings and offerings of investments in Austria;
- the Investment Fund Act, 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 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 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 provide the legal framework relating to listing and trading of securities as well as public takeover offerings;
- the Securities Deposit Act 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, including additional regulations, governs the organisation of the FMA, the cooperation with other regulatory authorities and the applicable cost framework;
- the Mortgage Bond Act applies to the issuance of mortgage bonds by credit institutions;
- the Financial Conglomerate Act contains provisions regarding the additional supervision of financial conglomerates by regulatory authorities;
- the Financial Markets Anti-Money Laundering Act (FM-GwG) entered into force in January 2017, implementing the revised Anti Money Laundering Directive (Directive 2015/849/EU). Prior to that, anti-money laundering regulations were implemented in the BWG; and
- specific other laws, inter alia, apply to Sparkassen, Bausparkassen and Hypothekenbanken.

In addition to Austrian law, certain EU regulations are directly applicable to Austrian credit institutions, including in particular the Capital Requirements Regulation (Regulation No. 575/2013) (CRR), which is to a large extent 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.

Further, the EU Funds Transfer Regulation will become effective in June 2017 (Regulation 2015/847/EU), repealing the Regulation 1781/2006.

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 No. 1024/2013) and the SSM Framework Regulation (Regulation No. 17/2014). Since then, banking supervision is performed by the ECB having extensive micro- and macroprudential powers. All credit institutions of the eurozone 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 126 credit institutions.

The following Austrian banks (including their subsidiaries or affiliates) are directly supervised by the ECB: BAWAG PSK AG, Erste Group Bank AG, Raiffeisen-Holding Niederösterreich-Wien reg. GenmbH, Raiffeisenlandesbank Oberösterreich AG, Volksbank Wien AG, Raiffeisen Zentralbank Österreich AG and – owing to significant cross-border assets – Sberbank Europe AG and VTB Bank (Austria) AG. UniCredit Bank Austria AG, as a subsidiary of UniCredit SpA, is also directly supervised by the ECB. The day-to-day supervision is conducted by joint supervisory teams (JSTs), which comprise 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 on a regular basis to the ECB 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 particularly 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 €1 billion 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 that, 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 payout 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 BWG), these include:

- 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 and which 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 an amount of €100,000; regarding undertakings, such claims have to be deducted by a deductible of 10 per cent.

In addition to deposit guarantee schemes, several banks (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 ESAEG transposed the Directive into national law in August 2015. The ESAEG provides a single protection scheme instead of currently five schemes of different trade associations. 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 financial crisis of 2008 and its aftermath, various Austrian banks had to be rescued or at least supported by the Republic of Austria. 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 privatised in 2015. Österreichische Volksbanken AG was restructured in 2015 and split into the bank Volksbank Wien AG and immigon portfolioabbau ag (Immigon). The Republic of Austria holds a 43.3 per cent stake in Immigon, which is a wind-down unit pursuant to section 162 of the BaSAG.

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 BWG, the FMA is entitled to supervise the transactions between the credit institutions, superordinate holding companies and thei subsidiary undertakings when the parent undertaking of a credit institution is a mixed financial holding company, a 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 which has its head office in the EU, and other entities, constitutes a financial conglomerate. Such term is defined in article 4 (21) CRR in conjunction with article 2(15) of Directive 2002/87/EC.

Credit institutions must have in place adequate risk management processes and internal control mechanisms, 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 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 comply permanently 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) prove a remarkable challenge for the Austrian banking industry. Hence 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 lie in the rapid development of banking regulations and the resulting necessity for banks to react quickly. Provisions regarding the professional qualifications and experience necessary for operating the credit institution for both the executive and supervisory board of credit institutions have been tightened in recent years (eg, fit and proper test). 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 of the eurozone must comply with ECB-issued guidelines and use standardised templates for data collection and information requests, and this may temporarily cause multitrack 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) and the Consumer Credit Act. The BWG also provides for consumer protection rules (eg, section 34 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 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, the WAG 2007 obliges banks to apply the necessary expertise and diligence for the best interests of their clients when providing investment services (section 38 WAG 2007).

The Consumer Payment Accounts Act, which implements the rules of the Payment Account Directive (Directive 2014/92/EU), entered into force in September 2016. The Directive provides for the 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 at a European level will continue and, thus, will significantly influence the Austrian banking industry in the upcoming years.

On 30 September 2015, the European Commission published its Capital Markets Union Action Plan, which provides for the establishment of a true single market for capital across the 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 small and medium-sized enterprises (SMEs), simplifying secondary issuing for listed companies).

The revised Markets in Financial Instruments Directive (Directive 2014/65/EU) (MiFID II) with its accompanying Markets in Financial Instruments Regulation (Regulation 600/2014) (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. The application of MiFID II, however, was postponed to January 2018 owing to concerns about the technical implementation. The member states

are now obliged to implement MiFID II by 3 July 2017. The bulk of provisions of MiFIR will apply on 3 January 2018 as well.

The Market Abuse Regulation (MAR) refers to definitions and concepts in MiFID II. Accordingly, references in MAR relating to organised trading facilities (a new type of trading venue introduced by MiFID II), SME growth markets and emission allowances will not apply until MiFID II enters into application on 3 January 2018. The bulk of MAR already applies since 3 July 2016.

PSD II (the Payment Services Directive (Directive 2015/2366)) will replace PSD I (Directive 2007/64/EC) and has to be transposed into national law by the 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.

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 in the member states (Austria's credit institutions contributed €204.30 million in 2016; the amount of deposits covered by the SRF should be about €50 billion by the end of 2024).

The FM-GwG entered into force in January 2017 and is implementing the Anti Money Laundering Directive (Directive 2015/849/EU).

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.

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. The OeNB 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 investigations of risks, risk controls and governance with a predefined 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 a 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 and that warrants 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 the OeNB jointly define an inspection plan for each upcoming 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 also 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 BWG;
- implementing certain measures pursuant to section 70 paragraphs 2, 4 and 4a BWG (eg, prohibition of profit distributions, complete or partial prohibition of the continuation of business operations, imposing additional capital requirements or fines, withdrawal of the banking licence);
- requesting reorganisation measures (receivership or insolvency proceedings) pursuant to section 81 et seq BWG;
- collecting penalty interest for violation of capital requirements pursuant to section 97 BWG; and
- imposing fines due to administrative offences stipulated in section 98 and 99 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 SSM Regulation).

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 2015, the FMA conducted 50 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 41 bank audit and early recognition meetings with bank auditors of the auditing associations of the decentralised sectors, issued 32 audit engagements to the OeNB, 23 audit engagements by the ECB concerning SI and an increasing number of on-site activities related to model approval took place compared to 2015. 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 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 ordered such measures on two occasions in 2015. The FMA also ordered nine 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 and charged interest pursuant to section 97 BWG on 23 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 such 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, as well as 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 has provided the regulatory authorities with a wide range of powers: for example, the FMA may appoint a temporary administrator in the event 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. Such 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 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 licence;
- 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 case of a group only the superordinate institution, central organisation or central institution) is obliged to draw up a recovery plan and a resolution plan. 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 the FMA detects any deficiencies, the credit institution is required to change the recovery plan or the resolution plan accordingly. The recovery plan and the resolution plan must be updated at least annually; in any event 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.

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). In the event managing directors do not comply with their notification obligation pursuant to section 114 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 of the BaSAG (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.

Capital requirements

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

The CRR and Directive 2013/36/EU (CRD IV) 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 provide 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.

16 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 FMA's authority to enforce banking laws and regulations (see questions 10, 17 and 18). 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.

17 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 asses the assets and liabilities of the institution.

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

Austria implemented the BRRD (Directive 2014/59/EU) 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.

Pursuant to section 49 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; and
- 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 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 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.

19 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 CRR and CRD IV 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.

On 23 November 2016, the European Commission proposed amendments to the capital requirement directive and regulation. The amendments include measures that will strengthen the resilience of the banking sector by introducing more risk-sensitive capital requirements. At the same time, the new measures will make CRD IV/CRR rules more proportionate and less burdensome for smaller financial institutions and will improve banks' lending capacity to support EU economy.

Ownership restrictions and implications

20 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 25).

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 that 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 25).

21 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 25, 26 and 28).

22 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 25).

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.

23 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 25);
- 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

Update and trends

Revised Payment Service Directive (PSD2)
Adopted by the European Parliament in October 2015 and by the European Union (EU) Council of Ministers in November 2015, the Directive on Payment Services in the Internal Market (PSD2) updates the first EU Payment Services Directive published in 2007 (PSD1), which laid the legal foundation for the creation of an EU-wide single market for payments. PSD2 came into force in January 2016 and is applicable from 13 January 2018, by which time member states must have adopted and published the measures necessary to implement it into their national laws. PSD2 provides a major update of payment market regulation in the EU/EEA. It extends the Directive's application to payments where only one Payment Service Provider (PSP) is located in the EU/EEA area and to payments in all official currencies, not just those of EU member states. The changes due to PSD2 will impact financial institutions' operations in different ways. The main scope of the PSD2 is to encourage new players to enter the payment market, and it does this by mandating banks to 'open up the bank account' to external parties (third-party players (TPP)). The regulator therefore introduced new security requirements for electronic payments and account access, along with new security challenges relating to TPP.

Prospectus Regulation proposal
In December 2016, the Commission, Council and European Parliament came to an agreement as to what the draft legislation concerning the Prospectus Regulation should provide for (the Proposal). The Proposal aims to ensure investor protection and market efficiency across the European Union. It is intended to broaden the attractiveness of offering and listing securities across the EU, while maintaining a high degree of investor protection.

The Proposal is intended to be resolved upon by the European Parliament and the Council of the EU still in 2017.

CRD V and CRR II proposals of the European Commission
On 23 November 2016, the Commission proposed amendments to rules on capital requirement (Directive 2016/0364 (COD), Regulation 2016/0360 (COD)). The amendments include measures that will strengthen the resilience of the banking sector by introducing more risk-sensitive capital requirements. The proposals amend the following pieces of legislation:

- the CRR and the Capital Requirements Directive (CRD), which were adopted in 2013 and which set out prudential requirements for credit institutions (ie, banks) and investment firms and rules on governance and supervision; and
- the BRRD and the Single Resolution Mechanism Regulation, which were adopted in 2014 and which spell out the rules on the recovery and resolution of failing institutions and establish the Single Resolution Mechanism.

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.

24 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

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

Already the 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 28). 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 2005/60/EC is being or has been committed or attempted, or that the potential acquisition could increase such risk.

Based on this appraisement, the FMA shall prepare a draft decision for the ECB to oppose or not to oppose the acquisition. The ECB shall decide 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.

26 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-EEA proposed acquirer or a proposed acquirer not subject to supervision under Directives 2013/36/EU, 2014/91/EC, 2014/51/EC or 2014/65/EC, the 60-day period can be suspended for up to 30 days (see questions 25, 28 and 29).

27 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 25 and 28).

28 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, by-laws, 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.

In the case 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.

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

Within two working days, the FMA has to confirm the receipt of the notification to acquire a qualifying holding. Within five working days of the acknowledgement of the receipt, the FMA has to notify the ECB of the intention of the 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 25). The authorities have 60 days to examine the intended acquisition and to prohibit it. In the case of 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.

WEBER & CO.
RECHTSANWÄLTE

Christoph Moser **c.moser@weber.co.at**
Stefan Weber **s.weber@weber.co.at**

Rathausplatz 4
1010 Vienna
Austria

Tel: +43 1 427 2000
Fax: +43 1 427 2010
www.weber.co.at

Canada

Pat Forgione, Ahsan Mirza, Darcy Ammerman and Tayleigh Armstrong
McMillan LLP

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 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. Further revisions to the Capital Adequacy Requirements Guideline came into effect in December 2016. The revised guideline is consistent with Basel III and has an aggressive schedule in lockstep with the Basel III timeline for the planned implementation. 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 service, acting as a financial agent, providing investment counselling services and portfolio management services and issuing and operating payment, credit or charge cards.

As of June 2015, there were 28 domestic banks, 24 foreign banks and 30 foreign bank branches operating in Canada. There were also 19 foreign bank representative offices established to represent foreign banks in Canada. Canada's six largest banks, being Royal Bank of Canada, Toronto-Dominion Bank, Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce and National Bank of Canada, have been identified by OSFI as domestic systemically important banks (D-SIBs).

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 2019. 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 (discussed further below) 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, 2016, No. 1 introduced a legislative framework for a bail-in regime for Canada's domestic systemically important banks. 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.

The FCAC is also 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, and money orders, bank drafts, 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 or investments in mortgages, stocks, bonds, or mutual funds.

As of March 2016, 78 financial institutions, including 44 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 Canada Deposit Insurance Corporation Act (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 such business as generally appertains thereto, 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 the 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 the 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 IRS 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.

Further, 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, rather than 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 (the industry term for 'financial technology'). 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 2013–14, the FCAC opened a total of 891 cases against banks and other federally regulated financial entities for issues such as credit card statement disclosure, fees or debt collection practices. The FCAC

issued a total of nine violations and imposed related penalties in the aggregate amount of C$775,000 (total for all financial services entities including insurance companies, payment card operators, etc).

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, FinTech 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.

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 International Financial Reporting Standard 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 and anti-money laundering regimes.

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.

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. The FCAC's consumer protection powers are briefly discussed in response to 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. The first stage 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. In the second stage, OSFI can require mandatory implementation of corrective measures and increase 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. The third stage 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. The fourth stage 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. FCAC's consumer protection enforcement is discussed in response to 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 LIBOR); however, this seems to be in response to international banking investigations related to LIBOR. There has been no commentary to suggest any manipulation of CDOR by Canadian banks. 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 board of directors of the bank, 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, described at 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 very rare in Canada and consequently, government or regulatory authority intervention by way of bank takeover is also very 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 Canadian Mortgage and Housing Corporation provided liquidity support during the recent 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 (NVCC) 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 (described at 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. In March 2013, OSFI designated Canada's six largest banks as D-SIBs and requires each of these banks to establish a resolution plan. In addition, the 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.

Capital requirements

15 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 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 9.25 per cent, 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. 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.

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 as of 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 $100,000.

16 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.

17 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.

18 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 June 22, 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 bail-in will work have not yet been published.

19 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 2016, D-SIBs are required to meet the target common equity Tier 1 (CET 1) ratio of 7 per cent of risk-weighted assets 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. As discussed in question 15, OSFI introduced a number of regulatory guidelines in 2014 which are, for the most part, in effect.

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 recent revisions to the Capital Adequacy Requirements Guideline also include:

- 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

20 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.

21 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 be one of the most interesting challenges facing the banking industry and regulators in 2017. We anticipate continued discussions among regulators and the financial services industry relating to potential regulatory changes to address the Fintech explosion and finding the balance between fostering innovation and protecting consumers. One trend that emerged in 2016 was the increased collaboration between banks and Fintech companies (as opposed to direct competition) and it will be interesting to see whether this trend toward collaboration continues. Finally, cybersecurity and cyber resiliency will continue to be of major concern to the banking industry as systems become more interconnected worldwide and fintech collaboration grows.

22 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 (the '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.

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

See question 22.

24 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 22, 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

25 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 and/or value of ownership stake, the ability to assert economic pressure on the entity, and the influence over corporate governance, operations and/or life of the entity. 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.

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

See question 21 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.

27 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.

28 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 22).

29 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. Although the application process usually takes a few months, 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.

mcmillan

Pat Forgione **pat.forgione@mcmillan.ca**
Ahsan Mirza **ahsan.mirza@mcmillan.ca**
Darcy Ammerman **darcy.ammerman@mcmillan.ca**
Tayleigh Armstrong **tayleigh.armstrong@mcmillan.ca**

Brookfield Place, Suite 4400
181 Bay Street
Toronto, Ontario M5J 2T3
Canada

Tel: +1 416 865 7000
Fax: +1 416 865 7048
www.mcmillan.ca

Ecuador

Patricia Ponce

Bustamante & Bustamante Law Firm

Regulatory framework

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

The Ecuadorian Constitution stipulates that the objective of the monetary, credit, exchange, and financial policy is to define the levels of overall liquidity to guarantee adequate financial safety margins and to direct liquidity surpluses towards investment required for the country's development. This is done through financial organisations from the public, private, public/private and peoples and solidarity economic sectors. They facilitate domestic production for its consequent strategic insertion in both the regional and global economy. Financial activities are deemed to be a public service performed by the public, private, and people's and solidarity economic sectors. Each sector has its specific rules and different oversight entities in charge of preserving the sector's security, stability, transparency and soundness. The Executive Branch has the exclusive power to formulate monetary, credit, exchange and financial policies and regulations.

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

The Organic Monetary and Financial Code (COMF) published in the supplement to Official Gazette 332 of 14 September 2014, regulates the monetary and financial systems of all sectors. Furthermore, it includes the framework for policies, regulations, supervision, oversight and accountability prevailing in the monetary and financial systems, the exercise of their activities, and their relationship with their users. The primary objectives of the COMF are:

- to ensure the economy's liquidity levels for contributing to the execution of the economic programme;
- to procure the sustainability of the national financial system and to guarantee that each sector and the entities forming it comply with the obligations;
- to mitigate systemic risks and to reduce economic fluctuations; and
- to safeguard the rights of users of financial services. Furthermore, the COMF includes the institutions that regulate and oversee the financial sector, especially banks, and sets certain parameters for the incorporation, merger, takeover merger and the like of the institutions of the financial system. It also defines the minimum requirements to be met by the entities of the financial sector with regard to their administration, legal banking reserve, appointment of directors and officers, and so on.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The Monetary and Financial Policy and Regulation Board is in charge of drafting and directing public policies, as well as of the monetary, credit, exchange and financial regulation and oversight. For this purpose, the Board may regulate and rule financial activities carried out by the national financial system.

The Central Bank of Ecuador's role is to instrument the monetary, credit, exchange and financial policies of the state.

The Superintendency of Banks, a technical entity, is in charge of supervising, auditing, intervening in, overseeing and monitoring the financial activities carried out by the public and private entities of the national financial system.

The Superintendency of the Peoples and Solidarity Economy Sector, an oversight entity, is in charge of supervising, auditing, intervening in, overseeing and monitoring of the people's and solidarity financial sector.

The Financial Analysis Unit, the operational entity of the National Anti-Money Laundering Council, is in charge of analysing unusual and unjustified financial operations or transactions and, if the case, reporting them to the Prosecutor's Office.

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 Ecuador, there are two liquidity funds that are independently administrated and managed: one of the funds corresponds to the private financial sector overseen by the Superintendency of Banks and the other to the social and solidarity financial sector, which is overseen by the Superintendency of the Social and Solidarity Economic Sector. These two funds are managed independently through two commercial trusts. Although both the resources and commercial trusts forming them are of a private nature, they cannot be seized and cannot be affected by the debt of the parties contributing to the fund, except for paying discount window operations and domestic investment from liquidity surpluses.

The monthly contribution that private financial sector entities have to make to the liquidity fund is a sum equal to 8 per cent of the average of their deposits subject to the previous month's legal banking reserve; the goal is to reach 10 per cent of deposits subject to such reserve.

The treatment is different in the case of social and solidarity financial sector entities:

(i) Each month, savings and loan associations for housing have to contribute a sum equal to 5 per cent of the average of the deposits subject to the previous month's legal banking reserve; again, the goal is to reach an amount equal to 10 per cent of deposits subject to the reserve.

(ii) Savings and loan cooperatives from segment 1 and central funds have to contribute to the trust each month. Their contribution must equal 0.5 per cent of the average of their liabilities to the public in the previous month and will be increased by 0.5 per cent in the month of January each year. The goal is to reach an amount equal to 7.5 per cent of their liabilities to the public.

(ii) Savings and loan cooperatives not included in point (ii) make their contributions, depending of the respective segment and pursuant to the rules issued from time to time.

Although the trustee of the trusts is the Central Bank of Ecuador, the Deposit Insurance Corporation, which forms part of the financial safety network, is in charge of managing the liquidity fund.

The amount protected by deposit insurance with respect to each individual or company is different depending on the insured financial sector:

- for deposits in banks and financial institutions overseen by the Superintendency of Banks, the amount is US$32,000;
- for deposits in financial entities from segment 1 of the people's and solidarity economic sector, it is twice the income tax exempt base fraction in effect, but cannot be less than US$32,000;

- For the remaining segments of the people's and solidarity financial sector, it is the income tax base fraction in effect, but cannot be less than US$11,000.

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.

Public and private financial entities in Ecuador are prohibited from carrying out lending, borrowing, contingent, and service operations with individuals or legal persons connected directly or indirectly with the institution's administration or ownership. Financial institutions may make capital investments in other companies from the financial system that provide financial services or auxiliary financial services in order to turn them into their subsidiaries or affiliates. They cannot, however, carry out lending, borrowing, contingent and service operations with those companies. Although the prohibition is strongly enforced, the following are permitted for operations with institutions from the social and solidarity economy:

- on their own account or for others, purchase, keep and sell securities issued by the public finances governing entity and by the Central Bank of Ecuador;
- receive sight and term deposits;
- perform cash and treasury services;
- receive and keep objects, moveable goods, valuables and documents under consignment for their custody and rent safety boxes for keeping valuables; and
- within the limits, and in compliance with the rules established by the Monetary and Financial Policy and Regulation Board, they may engage in loan operations with their employees who are not part of the entity's administration.

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

The Organic Monetary and Financial Code has ascribed greater transparency to the financial sector and has asserted more control over the sector's services, resulting in transparency and public protection in general. Nonetheless, it has conferred a series of powers to regulation and oversight entities which, if unchecked, may affect the sector's stability. One example is that they may easily change the legal banking reserve, maximum interest rates and direction of credit.

7 Are banks subject to consumer protection rules?

Financial services are public services. Therefore, users' rights are protected by both the Constitution and the Consumers' Defence Law or the Constitution and the COMF. Besides users being able to take civil and criminal action, regulation and oversight entities have the power to define the manner in which users' rights are respected and to place the fines in the case of non-compliance. Other aspects that are regulated and have been reviewed are:

- quality of services;
- minimum information and publicity requirements so that the contents and characteristics of advertisement are clear and not misleading;
- information and credit reports must be precise and updated;
- information about the existence of conflicts of interests regarding activities, operations, and services offered to customers;
- personal information is confidential and protected;
- charges for service must be expressly accepted; and
- the damage caused must be repaired.

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

The Monetary and Financial Policy and Regulation Board has broad law-making powers for directing monetary, credit, exchange and financial policies. Therefore, it is possible to amend secondary rules applicable to the financial sector. Based on the Board's actions these past months, some changes could include: legal banking reserve rate as a mechanism for planning, regulating and monitoring the economy's liquidity levels; regulation on management, solvency and prudence to which financial entities should be subjected; directives for credit and investment policy and, in general, for lending, borrowing and contingent operations of the entities of the national financial system.

Notwithstanding the foregoing, with respect to financial institutions from the social and solidarity economy, a new law is in the pipeline for subjecting them to the state oversight entity.

Supervision

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

Within the sphere of their competences, oversight entities and financial institutions have broad powers for supervising, auditing, intervening in and monitoring public and private entities forming part of the national financial system. The law dictates three levels of supervision: (i) preventive: applies to entities with adequate financial business management and, in the opinion of the oversight agency concerning stable economic-financial control, good corporate governance and good risk management, implying a lesser risk; (ii) corrective: applies to financial entities with a medium risk profile, understood as entities whose economic-financial condition, corporate governance quality or risk management, show moderate to significant weaknesses in terms of the size and complexity of their operations, warranting a strict follow-up on the supervisor's recommendations; and (iii) intensive: applies to financial entities with a high and critical risk profile. In other words, entities whose economic-financial condition, corporate governance quality, risk management, and so on show they are inadequate to deficient for the size and complexity of their operations. They require significant improvements; or, the likelihood that they will fail to meet the minimum solvency requirements is great or that they have already failed to meet such requirements. This same intervention applies to financial entities with good solvency levels, but that reported losses in the last two quarters or their business projections show that they may fall below the minimum technical equity in the next two quarters.

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

When it deems it appropriate, the oversight agency may exercise the following powers:

- audit;
- inspect;
- intervene in financial institutions when deemed necessary;
- demand that overseen entities define and adopt corrective and recovery measures;
- order overseen entities to increase their subscribed and paid-in capital in cash;
- order the liquidation of financial institutions; and
- initiate administrative processes and, if the case requires, start civil and criminal processes at the appropriate entities; for collecting debts and penalties, they have the power to initiate forced collection procedures, and so forth.

The resolutions passed by the oversight authority cannot be suspended if any claim or remedy is accepted for processing or is heard.

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

The following are the most common reasons for initiating control measures by requesting additional information, after the institution is audited, and ultimately arriving at the mandatory liquidation of a financial entity:

- liquidity gap;
- inadequate risk management resulting from insufficient assurances, among other things;
- capital shortfall;
- technical equity gap;
- legal banking reserve shortfall;
- inconsistent balance sheets; and
- administrative shortfalls resulting from a lack of knowledge of directors and administrators, among other things.

Normally, if the problem is not recurring, a warning and monetary fine will be issued to the institution; for repeated failure, the oversight entity will intervene and ultimately, as happened in 2014 with Banco Sudamericano, the financial institution will face mandatory liquidation.

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 guarantee the proper operation of financial institutions, oversight entities are required to permanently supervise them either onsite or offsite.

Although the oversight agency may intervene in a financial institution at any time, normally it will do so when intensive monitoring has been ordered. This is explained in question 9. The controller must ensure that the institution follows its restructuring plan, called an intensive monitoring plan, which includes commitments, debt and time periods that the institution has with its officers, shareholders and directors. The time periods for recovery cannot be more than 370 days, when intervention owes to equity shortfalls, or two years in other cases. If, within the recovery time period, the financial institution's problems have not been solved or the equity shortfall persists, the institution will be forced into liquidation.

Payments derived from the mandatory liquidation of a financial entity shall be made in the following order:

- deposits up to the legally insured amount covered by deposit insurance;
- payments owed to workers for salaries, indemnification, profit-sharing, reserve funds and retirement pensions paid by the employer, up to the amount stated in the calculations performed per the laws protecting them, as well as liabilities with the Ecuadorian Social Security Institute that are derived from employment relationships;
- discount window lending and domestic investment of liquidity surpluses;
- deposits for sums exceeding the insured amount of priority groups served, up to 50 per cent in addition to the insured amount;
- other deposits for sums exceeding the insured amount;
- other liabilities resulting from funds raised by the financial entity;
- sums paid by the Deposit Insurance Corporation and Liquidity Fund;
- payments owed for taxes, imposts and contributions;
- court costs arising in the common interest of creditors;
- suppliers of the financial entity, up to an amount equal to the deposit insurance; and
- other liabilities.

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 financial company enters into mandatory liquidation, the oversight agency will issue a resolution ordering the suspension of operations, the exclusion and transfer of assets and liabilities, and the appointment of a temporary administrator by the oversight agency. The temporary manager fulfils the duties of the administrators and exercises the legal representation of the financial entity, safeguarding its goods. The financial institution's administrators and directors who were in charge of the institution up to the time it entered into mandatory liquidation will no longer fulfil their duties, but will be subject to administrative, civil and criminal liability with respect to their actions and inactions leading to the financial institution's liquidation.

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

In a mandatory liquidation, the administrators and directors will automatically forfeit their positions and they will not be entitled to claim indemnification even if they are under a relationship of employment with the entity. Likewise, the assets of influential shareholders, related third parties and administrators, including directors, cannot be sold.

A shareholder in an entity from the financial sector is liable for the entity's solvency up to an amount equal to their stockholding; however, in the case of the mandatory liquidation of a financial entity, shareholders who directly or indirectly are persons with influential equity, as defined in point 10 hereof, administrators, officers or employees and related third parties, who have incurred in negligence, gross negligence or ordinary negligence will be liable, even with their personal property. If, during the liquidation, it is established that a crime or quasi crime was committed by an action or inaction, documentation must be provided to the prosecutor for the investigation. In addition, civil action may be started.

Capital requirements

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

The Monetary and Financial Policy and Regulation Board is the regulatory entity and, therefore, defines the minimum requirements for subscribed and paid-in capital of financial institutions. The oversight agency may order an increase in cash in subscribed and paid-in capital. In the incorporation of a financial institution, contributions in kind cannot be made for capital increases. If, however, it is stipulated that the capital increase is to be made in cash, a contribution in kind may be made with the approval of the oversight agency. The asset must be usable in the institution's line of business.

16 How are the capital adequacy guidelines enforced?

Entities from the public and private financial sectors have to create a legal reserve fund with an amount equal to at least 50 per cent of their subscribed and paid-in capital. For this purpose, at least 10 per cent of their annual earnings must be allocated to the fund. Furthermore, they have to comply with the rules regarding financial, liquidity, capital and equity indicators determined by the Monetary and Financial Policy and Regulation Board. These are set depending on the type and complexity of the financial entity and the economic area in which it operates, as well as the internal control systems and risk management demanded from them.

Entities from the national financial system have to keep sufficient reserves that are commensurate with their business in order to address the following, among other things: instantaneous liquidity, structural liquidity, liquidity reserves, domestic liquidity and liquidity gaps; and solvency and technical equity as needed and sufficient for backing the entity's current and future operations. They must also cover losses not protected by risk asset provisions and aimed at the institution's adequate macroeconomic performance. In addition, presently the financial institutions overseen by the Superintendency of Banks and the financial institutions from segment 1 of the social and solidarity economy must always keep a ratio of at least 9 per cent between their technical equity and the average sum by their risk-weighted assets and contingents. The Monetary Board sets the amount for the other segments of the people's and solidarity economic sectors.

In order to cover the money withdrawn by customers, entities from public and private financial sectors are obligated to maintain a legal banking reserve for the deposits and fund-raising they undertake. Presently, for financial institutions with assets over US$1 billion, the legal banking reserve is 5 per cent and for all others 2 per cent. The legal banking reserve is deposited at the Central Bank and does not bear interest in favour of the financial institution that made the deposit. Should a state-owned or private financial entity fail to meet the stipulated legal banking reserve percentage, the Superintendency of Banks will order it to immediately contribute the funds needed to cover the shortfall.

The solvency of foreign financial entities in which an Ecuadorian financial entity has a stockholding equal to more than 20 per cent of capital will be determined by the countries in which they are located. In no case, however, can it be below the higher of either 9 per cent of the ratio between technical equity and risk-weighted assets, which is calculated employing the calculation method applied to financial groups in Ecuador, or the minimum established by the Board.

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

The oversight agency will order a capital increase and, if the capitalisation is not made within the granted term, the entity will enter into mandatory liquidation.

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

When an institution is declared to be in mandatory liquidation, as described in question 14, and its administrators can no longer fulfil their duties, a receiver will be appointed ex officio. In addition to the civil and criminal action that may be taken against administrators and shareholders, precautionary measures may be taken against them. These measures will be kept in place until the liquidation is over.

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

With regard to technical equity, the guidelines were changed in December 2016 and that change may slightly alter the rules regulating the liquidity of institutions.

Ownership restrictions and implications

20 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?

An individual or company has direct influential power when one of the following conditions is met: It is the owner of 6 per cent or more of subscribed and paid-in capital or capital stock or if it does not quite meet the 6 per cent condition, it has shares in an amount greater than or equal to 600 times the income tax-exempt base fraction, presently at US$11,290.

Influential power because of an indirect relationship is determined as follows:

- the spouse, common-law spouse, or relatives up to the fourth degree of blood relation or second degree of family relation with the administrators of the financial institution or a company with influential power in the financial institution;
- if the person has at least a 1 per cent stockholding in the financial institution's subscribed and paid-in capital; or, if the stockholding is less, the subscribed and paid-in contribution is greater than or equal to 100 times the income tax exempt base fraction;
- the spouse, common-law spouse, or relatives within the second degree of blood relation and relatives up to the first degree of blood relation with shareholders who are persons with influential equity ownership, administrators of a financial entity, or officers of a financial entity who approve credit operations; and
- companies in which the spouse, common-law spouse, or relatives within the second degree of blood relation or first degree of family relation with administrators or officers who approve credit operations, and that own shares representing 3 per cent or more of the capital of the entity.

Persons related by presumption include:

- anyone who has received a loan in preferential conditions for time periods, interest rates, no security, or that is disproportionate with respect to the borrower's equity or payment ability;
- anyone who has received a loan without providing adequate security, has no loan history, or is domiciled abroad, and there is no available information on that person;
- anyone who has received a loan because of reciprocity with another financial entity;
- anyone who receives preferential treatment in lending operations; and
- anyone deemed to be related by presumption, subject to the general rule issued by oversight entities.

21 Are there any restrictions on foreign ownership of banks?

Foreign individuals or legal persons, including foreign financial entities, may incorporate financial entities or establish branches or representation offices in Ecuador, without any limits on investment, although subject to the same rules governing domestic investment. When a foreign financial institution operates through a branch or representation office, the parent company is jointly liable for the obligations of the branch or representation office in Ecuador.

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

The regulation and oversight entities listed in question 3 have broad regulating and oversight powers in the financial sector. Within their scope of action, they may:

- regulate the credit, exchange, financial, insurance and securities policy;
- define the mechanism for instrumenting and executing the policies and regulations of the monetary, exchange, and credit policy;
- monitor, audit, intervene in, oversee and supervise all financial institutions; and
- review unusual economic operations or transactions.

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

The shareholders, administrators, including directors, officers, or employees, internal and independent auditors, qualified risk firms, appraisal experts and others providing services supporting the supervision of the financial institution, have to ensure the correct management of the financial institution, as well as its strict compliance with the legal rules governing it, and are jointly liable for the financial institution's actions and inactions. Liability may be administrative, civil and criminal.

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

Anyone with direct or indirect influence will be jointly liable for the financial institution's actions and inactions. Liability may be administrative, civil or criminal.

Changes in control

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

Any change in the ownership of capital implying the direct or indirect taking of control of the financial institution requires the prior approval of the oversight entity.

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

There is no difference between nationals and foreigners; for foreigners, however, additional documentation regarding the legal existence of the company and the representation of the individual or company is required. If an acquisition is involved that could lead to the consolidation of a concentration of financial entities, the prior authorisation of the Superintendency for the Control of Market Power will be required.

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

In general, oversight agencies will check any change of control of the institution, as well as the origin of the funds used for the incorporation or acquisition of the financial institution. Consequently, before new shareholders are approved, the following must be submitted in addition to all identification documents, in the case of an individual, or certificate of legal existence, in the case of a company, whether national or foreign:

- Certificate stating that they have not been administrators, shareholders, or controlling shareholders, whether directly, indirectly, or otherwise, in financial institutions in or out of the country that were declared to be in mandatory liquidator or otherwise regularised with public resources or through deposit insurance systems, in the past 10 years. A controlling shareholder is a shareholder having asserted significant and decisive influence in the decisions or administration of such institutions.
- Sworn statement that the resources are their own and come from licit activities. For this purpose, they must provide information about their financial situation in the past five years.
- Sworn statement that they are neither the direct nor indirect title holders of stock in companies unrelated to the financial business, with presence or business in the Ecuadorian market.
- In the case of companies, a list of the shareholders representing more than 2 per cent of capital stock. The list must include all

shareholders until the natural persons representing them are ultimately determined. If the company is listed on the stock exchange, a certificate from the stock exchange and a certificate from those persons with dominant power or influence in the company will be required.

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

Generally, taking control of a financial institution requires authorisation from the Superintendency of Banks. It could also require the approval of the Superintendency for Control of Market Power when the direct or indirect acquisition of the ownership or other right over shares in capital or bonds or interest in the capital of a financial institution leads to either a horizontal or vertical economic concentration. This is also the case when a stock purchase produces a connection through the common management or other agreement or act or a factual or legal transfer of the assets of an economic operator to a person or economic group or grants them control or decisive influence in the decision-making by the financial institution's regular or special administration.

To request authorisation from the Superintendency of Banks for the stock purchase. Proof of the integrity and economic solvency of the shareholders must be provided in the terms and conditions described in question 27.

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

If approval from the Superintendency for the Control of Market Power is not needed, the authorisation could take 30 to 60 working days after all documents have been submitted. If approval from the Superintendency for the Control of Market Power is needed, it may take between six and eight months, which means that the process could take between 10 and 12 months.

Bustamante & Bustamante LAW FIRM

Patricia Ponce **mpponce@bustamante.com.ec**

Av Patria E4-69 and Av. Amazonas
Cofiec Building, 4th, 5th, 10th, 11th & 16th Floors
Quito
Ecuador

Tel: +593 2 256 2680 ext 248
Fax: +593 2 255 9092
www.bustamanteybustamante.com.ec

France

Pierre Casanova*
Darrois Villey Maillot Brochier

Regulatory framework

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

Various governmental and regulatory policies have shaped the French banking sector at different times at national level and increasingly at European level, notably:

- protecting the banking monopoly – only authorised banks may engage in certain activities – illustrated in 2012 and more recently in 2013 by hostility over 'shadow banking', which was the subject of the EU Commission's proposal No. 2014/0017 on transparency of securities financing transactions in January 2014 and subsequently the Regulation on Transparency of Securities Financing Transactions in October 2015;
- maintaining the solvency and stability of the French banking sector and preventing systemic default risk – the regulatory powers of the Prudential Control and Resolution Authority (the ACPR, formerly known as the ACP), already significant and far-reaching, were expanded by the Separation and Regulation of the Banking Sector Act of 26 July 2013 (the SRBS Act) and the Ordinance adopted on 20 February 2014;
- strengthening governance standards regarding risk-monitoring through the mandatory introduction of risk committees (separated from the audit committees) and nomination committees in banks as effected by the Ordinance dated 20 February 2014, which completed the implementation of the CRD IV package into French law favouring the centralisation of supervision and resolution at the European level, with a view to setting up a potential European banking union; and
- favouring global initiatives open to emerging market governments through the G20 summits and initiatives in favour of more banking transparency.

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

The primary laws and regulations governing the French banking industry are:

- international banking rules, especially those resulting from the Financial Action Task Force (regarding money laundering) and the Basel Committee on Banking Supervision (regarding prudential standards), the latest example being the substantive implementation of the Basel III Accord by the CRD IV package (see question 8);
- European banking legislation, and in particular, Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms (the Capital Requirements Regulation) and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (together with the Capital Requirements Regulation, the CRD IV package), EU Regulation No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank (ECB) concerning policies relating to the prudential supervision of credit institutions (the SSM Regulation), Regulation (EU) No. 468/2014 of the European Central Bank of 16 April 2014 establishing the single supervisory mechanism framework (the SSM Framework Regulation), Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD) and Regulation (EU) No. 806/2014 establishing a Single Resolution Mechanism (SRM), Directive 2015/2366/EU on payment services in the internal market (PSD2), establishing a framework for the security and confidentiality of banking data by increasing prudential requirements and security and information obligations of the payment service providers (by 13 January 2018, member states shall adopt and publish the measures necessary to comply with this Directive);
- more specifically, the Monetary and Financial Code (MFC), incorporating the main provisions of the Banking Act of 24 January 1984, the Financial Activity Modernisation Act of 2 July 1996, the Banking, Financial Regulation Act of 22 October 2010 and the SRBS Act, the Ordinance of 27 June 2013 and the Ordinance of 20 February 2014, the Ordinance of 6 November 2014 and the Ordinance of 20 August 2015, the Law No. 2016-1691 of 9 December 2016;
- the Civil Code (which includes general rules applicable to loans – see question 7), the Consumer Code (which includes rules applicable to consumer loans) and the Commercial Code (which includes rules applicable to commercial paper), providing the general basis; and
- regulations issued by regulatory authorities, such as orders of the minister of the economy, regulations issued by the Advisory Committee on Financial Legislation and Regulation (CCLRF) and regulations issued by the French Financial Market Authority (AMF).

3 Which regulatory authorities are primarily responsible for overseeing banks?

As explained in question 12, the EU Single Supervisory Mechanism (SSM) and, most recently, the SRM promoted the ECB as the main regulatory authority of significant banks, that is banks meeting any of the following criteria:

- the total value of its assets exceeds €30 billion;
- the ratio of its total assets over the GDP of the participating member state of establishment exceeds 20 per cent, unless the total value of its assets is below €5 billion; or
- following a notification by its national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, or if the BCE considers an institution to be of significant relevance where it has established banking subsidiaries in more than one participating member state and its cross-border assets or liabilities represent a significant part of its total assets or liabilities.

In France, 13 banks or banking groups (BNP Paribas, Crédit Agricole, Société Générale, BPCE, Crédit Mutuel, BPI, SFIL, Caisse de refinancement de l'Habitat, HSBC, Agence française de développement, Barclays Bank plc, RCI Banque and La Banque Postale), meaning more than 90 per cent of the assets of French banks, are regarded as significant and are under the direct authority of the ECB for their supervision and their resolution.

An accelerated shift of supervision authority of the French banking industry to the European level had begun in October 2013 through the 'comprehensive assessment' on 130 banks, led by the ECB, involving supervisory risk assessments, stress tests and asset quality reviews of

85 per cent of the banking assets in the eurozone, the results of which were published on 26 October 2014.

At national level, the ACPR has, subject to the powers granted to the ECB under the SSM regarding significant banks, ultimate responsibility for oversight of French banks.

The chairman of the ACPR's supervision and resolution commissions is the governor (or deputy governor) of the Banque de France. As the authority supervises both the banking sector and the insurance sector, the ACPR is required to have as its vice chairman a person with experience in insurance.

Regarding banks that are under its direct supervision, the ACPR is entrusted with supervisory authority and is in charge of the supervision and licensing of entities and persons involved in the insurance and financial services industries, any other person performing insurance or reinsurance activities and intermediaries in banking operations and payment services. The SRBS Act has extended the ACPR's scope to the prevention and resolution of banking crises, and the Ordinance of 20 February 2014 increased the ACPR's ability to take preventive measures.

The ACPR is divided into one supervision commission composed of a certain number of independent members (in charge of all responsibilities falling within the scope of the ACPR), one sanction committee and one resolution college.

The ACPR exercises administrative, supervisory and disciplinary powers (see question 10).

As a result of the transposition of the CRD III requirements on compensation limitations, the distribution of bonuses is spread over a minimum of three years and the ACPR was given additional authority over bank compensation policy (note that as a result of one of the new government's reforms the annual total remuneration of CEOs of state-owned banks is capped at €450,000, along with the CEOs of all state-owned companies). As a result of the CRD IV package, compensation policies concerning risks takers are strictly supervised.

Apart from the ACPR, the AMF is the competent supervisory authority for investment firms exclusively providing asset management services. As such, the AMF authorises and licenses such firms' activities, monitors compliance with the standards of sound professional practice by credit institutions' investment-services arms and supervises their asset-management activities. In its capacity as the authority charged with supervising securities markets, the AMF also monitors most major French banks, as they are either listed on the Paris stock market (Crédit Agricole SA, BNP Paribas, Société Générale and Natixis) or issuers of financial instruments falling within its authority.

The ACPR and the AMF coordinate their activities through a joint unit in charge of implementing supervision of the marketing of financial products and compliance by the regulated entities with their obligations towards their clients, borrowers, insured persons, members and beneficiaries.

Furthermore, the MFC provides for three consultative authorities:

- the CCLRF provides opinions to the French government on draft statutes, ordinances and EU rules (before examination by the Council of European Union) that relate to the insurance sector, the banking sector or investment firms (other than legislation relating to the AMF or falling within its jurisdiction);
- the Advisory Committee on the Financial Sector (CCSF). The CCSF is responsible for examining all issues regarding relations between credit institutions, financial companies, investment firms, and insurance companies and their clients, and for proposing appropriate measures related thereto, in particular in the form of opinions or general recommendations; and
- the High Council for Financial Stability (which replaces the Financial Regulation and Systemic Risks Council and has an extended remit covering prevention and supervision of systemic risks).

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 but by the Deposit Guarantee and Resolution Fund in accordance with the MFC, as regulated by CRBF Regulation No. 99-05 dated 9 July 1999. Any credit institution duly authorised to do business in France (and any financial companies, mixed financial holding companies or investment companies pursuant to the SRBS Act) is required to belong and contribute to the Deposit Guarantee and Resolution Fund in charge of indemnifying depositors in the event that their deposits become unavailable and may also be called upon by the ACPR in the context of resolution mechanisms. However, indemnification by the Deposit Guarantee and Resolution Fund upon request of the ACPR is limited to €100,000 per depositor (and limited to €500,000 in several cases of exceptional temporary deposits) and some deposits are excluded from the guarantee (deposits made by other credit institutions, insurance companies, pension funds, etc). Indemnification claims falling within the scope of the fund's guarantee must be compensated within seven business days from the request made by the ACPR.

Also, the Public Investment Bank (BPI) shares similarities with a governmental agency. It is jointly controlled by the French state and the Deposits and Consignments Fund (CDC), and supports French businesses either through minority ventures or cash facilities.

The French state has direct and indirect ownership interests in banks such as La Banque Postale, a subsidiary of the state-controlled postal service, and Caisse Française de Financement Local (100 per cent of which is held by Société de Financement Local in which the French state holds a 75 per cent direct shareholding, indirectly holding 20 per cent through the CDC and 5 per cent through La Banque Postale). It also owns an indirect interest in Banque PSA through its equity interest in PSA.

At the EU level, an intergovernmental agreement was signed in May 2014 regarding the transfer and mutualisation of contributions to the Single Resolution Fund (SRF) that will be established as part of the banking union. This fund will be gradually built up during the first eight years (2016–2023) and shall reach the target level of at least 1 per cent of the amount of covered deposits of all credit institutions within the Banking Union on 31 December 2023. This agreement sits alongside the SRM Regulation.

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.

While no specific limitation is applicable to transactions between a French bank and its affiliates other than usual corporate law 'conflict of interest' limitations applicable to a bank as a corporation, some regulatory limitations apply when a bank owns financial interests in another company that essentially does not belong to the financial sector.

Pursuant to CRBF Regulation No. 90-06 of 20 June 1990, unless the ACPR gives special authorisation, the shareholding interests owned by a bank in any such non-financial company must comply with the following two requirements: each interest must not represent more than 15 per cent of the bank's capital and all interests taken together must not represent more than 60 per cent of the bank's capital.

For purposes of this regulation, an 'interest' is defined as the ownership of at least 10 per cent of the share capital or voting rights of a company or the exercise of significant influence on a company.

In addition, pursuant to CRBF Regulation No. 96-16, any transaction resulting in a change of control of a credit institution, finance company or investment company or allowing a company to reach one or more ownership thresholds in a bank must be brought to the attention of ACPR when such transaction is undertaken by two companies that are effectively controlled by the same enterprise. For applicable thresholds and a definition of 'effective control' see question 25.

Finally, it should be noted that the BRRD, which was transposed by the Ordinance of 20 August 2015, enables banking groups to enter into intra-group financial support agreements. Nevertheless, these agreements must be approved by the shareholders' meeting of the relevant entities and are subject to a certain number of conditions including the fact that they do not jeopardise the liquidity or solvency of the group entity providing the support.

Last, the SRBS Act requires significant credit institutions, financial companies and mixed financial holding companies with trading activities to conduct proprietary trading through a dedicated subsidiary licensed as an investment firm or a credit institution (except for certain activities including the provision of investment services to clients, clearing of financial instruments, hedging of risks other than those of

such subsidiary and market-making). In this context, institutions are considered significant as soon as the threshold of trading activities on financial instruments meets 7.5 per cent of these institutions' balance sheet, on a consolidated basis as the case may be. Such subsidiary will be prohibited from practising high-frequency trading and prudential ratios will be applicable to it on an individual basis. Banks and financing companies that cross this threshold have six months starting from the closure of their accounts to identify the relevant activities and 12 months to perform the required segregation.

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

One of the challenges is the establishment of a new capital buffer dubbed TLAC for Total Loss Absorbing Capacity. The G20 has approved, on 15 and 16 November 2015, the proposal of the Financial Stability Board (FSB) concerning this new buffer designed to absorb losses of systemically important banks. This capital buffer will have to reach at least 16 per cent of the resolution group's risk-weighted assets by 1 January 2019 and at least 18 per cent as from 1 January 2022. At the European level, the BRRD requires banks to comply with Minimum Requirement for own funds and Eligible Liabilities (MREL) at all times by holding easily 'bail-inable' instruments in order to ensure that losses are absorbed and banks are recapitalised once they get into a financial difficulty and are subsequently placed in a resolution. TLAC and MREL have the same regulatory objective which is to enhance effectiveness of resolution by requiring banks to hold sufficient amounts of readily bail-inable liabilities, in order to safeguard financial stability and public funds.

On 23 November 2016, the European Commission has proposed to revise a number of features of MREL in light of the commitment at the level of the G20 to transpose into EU law the TLAC standard that should be applied as of 2019. To prevent unwarranted legal complexity and compliance costs due to a potentially parallel application of these two rules that have the same aim, the Commission proposed to merge them, by incorporating, as appropriate, the TLAC standard into MREL. The Commission proposed to introduce a minimum harmonised MREL requirement (also referred to as a Pillar 1 MREL requirement) applicable to Global Systemically Important Institutions (G-SIIs) only, in line with the scope of application of the TLAC standard agreed by the G20. In its report on MREL dated December 2016, the European Banking Authority (EBA) proposed to introduce an MREL requirement equal to 13.5 per cent of the resolution group's risk-weighted assets.

Finally, at a European level, the establishment of a European Deposit Insurance Scheme is a challenge for the upcoming years. The European Commission issued a communication on this topic in November 2015. The European Deposit Insurance Scheme would, among other things, harmonise the rules of the national deposit guarantee schemes of the member states participating in the SSM, guarantee the deposit and provide customers with a protection of €100,000 per person.

7 Are banks subject to consumer protection rules?

Consumer laws in France govern relationships between professionals and consumers, and therefore apply to banks when they are dealing with their customers.

The Consumer Credit Act of 1 July 2010 sets out consumer protection rules specifically applicable to banks. More recently, the Consumer Protection Act of 17 March 2014 introduced a certain number of additional duties for professionals. In this context, a consumer is defined as a natural person acting for purposes that are outside his or her trade, business, craft or profession.

A bank, as any other professional engaging with consumers, is under a broad obligation to provide adequate information to consumers prior to entering into any agreement. This information must cover the main characteristics of the goods or services and their financial terms and conditions. Clauses must therefore be drafted in plain and intelligible language. More generally, consumers have a 14-day withdrawal right (Decree dated 17 September 2014). More recently, the French Law of 6 August 2015 established a service of 'banking mobility' enabling consumers to transfer their accounts more easily from one bank to another.

Specific duties apply when banks are granting loans to consumers in order to ensure that consumers fully understand the extent of their commitments. In the event banks breach these obligations, they may lose their right to claim interest and be exposed to civil and criminal liability.

In addition, the SRBS Act increased transparency of banking fees (such provisions entered into force on 1 January 2016) and provided that banks must verify the clients' solvency.

Under well-established French case law, banks also have a general obligation to provide advice and guidance to borrowers who lack sufficient knowledge to fully understand the extent of their undertakings or the risks they would be exposed to. In this respect, the borrower's capacity to measure the financial risk incurred, the borrower's profession and the complexity of the transaction are taken into account. This duty may, however, be waived in the event the borrower conceals or withholds relevant information.

The Directorate General for Competition Policy, Consumer Affairs and Fraud Control (DGCCRF) is in charge of verifying that consumer laws are complied with and may impose administrative fines upon professionals up to €15,000 per infringement.

The ACPR is also entrusted with the power to supervise banks in order to ensure their clients are adequately protected.

Furthermore, it should be noted that the Consumer Protection Act of 17 March 2014 introduced class actions into French law. Although these may only be introduced by a limited number of authorised consumer associations and plaintiffs may only join on an 'opt-in' basis, this represents a significant increase in potential liability for banks.

Finally, certain suspect practices have been evidenced by the DGCCRF in recent years including lack of clarity regarding variable rates of loans.

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

Limiting systemic risk while increasing the stability and competitiveness of the banking system remains a central issue in Europe. The EU has, inter alia, increased the banks' capital requirement through several pieces of legislation over the past five years (CRD I, CRD II, CRD III and CRD IV packages). The CRD IV package implements most Basel III measures and contains detailed prudential requirements for credit institutions and investment firms. It requires banks to hold more and better capital to resist future shocks. In addition, it introduces rules relating to bonuses paid to material risk takers, governance, capital buffers and prudential rules that are harmonised through a single rule book. Implementation of the CRD IV package into French law was anticipated by the SRBS Act and completed by the Ordinances adopted on 20 February 2014 and on 20 August 2015.

Along with the European banking union and the implementation of the CRD IV package and the SRBS Act at the national level, the overarching objective of the eurozone is to strengthen the resilience of the EU banking sector with the harmonised application of the new banking regulations throughout Europe while ensuring that banks continue to finance economic activity and growth. In addition to the transposition of the Basel III Accord through the CRD IV package, the road to European banking union has taken a path through the implementation of the SSM and the setting up of the SRM.

Further to a public consultation process launched in July 2015, the European Commission has proposed on 23 November 2016, a comprehensive package of reforms to amend the Capital Requirements Regulation (CRR), the Capital Requirements Directive (CRD), the BRRD and the Single Resolution Mechanism Regulation. The package contains measures to increase the resilience of EU banks and to enhance financial stability, while ensuring that banks can continue to support the real economy. These measures incorporate the remaining elements of the regulatory framework agreed recently within the Basel Committee on Banking Supervision and the FSB and include, in particular:

- more risk-sensitive capital requirements, in particular in the area of market risk, counterparty credit risk, and for exposures to central counterparties;
- implementing methodologies that are able to reflect more accurately the actual risks to which banks are exposed;
- a binding leverage ratio (LR) to prevent institutions from excessive leverage;

- a binding net stable funding ratio to address the excessive reliance on short-term wholesale funding and to reduce long-term funding risk;
- a requirement for G-SIIs to hold minimum levels of capital and other instruments which bear losses in resolution, known as TLAC (see question 6); and
- specific measures to improve banks' lending capacity to support the EU economy and, in particular, to:
  - make CRD/CRR rules more proportionate and less burdensome for smaller and less complex institutions; and
  - enhance the capacity of banks to lend to SMEs and to fund infrastructure projects.

At a national level, it remains necessary to fix troubling discrepancies between banking regulations and insurance-specific regulations and to finalise a comprehensive single book of regulation for the banking and insurance sectors.

Finally, some bank groups in Europe have recently developed a new strategy whereby they enter into institutional protection schemes (IPS), in order to benefit from more relaxed prudential requirements than those applicable to individual banks. An IPS is defined in the CRR as a contractual or statutory liability arrangement between banks of the same banking group where said arrangement protects its member institutions and in particular ensures that they have the liquidity and solvency needed to avoid bankruptcy where necessary. In this context, in July 2016, the ECB issued guidelines on the approach for the recognition of IPS for prudential purposes, which clarify the assessment of the eligibility of IPS. In France, it is interesting to note that the mechanism of consolidated banking groups with a central managing entity (such as Crédit Agricole) (instead of IPS) has been implemented. However, the relevance of implementing such schemes in France has been debated recently.

Supervision

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

Apart from the powers to be exercised by the ECB on the most significant banks under the SSM (see question 3) and the SRM (see question 12), the ACPR has primary responsibility for supervising banks that it has authorised to conduct business in France. In addition, as indicated in question 3, the AMF has investigative powers regarding financial activities.

The ACPR is vested with broad administrative powers allowing it to carry out various types of examination. In practice, banks are subject to such supervision in two different ways:

- off-site monitoring – each quarter, based on the findings of quarterly or semi-annual accounting and prudential reports, the senior management of banks meets with the ACPR for a general discussion of potential issues relating to the evolution of their business, the management and monitoring of risks and the soundness of their financial conditions; and
- on-site inspections.

The ACPR's supervision may result in two types of on-site inspections:

- general inspections – these are carried out every one or two years, with the purpose of evaluating whether the information disclosed by a bank accurately reflects its situation, and typically concern the bank's organisation, the soundness of its management, its risks and its financial condition (for large banks, the ACPR tends to favour the investigation of certain business segments or specific risks over a general inspection); and
- specific inspections – the ACPR may, at any time, carry out more specific inspections, usually based on its review of the bank's periodic disclosures. In addition, the ACPR may decide to proceed with a series of inspections targeting a particular segment of the banking industry, to increase its knowledge of such segment.

Pursuant to the SRBS Act, when services are provided via the internet, inspectors are entitled to use a false identity. The ACPR may also address and hear collectively the members of the board of directors. In addition, extension of inspections to foreign subsidiaries is now possible, outside any bilateral agreement, upon express consent by the foreign supervisory authority.

As a consequence of the implementation of the 2007/64/EC Directive, a new category of banking entity referred to as the 'payment institution' had been recognised. Payment institutions are providers of payment services but do not take deposits or issue electronic money. They are supervised by the ACPR and need its authorisation before offering or performing payment services (that is, services enabling cash to be used in a payment, activities required for operating a payment account, services enabling cash withdrawal from a payment account, execution of payment transactions, issuing or acquiring payment instruments, remittance of money and execution of payment transactions where the consent of the payer to execute a payment transaction is given by means of any telecommunication and the payment is made by the payment institution acting only as an intermediary between the payment service user and the supplier of the goods and services). In addition to obtaining the authorisation of the ACPR, the payment institutions must also meet regulatory prudential criteria and are bound by professional secrecy rules.

The 2015/2366 Directive (PSD2) repealed the 2007/64/EC Directive and established a framework for the security and confidentiality of banking data by increasing prudential requirements and security and information obligations of the payment services providers. In addition, in the case of an acquisition or an increase of stake in a payment services provider, the national supervisory authority will have to be preliminarily informed (see question 25). Member states shall adopt and publish the measures necessary to comply with it by 13 January 2018.

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

For a discussion of the ECB's powers, see question 17. In coordination with the ECB, the ACPR, for less significant banks, ensures that banking regulations are observed through the exercise of its administrative powers.

First, the ACPR issues instructions, notes and circulars that typically intend to clarify the reporting requirements imposed on banks.

Second, as a result of its off-site monitoring and on-site inspections, the ACPR sends follow-up letters to banks, stating the main findings of the examinations and pointing out the improvements that must be achieved. In practice, the ACPR may take the following actions:

- send a cautionary notice to management of the bank, allowing it to provide the ACPR with an explanation for not complying with the applicable regulations;
- issue a recommendation to a bank, describing the necessary measures to improve the bank's financial condition or management methods; the bank must respond to a recommendation within two months and give details of the measures undertaken; and
- issue an order to the bank requiring that certain measures be taken within a certain period of time.

Through its sanction powers, the ACPR may impose a wide range of sanctions on a bank, either because the latter has violated applicable regulations or because it has failed to comply with a cautionary notice, a recommendation or an order issued by the ACPR. These 'disciplinary' sanctions are:

- a warning to cease certain practices;
- a reprimand;
- a prohibition on engaging in certain operations or limitations on the conduct of certain banking activities;
- a temporary suspension of one or more senior managers or members of the board of directors of the bank (with or without the appointment of a provisional administrator);
- requiring the resignation of one or more senior managers or members of the board of directors (with or without the appointment of a provisional administrator); or
- striking a bank off the list of credit institutions authorised to conduct banking activities in France (with or without the appointment of a liquidator).

Regarding this sanction, the ACPR's decision to withdraw the authorisation of a credit institution is subject to confirmation by the ECB.

Also, the ACPR may impose a monetary fine up to €100 million, prohibit or limit the payment of dividends to shareholders and order

the sanction to be published at the expense of the bank. In the event the relevant institution has breached a provision under the Capital Requirements Regulation, the fine can reach 10 per cent of the net annual turnover and twice the amount of the benefit obtained from the infringement when it can be determined.

Lastly, the ACPR's sanction power can reach the level of public order administrative measures. The ACPR can order a bank to take any measures necessary to achieve compliance within a set time or to submit for the ACPR's approval a recovery plan covering all the measures needed to restore or strengthen its financial situation, or to improve its management methods or organisation. And where the solvency or the liquidity of the bank (or the interests of its clients or beneficiaries) are likely to be compromised, or when a bank is likely to breach its obligations under the Capital Requirements Regulation in the next 12 months, the ACPR may:

- place the entity under special supervision;
- ask its agents to exercise permanent supervision within the bank in order to closely follow the situation;
- limit or temporarily prohibit the execution of certain transactions or activities;
- suspend, restrict or temporarily prohibit the free disposal of all or some of the bank's assets (the 2013 reform broadens this power);
- order the bank to cease activities;
- limit the number of agencies or branches;
- order the bank to suspend or limit payments, including the payment of interest on common equity Tier 1 instruments unless this triggers an event of default;
- require the reduction of risks inherent to the activities, the products and systems of the relevant institution;
- order the transfer, without consultation, of some or all of the insurance contracts and settlement portfolios or credit portfolios and deposits;
- decide to prohibit or limit the distribution of a dividend to the shareholders or a return on the membership shares of said entities;
- suspend one or more of the bank's senior managers and board members when they fail to comply with the requirements of respectability, competence or experience; or
- appoint a provisional administrator to manage the bank.

Since the SRBS Act, the ACPR may also limit or suspend the execution of certain transactions when the relevant entity's activity is likely to adversely affect financial stability or in the event of such emergency situations as contemplated in EU Regulation 1093/2010.

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

Issues that have most commonly been addressed by the ACPR in the course of examinations relate to counterparty risk and information systems. The ACPR has raised the counterparty risk issue in connection with a variety of business segments (such as the credit business and securitisation), whereas inspections carried out by the ACPR typically focus on the efficiency of banks' information systems, especially after an external growth transaction. One of the ACPR's most recurrent concerns is the ability of a bank to build a comprehensive and integrated information system allowing global assessment and management of accounting, production, etc.

Issues that have recently triggered ACPR investigations and sanctions include failure to comply with corporate governance, internal control and accounting rules. More specifically, several credit institutions and investment firms have been sanctioned for unsatisfactory compliance with their internal control obligations.

In addition, the manner in which money laundering regulations are implemented and complied with is one of the most common enforcement issues in the banking sector. The ACPR regularly publishes guidelines and recommendations on how to implement applicable regulations. The recent EU Directive 2015/849 regarding the prevention and the use of the financial system for the purpose of money laundering and terrorism is a topic example in this respect.

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 the European Regulation 806/2014 establishing a single resolution mechanism, the ECB has powers, for significant banks, to launch and supervise the resolution procedure through the Single Resolution Board (SRB). Correlatively, for the less significant banks, the ACPR has sole power to launch and supervise the resolution procedure.

Prior to the SRBS Act, the powers granted by the MFC to the ACPR (see question 10) were sometimes used to persuade banks to halt or dispose of loss-making activities or subsidiaries. The SRBS Act created actual binding resolution mechanisms at a national level and granted additional powers to the ACPR (see question 13). This legal framework has been supplemented by the Ordinance of 20 August 2015, the Ministerial Order of 11 September 2015 and the Decree of 17 September 2015 transposing the EU Resolution Directive.

Pursuant to these rules, and particularly article L.612-1.IV of the MFC, the ACPR is the competent authority to implement the SRM. Alongside the preventive recovery plans (see question 13), the Resolution College of the ACPR must establish a preventive resolution plan for credit institutions and investment firms defined at article L.613-34 of the MFC. This plan details the measures to be implemented when a resolution procedure is launched in the context of a bank failure.

Should the ACPR consider that the organisation or operation of any such entity may hinder the efficient execution of such plans, it may ask the relevant entity to take appropriate measures to reduce or remove such hindrance.

Once the ACPR has been seized, the Resolution College of the ACPR must assess whether the entity, taken individually or within its group, is defaulting and whether there is any prospect of this default being avoided within a reasonable time frame without implementing resolution measures.

Default by an entity is constituted by breach of capital requirements conditioning its authorisation to operate, inability or imminent ability to make its payments or need for exceptional financial support from the state.

In the context of resolution, the Resolution College of the ACPR may notably:

- appoint a provisional administrator;
- remove the 'top-two' management;
- decide on the transfer of all or part of certain lines of business;
- decide to use a bridge institution tool;
- decide to use an asset management structure to which all of the rights and obligations of the bank are transferred in the view of selling its assets;
- impose a share capital decrease or a cancellation of shares;
- impose issuance of new shares or any capital financial instrument;
- temporarily limit or prohibit the implementation of certain transactions; and
- limit or prohibit distribution of dividends.

The MFC provides that such measures pursue the public interest goals of preserving financial stability and ensuring continuous operation of the relevant entity's business (the BRRD is more stringent as it provides that resolution action must be necessary in the public interest in that it achieves and is proportionate to one or more of the resolution objectives, whereas winding up under normal insolvency proceedings would not).

Under this new regime, in the context of a resolution, the Resolution College of the ACPR ensures that the loss suffered by the shareholders, partners or creditors of the defaulting bank is no greater than what it would have been had the bank been liquidated in accordance with general bankruptcy laws. It should be noted that the BRRD extends resolution tools available to resolution authorities (ie, the sale of business, recourse to a bridge institution, asset separation and bail-in). These have not yet been implemented into French law.

As regards the EU level, the SRB is currently working on the elaboration of resolution plans in cooperation with the national resolution authorities. The SRB has been fully operational since 1 January 2016.

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?

Pursuant to article L.613-35 of the MFC, credit institutions that are under the direct supervision of the ECB (see question 3), credit institutions and investment firms that constitute a significant share in the French financial system (according to article 11 paragraph 8 of the SRM Regulation an institution shall be considered to constitute a significant share of the financial system of a member state of the eurozone where the total value of its assets exceeds €30 billion or the ratio of its total assets over the GDP of the member state where it is established exceed 20 per cent, unless the total value of its assets is below €5 billion), credit institutions and investment firms that are not part of group supervised on a consolidated basis, parent undertakings (a company holding a shareholding in a credit institution), are bound to establish and submit preventive recovery plans to the ACPR (and to the ECB for the institution which are under its direct supervision) setting out the measures that are contemplated in the event of significant deterioration of their financial position ('living wills'). Such measures may not take into account any potential bailout by the state or the Deposit Guarantee and Resolution Fund.

The Resolution College of the ACPR (the SRB for the credit institutions that are under direct supervision of the ECB) establishes preventive resolution plan for the institutions bound to establish preventive recovery plan (see question 12).

When the resolution plan is implemented, the Resolution College of the ACPR may remove the 'top-two' management (in which case no severance package will be payable) in addition to the broader right to suspend board members and directors for lack of respectability, competence or experience. The 'top-two' management is defined as the two individuals 'effectively directing the bank' pursuant to the MFC.

The transfer of business, rights or obligations of the defaulting bank imposed by the ACPR (see question 12) could result in limiting the scope and powers of the managers in practice. Last, the SRBS Act provides that when a provisional administrator has been appointed by the ACPR, the severance package of the suspended managers cannot be paid up until the end of the provisional administrator's assignment, following which it needs to be approved by the shareholders.

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

In certain circumstances general French bankruptcy law can hold managers and directors of failing banks liable, particularly in cases of mismanagement, shortfall of assets, fraud and tort liability.

More specifically, article L.612-40, VII of the MFC provides that effective managers can be fined up to €5 million for an infringement of any rules under the CRD IV Package.

Capital requirements

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

Credit institutions and finance companies must have an initial paid-up capital or an endowment of a minimum amount between €1 million and €5 million depending on the authorisation granted (article L.511-11 of the MFC). For instance, banks must have an issued share capital of at least €5 million (CRBF Regulation No. 92-14 as amended).

In addition to the minimum share capital requirement, credit institutions and finance companies are required to comply with management standards to ensure their liquidity and solvency in respect of depositors and, more generally, third parties, and the balance of their financial structure. To this end, credit institutions and finance companies must comply with prudential ratios to guarantee their liquidity and solvency (article L.511-41 of the MFC). Below are the main applicable ratios:

- CRBF Regulation No. 91-05 (as amended) relating to the solvency ratio – credit institutions are required to maintain, at all times, a solvency ratio (ie, the ratio of capital to aggregate operating credit risk exposure) of at least 8 per cent. Under the CRD IV Regulation, while the total capital an institution will need to hold remains at 8 per cent, the share that has to be of the highest quality and that allow an institution to continue – common equity Tier 1 (CET 1) – increases from 2 per cent to 4.5 per cent.
- the Regulation establishes five capital buffers: the capital conservation buffer, the countercyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer. These additional own funds obligations have been transposed into French law by the Decree dated 3 November 2014.
- CRBF Regulation No. 93-05 (as amended) relating to the supervision of large exposures – the ratio of a credit institution's overall exposure to any counterparty may not exceed 25 per cent of the credit institution's capital. When the counterparty is a credit institution or a group of credit institutions, the total sum of net risk-weighted assets shall not exceed the greater of €150 million and 25 per cent of the funds of the credit institution concerned; and
- the Decree dated 5 May 2009 (as amended in November 2014) relating to the identification, measure, management and control of the liquidity risk on a short-term as well as on a long-term period – a credit institution's ratio of liquid assets to liquid liabilities (or liquidity coefficient) shall be above 100 per cent at all times. Liquid assets and liabilities include cash positions, claims (including repo-related claims with up to one month of remaining maturity) and negotiable securities, as well as off-balance sheet commitments and available liquidity lines. The ratio of liquid assets to liquid liabilities uses a weighting scheme defined by the ACPR to reflect the likelihood of items being rolled over or being available in event of a liquidity squeeze. Accordingly, bank liquidity management involves not only the liquidity of assets but also the nature and structure of, and changes in, liabilities.

Credit institutions must also maintain adequate liquidity buffers (article L.511-41-1-B of the MFC).

Applicable liquidity buffers are:

- first, to improve the short-term (over a 30-day period) resilience of the liquidity risk profile of financial institutions, there is a liquidity coverage requirement; and
- second, to ensure that an institution has an acceptable amount of stable funding to support the institutions assets and activities over the medium term (over a one-year period), there is a net stable funding requirement.

On 23 November 2016, the European Commission proposed a comprehensive package of reforms that contains, in particular, a requirement for G-SIIs to hold minimum levels of capital and other instruments which bear losses in resolution. This requirement, known as TLAC, will be integrated into the existing MREL system (see questions 6 and 8).

Under French law, the Decree of 5 May 2009 provides that institutions must implement a general policy to assess the liquidity risk that meets the criteria set out in sections 148 to 167 of the Decree dated 3 November 2014. Article 148 of this later Decree transposes the long-term and the short term liquidity buffers mentioned above. Article 149 compels credit institutions to set up internal policies and procedures proportional to their scale, the nature and complexity of their activities, and to the risks incurred to determine and manage their risks on a permanent and proactive basis. The scope of the internal control includes rules relating to anti-money laundering and terrorism financing.

16 How are the capital adequacy guidelines enforced?

As mentioned above, the ACPR receives (through secure IT systems and databases) monthly, quarterly and semi-annual accounting and prudential reports from all banks, allowing for periodic assessment of compliance with capital adequacy guidelines (L.612-23 and L.612-24 of the MFC). For significant credit institutions, every other prudential declaration that is not issued on a regular basis has to be directly transmitted to the ECB. For a less significant credit institution, declaration is directly filed with the ACPR (article 140 of Regulation No. 468/2014 of the ECB). Moreover, every bank must justify at all times that its assets actually exceed the minimum share capital amount.

Banks must also implement an adequate system of internal control enabling them to assess the risks and profitability of their activities, and to produce useful information for the ACPR's surveillance (articles L.511-41 et seq of the MFC).

As a result of such assessment, a wide range of administrative remedies or sanctions are available to the ACPR to ensure that the capital

adequacy guidelines are enforced. Sanctions range from simple warnings and formal notice to the withdrawal of the banking licence (article L.612-39 of the MFC).

The CRD IV package reiterates that the EBA is in charge of monitoring the quality of own fund instruments issued by institutions across the EU, in particular by organising stress tests on a regular basis.

Under article 4 of the SSM Regulation, the ECB may carry out prudential controls in order to determine whether the arrangement, strategies, processes and mechanisms put in place by credit institutions and the own funds they held ensure a sound management and coverage of their risks. In this context, the ECB is responsible for carrying out, in coordination with EBA, stress tests and publishing the results. On the basis of these tests, the ECB may impose on credit institutions several obligations, such as additional own funds requirements, specific publication requirements, specific liquidity requirements or other measures.

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

The SSM Regulation (article 16 of the Regulation) entitles the ECB to require any significant credit institution or financial holding company to take the necessary measures at an early stage to address the problem in the event that the arrangement, process and mechanism implemented by these institutions and their own funds and liquidity does not ensure a sound management of the risks. In particular the ECB has the power:

- to require institutions to hold own funds in excess of the capital requirements;
- to require institutions to present a plan to restore compliance with supervisory requirements;
- to restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive risks to the soundness of an institution;
- to require institutions to use net profits to strengthen their own funds;
- to restrict or prohibit distribution by the institution to shareholders, members or holders of additional Tier 1 instruments where the prohibition does not constitute an event of default of the institution;
- to impose additional or more frequent reporting requirements, including reporting on capital and liquidity positions; and
- to impose specific liquidity requirements, including restriction on maturity and mismatches between assets and liabilities.

For banks that are not directly subject to the supervision of the ECB, the ACPR may require the necessary measures in the event they become undercapitalised. The ACPR will first typically give notice to a bank to take appropriate actions to restore or increase its financial position.

To this end, and pursuant to article L.511-41-3 of the MFC, when the financial situation of a credit institution, an investment firm or a finance company is compromised or likely to be, the ACPR may:

- require the company to publish additional information;
- order the company to take within a specified period all measures to restore or increase its financial position or liquidity, improve its management or to ensure the adequacy of its organisation, its activities or its development objectives;
- order the company to submit to a specific liquidity requirements, including restrictions on asymmetrical maturities between assets and liabilities;
- request that the company holds total assets of an amount greater than the minimum stipulated by the applicable regulations and require the application of a specific provisioning policy's assets or specific treatment under the capital requirements;
- require the company to assign its profits to the strengthening of its total assets; and
- require the company to curb variable compensation as a percentage of total net income.

Pursuant to article L.511-42 of the MFC, when appropriate, the governor of the Banque de France is entitled to 'invite' (not 'request') the shareholders of a bank to provide the necessary support (concerning significant banks, the governor must first seek the ECB's opinion).

If the measures taken by the credit institution are not sufficient to restore or increase its financial position, the ACPR must, under its administrative police powers, take several actions to ensure that a lack of capitalisation is remedied in due course (see question 10).

If necessary and where applicable, ACPR may also order resolution decisions (see question 12).

18 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 as set out in question 12 should apply.

Further to question 12, French legislation governing the insolvency of credit institutions mainly consists of the general bankruptcy provisions set forth in the Commercial Code regarding the insolvency of corporations.

However, articles L.613-24 et seq of the MFC provide for three main rules unique to the insolvency of a credit institution:

- a specific definition of 'insolvency' for credit institutions – a bank is considered insolvent when it is unable to meet its current liabilities immediately (ie, ability to repay demand deposits) or in the near future (ie, ability to repay short-term savings);
- the ACPR may appoint a liquidator to which all the powers of administration, management and representation of the corporation are transferred; and
- the president of the competent commercial court is entitled to initiate bankruptcy proceedings against a credit institution only with the ACPR's assent.

In addition, France has implemented Directive No. 2001/24/EC of 4 April 2001 on the reorganisation and winding-up of credit institutions, providing, inter alia, for a single bankruptcy proceeding when a bank with branches in several EU member states becomes insolvent.

Finally, the French Deposit Guarantee and Resolution Fund may intervene upon request from the ACPR to compensate depositors in case of unavailability of their deposits or securities (see question 4). This mechanism was replaced by the SRF on 1 January 2016.

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

Since the implementation of the CRD IV package, it is not expected that capital adequacy guidelines will fundamentally change in the near future. However, on 23 November 2016, the European Commission proposed (i) more risk-sensitive capital requirements, in particular in the area of market risk, counterparty credit risk, and for exposures to central counterparties (and (ii) a requirement for G-SIIs to hold minimum levels of capital and other instruments which bear losses in resolution known as TLAC (see questions 6, 8 and 17).

Ownership restrictions and implications

20 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 of a bank and the investment in a bank are subject to authorisation. Since the implementation of the SSM resolution and pursuant article L.511-10 of the MFC, the ECB has the primary responsibility for granting licences to credit institutions. The ACPR shall only propose to the ECB the granting of such a licence. The ACPR has still primary responsibility of granting licences to 'finance companies'. When a bank applies for authorisation to carry out banking activities in France, or when a proposed acquirer applies for authorisation to invest in a bank, the ACPR examines, before transmitting the request to the ECB, several criteria that are considered equally important to the outcome of its decision; among are the identity of the shareholders, the amount of their participation (article L.511-10 of the MFC) and the honourability and financial solidity of the proposed acquirer (article R.511-3-1 of the MFC).

These criteria are justified by the substantial liabilities borne, and the significant influence exercised, by the main shareholders of a bank.

The Decree of 3 November 2014 states that any company seeking authorisation indicates, in support of its request, the identity of its direct or indirect capital providers, natural or legal persons having a qualifying holding (directly or indirectly, at least 10 per cent of the capital or voting rights, or any ability to exercise significant influence

over the management of the enterprise) or, alternatively, the identity of the 20 main capital providers and the amount of their participation.

Pursuant to article L.511-10 of the MFC, the ECB or the ACPR refuse to grant the authorisation when:

- the exercise of the monitoring mission on the applicant company is likely to be impeded either by the existence of capital links or direct or indirect control between the company and other natural or legal persons or by the existence of laws or regulations of a state which is not a party to the Agreement on the European Economic Area which govern these persons;
- the members of the management do not have the honourability, knowledge, skills or experience required for the performance of their duties or if they do not dedicate enough time for the performance of their duties (articles L.511-51 and L.511-52 of the MFC); and
- in the light of the assessment criteria, there are reasonable grounds to believe that the quality of capital providers does not ensure a sound and prudent management or if the information communicated is incomplete.

The ACPR may also restrict, or propose to the ECB to restrict, the licence to be granted to a limited field of operations (article L.511-10 of the MFC). The ACPR may also submit, or propose to the ECB to submit, the authorisation to several specific conditions in order to preserve the financial structure of the enterprise and the good functioning of the banking system (article L.511-10 of the MFC).

On a practical level, the ACPR also generally scrutinises the following:

- when the effective control of a bank is not held by a single shareholder, the ACPR ensures that the allocation of the share capital is sufficiently stable, requires certain undertakings from the main shareholders, and usually recommends that the bank's shareholders enter into a shareholders' agreement (which shall provide mechanisms to avoid deadlock situations);
- the ACPR does not tend to grant authorisations to banks that are owned by a single individual; in general, the level of ownership that can be held by an individual depends on the type of bank, the identity of the other shareholders and the personal condition of such individual; and
- the ACPR prefers bank shareholders to hold their interests directly in the bank rather than through holding companies or special purpose vehicles.

21 Are there any restrictions on foreign ownership of banks?

Since the implementation of the SSM Regulation, the ECB is responsible for granting licences to significant credit institutions (see question 20) and for approving significant changes in the distribution of the capital of credit institutions (see question 25). The ECB seems not to have issued any position regarding the foreign ownership of a bank.

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

Since the implementation of the SSM Regulation, the ECB has the mission of carrying out supervision on a consolidated basis over credit institutions' parents established in one the participating member states, including over financial holding companies and mixed financial holding companies. For the purposes of this supervision, the ECB may require financial holding companies, mixed financial holding companies and mixed holding companies to provide all information that is necessary in order to carry out its mission, including information to be provided at recurring intervals and in specified formats for supervisory and related purposes (article 10 of the SSM Regulation).

Moreover, the ECB may conduct investigations on the financial holding companies, mixed financial holding companies and mixed activity holding companies and has the right to (article 11 of the SSM Regulation):

- require the submission of documents;
- examine the books and records and take copies or extracts of such books and records;
- obtain written or oral explanation; and
- interview any other person who consents to be interviewed for the purpose of collecting information relating to the subject matter of an investigation.

The ECB may also conduct on-site inspections.

For less significant credit institutions, the ACPR may require the holding company of a bank that is under its supervision to communicate of all necessary information, and to disclose publicly an annual description of its legal structure, and of its governance and organisational structure.

The ACPR tends to consider that when a controlling position is owned by entities that are not subject to the supervision of the banking authorities, the authorisation is granted (or maintained) only if the entities' investment in the bank is reasonable given their assets and available capital. In addition, the non-banking activities of such entities have to generate annual financial results sufficient to satisfy future needs to reinforce the capital of the bank. The ACPR often requires non-banking controlling shareholders to be sponsored by an EU-authorised bank. It could also ask for a comfort letter from such entities (providing for long-term ownership of the bank, permanent supervision of the bank's business and a commitment to provide financial support to the bank, if necessary).

Notwithstanding the foregoing, the ACPR may decide to qualify an entity that controls a bank as a 'finance company' and, hence, impose reporting duties and prudential supervision on such controlling entity. A finance company is not, however, required to be registered with or granted a licence by the ACPR (pursuant to article L.517-5 of the MFC). The ACPR may do so only if the controlling entity is a company whose subsidiaries are, mainly or exclusively, financial institutions.

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

As explained in question 17, there is no obligation for a shareholder to provide additional capital in the event that a bank becomes under-capitalised, absent an explicit commitment by such shareholder to do so. The governor of the Banque de France is only entitled to 'invite' shareholders of a bank to provide financial support (article L.511-42 of the MFC). In this case, article L.613-50 of the MFC provides for the ACPR to ensure that the loss suffered by the holder of a share of the capital or of any property right of the defaulting bank will not be greater than what it would be if the bank was liquidated in accordance with general bankruptcy laws.

Nevertheless, in practice, shareholders of a credit institution may be required to give support to a bank upon request of the ACPR. Indeed, article L.511-10 of the MFC provides that the ACPR may attach special conditions to the authorisation granted for purposes of carrying out certain banking activities. As a result of such conditions, that could be materialised into a comfort letter, an entity or individual controlling a bank may be subject to duties and responsibilities such as an obligation to contribute additional capital upon request of the ACPR.

The Ordinance of the 20 August 2015, ratified by the Law No. 2016-1691 of 9 December 2016, sets out a bail-in mechanism that forces shareholders to provide priority financial support to the bank for its resolution.

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

Articles L.612-33, L.613-24 et seq and L.613-50 et seq contain provisions that could be applied to controlling entities or individuals if a credit institution becomes insolvent.

Pursuant to those articles, if a bank becomes insolvent or if its solvency or liquidity is likely to be compromised, the ACPR may impose the following sanctions that could affect its controlling entity or individual (pursuant to article L. 613-34 of the MFC, for significant banks that are under direct supervision of the ECB, these sanctions shall be carried out by the ECB or the SRB, according to their respective powers):

- suspend, restrict or temporarily prevent the disposal of all or part of the assets of the controlled bank;
- restrict or prevent the distribution of dividends to the shareholders of the bank;
- order the mandatory transfer of all or part of the credit or deposit portfolio of the credit institution; and
- upon a petition presented to the Paris Court of First Instance, order the mandatory sale of the shares of the bank.

Pursuant to article L.613-48 et seq, if a bank is defaulting, the Resolution College of the ACPR may impose the following measures that could affect its controlling entity or individual (pursuant to article L.613-34 of the MFC, for significant banks that are under direct supervision of the ECB, these measures shall be carried out by the ECB or the SRB, according to their respective competences):

- the exercise of the rights and powers of the bank shareholders or appointment of a special administrator to whom all the powers of administration, management and representation of the bank and all the powers of the shareholders are transferred (pursuant to article L.613-51-1 et seq of the MFC);
- ordering the mandatory transfer, on a provisory basis and in the view of a selling of all or part of the assets of the controlled bank to a dedicated entity (pursuant to article L.613-51 et seq of the MFC);
- ordering the mandatory transfer of all or parts of the assets of the controlled bank to a third party (an entity differing from the dedicated entity) (pursuant to article L.613-52 of the MFC);
- ordering the mandatory transfer of all or parts of the controlled bank to an asset management structure in the view of their realisation (article L.613-54 of the MFC); and
- ordering a reduction of the subscribed capital, a cancellation of shares of the capital or the conversion of liabilities elements (article L.613-55 of the MFC) or the issuing of new shares of capital (pursuant to article L.613-56 of the MFC).

The general bankruptcy provisions set out in the Commercial Code regarding the insolvency of corporations may also be applicable under certain conditions. As to those general principles, the controlling entity shall not assume any liability if it has not intervened in the daily management of the bank and if it did not force the bank and its management team to make decisions that directly led to bankruptcy.

Changes in control

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

Pursuant to article L.511-12-1 of the MFC, modifications in the distribution of capital of a credit institution or a finance company must be notified to the ACPR.

Direct or indirect acquisitions of qualifying holdings (meaning a direct or indirect holding 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) or increases in holdings in any bank must be notified to the ACPR, and approved by the ECB, in compliance with sections 4 and 15 of EU Regulation No. 1024/2013 of 15 October 2013.

In this context, the ACPR must notably evaluate the suitability of the proposed acquirer and the financial soundness of the proposed acquisition (article R.511-3-2 of the MFC). The ACPR must also verify that this transaction does not affect the conditions under which the licence to operate was granted to the relevant institution (article L.511-12-1 of the MFC).

The ACPR shall examine the contemplated acquisition and forward the notification and a draft decision to the ECB.

If the ECB fails to respond to a duly documented application for more than 60 days, authorisation is deemed granted. This deadline may be suspended by 20 days more or 30 days when the acquirer is a non-EU state, or is not subject to EU legislation or does not fall within the scope of the surveillance set up under the 2013/36/EC, 2009/65/CE, 2009/138/CE or 2004/39/CE Directives (Decree No. 2014-1281 of 23 October 2014 as modified by Decree No. 2016-935 of 7 July 2016).

In addition, if the bank is listed on a regulated stock exchange and the change in control is meant to occur as a result of a tender offer, the AMF's approval is also required prior to the filing by the offeror of its tender offer prospectus (see question 28). Any person intending to launch a takeover offer on the shares of a credit institution authorised in France or a finance company may first inform the governor of the Banque de France and president of the ACPR eight business days before the filing of the draft tender offer prospectus with the AMF, or the public announcement of such tender offer, whichever is earlier (article R.511-3-5 of the MFC).

Finally, the acquisition of control may often require the approval of French or EU competition authorities.

Directive 2015/2366/EU on payment services in the internal market (PSD2) sets forth a control over the payment service providers' shareholding. Article 6 of PSD2 provides that any person who intends to acquire or to further increase, directly or indirectly, shares in a payment institution, crossing the 20, 30 or 50 per cent thresholds of the shares or voting rights, shall inform the competent authorities in writing of their intention in advance. The same rules apply to any natural or legal person who has taken a decision to dispose, directly or indirectly, of its shares, or to reduce its shareholding, crossing the 20, 30 or 50 per cent thresholds of the shares or voting rights, or so that the payment institution would cease to be its subsidiary. Article 6 of PSD2 also provides that member states shall require that where the influence exercised by a proposed acquirer is likely to operate to the detriment of the prudent and sound management of the payment institution, the competent authorities shall express their opposition or take other appropriate measures to bring that situation to an end (such measures may include injunctions, fines against directors or the persons responsible for the management, or the suspension of the exercise of the voting rights attached to the shares held by the shareholders of the payment institution in question). If a shareholding is acquired despite the opposition of the competent authorities, member states shall, regardless of any other penalty to be adopted, provide for the exercise of the corresponding voting rights to be suspended, the nullity of votes cast or the possibility of annulling those votes.

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

It should be noted that the Ordinance dated 6 November 2014 has aligned the process for EU and non-EU acquirers by repealing section L.511-12 of the MFC.

However, no acquisitions of control of significant French banks by foreign acquirers have taken place in the past four years and, thus it is difficult to assess the ACPR's reaction in future in relation to this type of purchaser. One of the consequences of the results of the comprehensive review at the time of writing might be an increase in cross-border consolidation transactions, within or without the eurozone, in which undercapitalised financial institutions would be a key part.

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

As stated above, the ACPR shall verify that the acquisition does not affect the conditions attached to the authorisation granted to the credit institution or finance company (see question 15).

To that end, the ACPR must assess the suitability of the proposed acquirer and the financial soundness of the proposed acquisition in accordance with the following criteria:

- the reputation of the proposed acquirer;
- the reputation, skills and experience of any member of the management body and any member of senior management who will direct the business of the credit institution as a result of the proposed acquisition;
- the financial soundness of the proposed acquirer;
- the ability of the acquirer to comply with the prudential requirements as defined in the CRD IV package (Directive and Regulation (EU) No. 575/2013); and
- whether there are reasonable grounds, in connection with the proposed acquisition, to suspect the existence of money laundering or terrorist financing (article R.511-3-2 of the MFC).

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

To receive the authorisation for an acquisition of control of a bank a comprehensive application (available online on the ACPR website) must be filed by the acquirer with the ACPR. This application includes information regarding the target, the acquirer, the shareholders agreement (if any), the proposed transaction, and its consequences on the parties (especially, where applicable, with respect to their prudential ratios – see question 15). The ACPR may request any additional information or clarification.

The ACPR also examines the contemplated acquisition (notably evaluating the suitability of the proposed acquirer and the financial soundness of the proposed acquisition), and shall forward the notification and a draft decision to the ECB.

In addition to this application, and in the event that the acquisition of control takes the form of a tender offer, the governor of the Banque de France may be formally informed (usually by a letter) of the tender offer eight business days before the filing of the draft tender offer prospectus with the AMF, or the public announcement of such tender offer, whichever is earlier (article R.511-3-5 of the MFC). Moreover, the offeror and the target must proceed with all the ordinary prospectus filings with the AMF that are necessary for the implementation of a tender offer. In addition, customary competition filings may be required based on the nature of the transaction.

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

Depending on the size and nature of the transaction, the regulatory approval process usually takes two to three months from the date the application is made, though it could be completed faster if some publicly known risks are present (see question 25).

In practice, preliminary discussions with the regulators are necessary to evaluate the feasibility of the transaction. No application is filed and no transaction is implemented unless the banking authorities give a favourable informal opinion on the proposed transaction structure. As a result, dismissed applications are fairly rare and mainly result from the occurrence of adverse developments after the filings.

As described in question 26, although there is no significant difference between a foreign and a domestic acquirer, the process may be longer for a foreign acquirer, as the regulator may require specific undertakings to be made or impose certain conditions on the transaction.

* *The author would like to thank Nicolas Mennesson, Patrick Mèle, Christophe-Marc Juvanon and Guillaume Griffart for their successive contributions to this chapter over the past few years.*

DARROIS VILLEY MAILLOT BROCHIER

Pierre Casanova **pcasanova@darroisvilley.com**

69 avenue Victor Hugo
75116 Paris
France

Tel: +33 1 45 02 19 19
Fax: +33 1 45 02 49 59
www.darroisvilley.com

Germany

Christoph Schmitt and Rainer Süßmann
Beiten Burkhardt

Regulatory framework

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

The main objective of the German banking supervision is to ensure stability, efficiency and integrity of the domestic financial market. Regulatory provisions aim at preventing irregularities in Germany's credit sector as such irregularities could jeopardise the assets entrusted to the credit institutions, compromise the proper conduct of banking business or create disadvantages for the overall economy. The scope and intensity of supervision primarily depends on the nature and extent of the transactions executed by the credit institutions. In general, banking supervision's primary concern is that financial institutions are vested with sufficient capital, maintain appropriate liquidity reserves and have installed adequate risk control mechanisms.

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

The German banking sector is mainly governed by the following regulations:

- the German Banking Act (KWG) provides regulatory provisions which credit institutions have to observe and comply with when setting up business and running operations;
- the EU Regulation No 575/2013 on prudential requirements for credit institutions and investment firms (CRR);
- the Payment Services Regulation Act (ZAG) comprises specific provisions for payment service providers (in particular e-money, credit and payment institutions) and implements the Payment Services Directive (Directive 2007/64/EC on payment services in the internal market) as well as Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions;
- the Securities Trading Act (WpHG) governs the securities trading in Germany, providing in particular for comprehensive rules of conduct, organisational and transparency obligations;
- the Anti-Money Laundering Act (GWG) serves to prevent money laundering and thus serves fighting organised crime. Banks and the institutions specified in section 2 GWG are encouraged to monitor suspicious transactions and to report any suspicions of money laundering;
- the German Mortgage-Backed Bonds Act governs the issuance of mortgage-backed bonds and stipulates specific requirements, exceeding the provisions of KWG, regarding the necessary licensing of credit institutions that intend to engage in mortgage-backed bonds operations; and
- no regulations, but kind of 'soft law' the circulars, guidance notices and other announcements of the Federal Financial Supervisory Authority (BaFin).

3 Which regulatory authorities are primarily responsible for overseeing banks?

Since the implementation of the uniform supervisory mechanism of the new European System of Financial Supervisors in November 2014, banking supervision in Germany is carried out for significant institutions by the European Central Bank (ECB) in cooperation with the national regulatory authorities BaFin and Deutsche Bundesbank, for other banks by BaFin and Deutsche Bundesbank. The ECB's supervisory actions cover so-called significant institutions (ie, inter alia, institutions whose total value of assets exceeds €30 billion or 20 per cent of national GDP). The national supervisory authorities remain in charge of supervising the less significant small and medium-sized institutions. However, decisions on granting licences or on ownership control are always subject to ECB's decision irrespective of the size of the institution.

In the following the description is limited to the supervision by BaFin for medium-sized or smaller 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.

Deposits of private individuals, partnerships and small companies are legally protected up to an amount of max. €100,000 by the Deposit Protection Act. In addition, the German banking associations offer voluntarily protection schemes securing deposits above €100,000. The German cooperative banks, as well as the German savings banks, offer a protection without amount-related restrictions for all customer deposits and bearer bonds.

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 KWG, the supervisory authorities must be notified of significant intra-group transactions with mixed-activity holding companies. Here, an intra-group transaction shall be presumed to be significant if its volume exceeds at least 5 per cent of the total amount of capital adequacy requirements at group level. The performance of such transactions is subject to a unanimous decision of all the institution's managing directors.

German regulatory law moreover includes specific restrictions as to the granting of loans, inter alia, to the institution's managing directors, to members of the institution's supervisory body or holders of substantial holdings (institutional credits). Pursuant to section 15 KWG, such loans may be granted only by virtue of a unanimous decision by all managing directors and the explicit approval of the supervisory body of the institution and only on prevailing market terms. If loans are granted contrary to these requirements, they shall be repaid immediately unless all managing directors and the supervisory body approve of the granting of these loans subsequently without undue delay. BaFin may impose upper limits for the granting of institutional credits in individual cases.

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

One of the major challenges banks are faced with is the fulfilment and implementation of the constantly increasing requirements regarding risk management, liquidity and capital adequacy as well as compliance and more detailed rules for doing retail business. In addition,

increasingly stringent reporting obligations are applied. Such development primarily means a bigger financial burden for institutions but also business downturns. In particular, many bank advisers tend to avoid retail business with private customers owing to the numerous legal risks and the burden of compliance measures related to it. Further difficulties arise for the institutions as regards the bulk of laws (national laws, European directives and their implementation through German legal instruments as well as directly applicable European regulations or detailing Level II legislation) and their interaction.

7 Are banks subject to consumer protection rules?

In Germany, banking institutions are, in fact, subject to extensive consumer protection rules. The WpHG, for example, includes specific record-keeping obligations in connection with providing investment advice to retail clients. When providing investment advice to a retail client, written minutes always have to be taken which must indicate the reason for and period of the consultancy, the client's personal situation and investment interests as well as the bank adviser's recommendations and the adviser's underlying reasons. The minutes are to be signed by the adviser who has rendered the consultancy and the client shall be provided with a copy.

Furthermore, before an acquisition of securities or investment fund units is carried out, consumers must be informed by means of product information sheets or key investor documents in a brief (not more than two A4 pages) and easily understandable manner on the substantial risks and rewards of the respective investment. The information to be given shall include:

- the nature of the investment products;
- its functioning;
- the related risks;
- the prospects of capital repayment and proceeds under various market conditions; and
- the costs incurred by the investment.

In addition, the German Civil Code contains special provisions regarding consumer loan agreements, which provide for specific rights of consumers as regards banks, such as specific revocation rights. Disputes in this context and their settlement are, however, not included in the scope of work of supervisory authorities, but are exclusively referred to ordinary courts.

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

We continue to expect a progressive harmonisation of the regulatory frame, especially through European directives and regulations in the future as well as a stronger, increased focus on consumer protection by both the European and the national legislative authority. In addition, the ECB wishes to harmonise the banking regulation in order to handle only with a single rule book when supervising the significant banks.

Supervision

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

Within the framework of its ongoing supervisory work, BaFin reviews any regulations, strategies, procedures and processes an institution has developed and established to ensure compliance with the regulatory requirements, and, taking into account the kind, scope and complexity of an institution's business activities, it assesses the risks to which the institution is or may be exposed. Based on such review and assessment, BaFin evaluates in summary and with a forward-looking view whether the risk management processes an institution has implemented and the liquidity and own funds it maintains provide for an adequate and efficient risk management and ensure sound coverage of any risks.

Frequency and depth of these reviews and assessments depend on the size, its relevance to the banking system and the kind, scope and complexity of an institution's business activities, but are carried out at least once a year (section 6b (4) Sent. 2, 3 KWG) in coordination with Deutsche Bundesbank.

Owing to the system of reporting obligations for significant business transactions and organisational measures (section 24 KWG) as well as routine reports on the ongoing business development (eg, sections 25 and 26 KWG, referring to financial information, monthly accounts, etc) enshrined in the KWG, provision of continuous information to BaFin is guaranteed, thus establishing the basis for efficient supervision. In addition, BaFin may without special cause request any supervisory information; in particular, BaFin may request information on all business activities and submission of books and other relevant documentation pursuant to section 44, the so-called special audit.

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

The majority of ongoing regulatory measures are carried out in the course of informal procedures. BaFin, in general, requests information, notifies single institutions of the authorities' opinion on business transactions and other proceedings and more or less clearly pronounces warnings and announces consequences in case the institution does not comply with the requirements of the banking supervision. Usually, these informal administrative procedures result in a clarification or even an actual change in the institution's practice so that formal administrative acts in the ordinary course of the institutions' business only occur relatively infrequently.

In order to perform its duties, BaFin may order special audits, undertaken by independent auditors and to be paid by the respective bank. As an ultima ratio, BaFin may revoke the licence (section 35 KWG), dismiss managing directors (section 36 KWG) or takes other measures to avert dangers (sections 46 et seq KWG). BaFin may enforce the orders it issues within the scope of its statutory powers by taking enforcement measures as, for example, the imposition of coercive fines of up to a maximum amount of €250,000 (section 17 of the German Act Establishing the Federal Financial Supervisory Authority). Furthermore, the violation of numerous supervisory requirements carries administrative fines (section 56 KWG) or punishments (sections 54 to 55b KWG).

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 2015 (the annual report for 2016 was not yet available at the time of printing; publication is expected in May 2017), BaFin conducted 176 special audits in the BaFin supervised less significant institutions (previous year 203, including the now ECB supervised significant institutions), of which were 156 initiated by BaFin itself (previous year: 156). As a result, BaFin lodged serious objections in 82 cases. In one case, the bank has been closed and liquidated upon BaFin's request. The number of administrative fines initiated against institutions has not been disclosed.

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 aim of the German Act on Ringfencing and Recovery and Resolution Planning for Credit Institutions (SAG), tracing back and thus attributable to European requirements (Directive 2014/59/EU), is to avoid a takeover of banks by the government but to reorganise and liquidate a bank in the best manner. Under section 3 (1) SAG, the Financial Market Stabilisation Agency (FMSA) as a resolution authority is entitled under certain conditions to impose the transfer of institutions with customer deposits (CRR institutions) (article 4 (1) No. 1 of the Regulation (EU) No. 575/2013) to an already existing institution or to a state bridge bank, established solely for the purpose of transfer (section 107 SAG). The subject of transfer can either be the shares issued by the respective institution or all or part of the assets of the institution. The accepting legal entity must give its consent to the transfer (section 109 SAG). Moreover, the issuance of a transfer order by the FMSA pursuant to section 62 SAG requires that:

- the institution concerned is faced with a going-concern threat;
- the execution of the transfer in order to achieve one or more resolution objectives such as averting systemic risks or the protection of public funds (section 67 SAG) is required and proportionate; and
- it will not be possible to eliminate the going-concern threat within the available period of time through application of other regulatory measures in accordance with sections 36 to 38, 45 et seq. KWG or

Update and trends

Stronger capital requirements for CRR institutions with a number of changes form the Basel III rules to the Basel IV rules and their implementation are still under discussion. The ECB has proposed additional and very detailed reporting obligations.

The always increasing regulation, requiring expansive IT investments, combined with very low or even negative interest rates influence the business models of many banks.

measures applied by the private sector, including an institutional guarantee system (ultima ratio principle).

The required going-concern risk of an institution is deemed to exist if:

- the institution violates the requirements related to the licence granted pursuant to section 32 KWG in a way that would justify a revocation of the licence by the supervisory authority, or if there are objective indications that this could occur in the near future;
- the institution's assets fall short of the amount of its liabilities, or there are objective indications that this could occur in the near future; or
- the institution has become insolvent or if there are objective indications that in the near future the institution will not be able to meet its existing payment obligations when due.

After execution of the transfer, the FMSA has to have an independent expert to assess if and to which extent unit holders and creditors are disadvantaged owing to the imposition and execution of measures compared to the situation which would have arisen if insolvency proceedings over the institution's assets had been opened and carried out (section 146 SAG). Any disadvantages suffered by the parties concerned give rise to a compensation claim against the Restructuring Fund in the amount of the difference (section 147 SAG in connection with section 8 German Restructuring Fund Act.

The FMSA executes its tasks within the framework of the SAG, regularly coordinating its activities with BaFin (section 2 SAG). Apparently, the option of transfer pursuant to SAG has not been realised up to now. In 2018 the FSMA will become part of BaFin.

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?

Since 1 January 2015, CRR institutions (see question 12) are obliged to draw up a recovery plan which has to be regularly updated, at least once a year (section 12 SAG). If certain requirements are met, credit institutions that are members of an institutional guarantee system may be exempted from such obligation by BaFin with the consent of the Bundesbank (section 20 SAG).

In such recovery plan the institutions have to explain the arrangements which will ensure or recover their financial stability if their financial position deteriorates substantially and such deterioration may trigger a going-concern risk for the institution (crisis). The SAG establishes very detailed and comprehensive requirements for the contents of a recovery plan. The recovery plan has to comprise, for instance, an outline of its essential contents including an assessment of an institution's potential for recovery, a strategic analysis of the institution's structure and a presentation of available options for action, including an analysis of its feasibility and consequences (as regards requirements in detail, see section 13 SAG). With the consent of Bundesbank, BaFin may in certain circumstances deviate from the above statutory requirements on the content and level of detail of a recovery plan and impose simplified requirements for individual institutions (section 19 SAG).

In the event that recovery and reorganisation measures have a priori no prospects of success, or if measures taken do not lead to results and an institution is facing insolvency, insolvency proceedings must be opened over its assets (see question 18).

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

The liability of supervisory board and managing board members is subject to general rules of German corporate law. Accordingly, they may be liable for any breaches of their statutory management duties towards the bank. The claims terminate and expire after 10 years, irrespective of any general provisions on limitation periods. The time limit begins upon the claim arising.

Capital requirements

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

Depending on the type of transactions carried out, the institutions have to comply with specific minimum requirements as to their capital resources. The KWG, for example, stipulates that credit institutions and financial services institutions must provide evidence of a minimum initial capital of €25,000 up to €5 million (in the case of CRR institutions) prior to taking up business. However the required equity needs to be calculated in accordance with the detailed requirements stipulated in the CRR and depending on the business and the related risks. Also depending on the business activities, the ZAG requires e-money and payment institutions to prove a minimum capital of €20,000 up to €350,000.

The European rules and guidelines now have a significant impact on the requirements in respect of capital resources in Germany, most recently being harmonised by the CRD IV reform package, now implemented into the KWG and the CRR provisions.

The CRR/CRD IV stipulate not only which own funds (capital resources) shall be acknowledged by national supervisory authorities but also in which amount institutions must maintain own funds to adequately cover their risks. To that effect, article 107 et seq. CRR specifies in detail the methods to be applied for calculation of the capital adequacy with regard to single types of risks, in particular name risks, market risks and the operational risk. Moreover, the CRR includes in its article 431 et seq the specification of disclosure requirements for the institutions.

In certain cases institutions are required to hold, in addition to other own fund requirements, a capital conservation buffer and a countercyclical capital buffer to ensure that they accumulate, during periods of economic growth, a sufficient capital base to absorb losses in stressed periods which can include contingent capital arrangements.

For the significant banks, the ECB stipulates individual additional capital requirements under the so-called Supervisory Review and Evaluation Process.

16 How are the capital adequacy guidelines enforced?

Compliance with the capital resources requirements is monitored by the supervisory authorities within the framework of their ongoing supervision. Therefore, credit institutions have to meet different reporting obligations as, for instance, reporting on own funds requirements and financial information (article 99 CRR) or liquidity reporting (article 415 CRR), enabling authorities to identify risks.

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

If an institution gives reason to presume that it will not be able to comply with the CRR requirements regarding capital adequacy, based on section 45 KWG, the supervisory authorities may, inter alia:

- order the institution to provide a report including suitable measures to increase the Tier 1 capital, own funds and the institution's liquidity;
- request the institution to present a concept to avoid a potentially dangerous situation or to present a restructuring plan;
- prohibit or limit withdrawals by the owners or partners and the distribution of profits;
- prohibit or limit accounting measures taken to settle an annual shortfall or report a balance sheet profit; and
- order that the payment of all kinds of proceeds on own funds instruments be cancelled without substitution in whole or in part.

The KWG provides the supervisory authorities with further options for action, covering a scope from appointing a special commissioner and conferring upon him supervisory or management functions (section 45c KWG) up to the revocation of the licence for the conduct of business (section 35 KWG).

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

If an institution is facing insolvency (ie, if it becomes insolvent or overindebted), the managing directors shall report this fact to BaFin without undue delay. Notwithstanding the general provisions of the German Insolvency Code (InsO), the application for the initiation of insolvency proceedings over the institution's assets may only be filed by BaFin (section 46b KWG). Otherwise, the execution of insolvency proceedings is subject to the provisions set forth in the InsO, modified by section 46c KWG).

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

German regulatory banking law has undergone fundamental changes due to the implementation of the CRD IV reform package (see question 15), especially as the qualitative requirements for the capital adequacy were tightened up. As the capital adequacy rules are now European law, they are subject to European legislation, particularly level II legislation and amendments.

Ownership restrictions and implications

20 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 over an institution is always at hand if another entity or individual has to be considered its parent company or if another kind of hierarchical relationship (eg, owing to a majority of voting rights) exists between both.

A 'substantial holding' is given if the interest held, directly or indirectly, amounts to at least 10 per cent of the relevant institution's capital or voting rights or if there is another way to exercise significant influence on the institution's management.

German regulatory law does not know any particular restrictions in connection with the holder of such a substantial holding. However, the ECB may prohibit the intended acquisition of a substantial holding if, for example, there is doubt with regard to the acquirer's reliability (see question 25).

21 Are there any restrictions on foreign ownership of banks?

There are no general restrictions in this case.

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

Entities that control a German bank are subject to extensive transparency obligations. For example, BaFin may request the holders of a substantial holding to provide information regarding any and all business activities and submit the respective documentation. Moreover, it may carry out on-site inspections during normal business hours.

Under certain conditions, BaFin is even entitled to prohibit the holder of a substantial holding to exercise its voting rights and to order that the shares may only be used with the authority's consent.

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

The holder of a substantial holding must notify the supervisory authorities of any changes in such holding insofar as certain thresholds (10 per cent, 20 per cent, 30 per cent or 50 per cent of the capital or the voting rights) are reached or exceeded. In addition, the supervisory authority must be notified of any pending penal procedures against the holder of a substantial holding.

In the ordinary course of business with the institution, the holder of a substantial holding has to comply with general fiduciary duties such as not to cause damage to the company and to keep confidential the company's business secrets. In addition, German regulatory law provides for particular requirements regarding lending activities in favour of persons, affiliated with the lending institutions either personally or under corporate law. Pursuant to section 15 KWG, loans to governing and related bodies may be granted only by virtue of a unanimous decision by all of the institution's senior managers of the management board and the supervisory body only on market terms. For an institution in crisis such loans are recognised and treated as liable equity capital.

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

Depending on the corporate structure of the institution concerned, unit holders are mostly liable only in proportion to their stake.

In the event that an institution chooses to carry out a reorganisation procedure in accordance with the SAG (see question 12), the reorganisation provides for a possible intervention in the position of the stakeholders of the respective institution, subject to certain conditions even without their explicit consent.

Changes in control

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

The acquisition of a 'substantial holding' in an institution requires a successful owner control process which may be burdensome. For example, the acquirer(s) must notify BaFin of the proposed acquisition. The ECB may prohibit the proposed acquisition, for example, if:

- the acquirer lacks reliability or for other reasons does not meet the demands required in the interest of ensuring a sound and prudent management of the institution;
- the institution is not or does not remain able to comply with regulatory requirements, or the acquisition of or increase in the substantial holding would integrate the institution into a corporate association with the holder of the substantial holding which could obstruct efficient supervision of the institution;

BEITEN BURKHARDT

Christoph Schmitt **christoph.schmitt@bblaw.com**
Rainer Süßmann **rainer.suessmann@bblaw.com**

Mainzer Landstr. 36
60325 Frankfurt
Germany

Tel: +49 69 756095 434
Fax: +49 69 756095 441
www.beitenburkhardt.com

- the acquisition either gives rise to money laundering or the financing of terrorism as a matter of fact or it gives reason to fear such development; or
- the acquirer lacks the required financial soundness.

See question 20 regarding the meaning of the terms 'control' and 'substantial holding'.

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

According to our experience, this mostly depends on the relevant jurisdiction. As regards certain jurisdictions, BaFin's concerns seem to be particularly serious. From a technical point of view, for example, for foreign non-EU acquirers (having no registered office in an EU member state) the period within which the supervisory authorities can review the submitted documents and prohibit the transaction amounts to a maximum of 90 days. For acquirers from an EU member state the maximum assessment period amounts to only 80 days.

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

The examination programme of the supervisory authority regularly confines itself to reviewing the documents submitted by the acquirer. The supervisory authority can, however, request additional information or documents and make further inquiries, if need be. This is often the case meaning that in praxis procedures last much longer than anticipated by the law as described above.

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

Reporting duties are set forth in the Ownership Control Ordinance pursuant to which the acquirer has to provide, inter alia, the following information to BaFin:

- personal details of the acquirer in the case of legal entities, including, if relevant, their group structure and ownership or control;
- information regarding reliability of the acquirer (eg, whether the managing directors of the acquirer or its parent company or the beneficial owner, if an individual, are subject to criminal proceedings or had been prosecuted and convicted for criminal or administrative offences in the past);
- shareholding structures and description of whole group, if applicable;
- details on the acquirer's financial or economic situation;
- a statement setting out the financial arrangements of the acquisition; and
- an outline of the acquirer's strategic objectives and plans.

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

Technically, the authorities can prohibit the transaction within 60 days (assessment period) after it has received all information necessary. The authorities have a wide discretion regarding defining what information is required. In practice, this can lead to the effect of there being no reliable time frame. In addition, the ECB more or less starts new investigation when finally deciding in the case at hand. If the acquirer is not a banking or financial services institution regulated within the EU, the length of the procedure is not predictable.

Hungary

Zoltán Varga and Lili Galló

Nagy és Trócsányi

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 (the Resolution Act);
- Act CCXXXVII of 2013 on credit institutions and financial enterprises (the Banking Act);
- Act CXXXIX of 2013 on the Hungarian Central Bank (the 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 (the 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 CXXXVI of 2007 on the Prevention of Financing Money Laundering and Terrorism, Act CXXXVIII of 2007 on Investment Firms and Commodity Dealers, and on the Regulations Governing their Activities, Act CXXXVIII of 2007 on Investment Service Providers, Act CCXXXV of 2013 on Certain 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, 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, one of which is 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 per cent 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 the 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.

The other element, laid down in Act CXXXVII 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 state's stake in the Hungarian banking system. The current state ownership in credit institutions is around 50 per cent. Following the restructuring of the distressed MKB Bank according to the Resolution Act the temporary state interest terminated and the ownership of the bank has been acquired by private investors.

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, financial enterprise or investment enterprise, or the parent company has a holding in such an institution, or if the credit institution's parent company is a financial holding company. In the above cases the companies are subject to supervision on a consolidated basis, which basically 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 that qualify as subject to the supplementary supervision – 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 entitled to perform exclusively the following activities:

- activities auxiliary to financial services (currency exchange activities; operation of payment systems; money processing activities; financial brokering on the interbank market; credit consultancy services);
- insurance mediation services;
- securities lending or borrowing, acting as nominee for shareholders, pursuant to Act CXXXVIII of 2007 providing investment services, 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 in custody 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 challenges to other EU countries. In line with the decision of the Basel Committee on Banking Supervision, the Central Bank will have a key role in facilitating and supervising that banks refill their liquid reserves and reach 70 per cent by 2016 and 100 per cent by 2019. The Central Bank is also expected to keep a close eye on internal audit systems and company-level management.

In terms of the purpose of the recent reform, the Central Bank will carry out more efficient macroprudential and microprudential supervision, thus it must take measures to prevent excessive lending, mitigate systematic liquidity risks, operate the countercyclical capital buffer and reduce the probability of systemically important financial institutions defaulting. Moreover, the Hungarian government is decreasing the volume of the bank levy in 2017 to boost the lending of the credit institutions.

Another challenge arises from the evolving digitalisation trends in the banking sector such as maintaining digital payment services, exposure to cybercrime and dealing with the accumulation of big data.

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 three months. In this period the Central Bank has the power to carry out trial transactions and to conduct direct inquiries or thematic investigations. 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.

Also it should be noted, the European Banking Authority has issued its Single Rule Book, which aims to provide a single set of harmonised prudential rules that institutions throughout the EU must respect. Moreover, it intends to ensure uniform application of Basel III in all member states. It aims to close regulatory loopholes and thus contribute to a more effective functioning of the single market.

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 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.

In the event of a bank violating the laws concerning it, the Central Bank will consider taking measures (eg, calling upon the bank to take the necessary reparatory steps, requiring 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 said 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 violate 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 address the issue to the European Banking Authority.

If the Central Bank considers that the continuance of the 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 2017 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 market of mortgage lending, risks threatening the liquidity of certain financial institutions and handling (eliminating) 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 European-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 the regulation of the money, capital and insurance market if the objective of resolution has not been accomplished by way of the resolution actions applied by the Central Bank. Based on the notification in his or her decision the minister in charge of the regulation of the money, 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 basis of 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 via 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.

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 and 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; they will 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 member states of the European Union and in third countries.

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 16 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 mentioned 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.

Capital requirements

15 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, so as 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 575/2013/EU; 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 575/2013/EU 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.

16 How are the capital adequacy guidelines enforced?

Banks have certain notification requirements 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 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.

17 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 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 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.

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

The Banking Act does not explicitly define the concept of insolvency and does not specify which requirements must be violated or to what extent for a bank to be considered 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. The Central Bank may, from the submission of the request for liquidation, order prohibition of all payments until the starting date of the procedure (the date of the promulgation of the order in the Official Gazette).

The court must then arrange a meeting to negotiate a settlement at the request of the debtor bank. The court will confirm this settlement by an order only if solvency of the debtor bank will be restored through the settlement and the settlement is in conformity with legal regulations. The permission of the Central Bank is also required for approval of the settlement 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 about, 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 effect of the order on liquidation applies to the entire EU territory.

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

19 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 all member states of the European Union and the EEA. 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.

Ownership restrictions and implications

20 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 which makes it possible to exercise a significant influence over the management of that undertaking.

In respective 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.

21 Are there any restrictions on foreign ownership of banks?

There are no restrictions.

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

Once the permission described in question 20 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.

23 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 20).

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 basically not the owners' responsibility. Therefore, if the amount of a

Update and trends

The Hungarian state – through the state-owned Corvinus Investment Ltd and the European Bank for Reconstruction and Development, in agreement with Erste Group Bank AG – acquired 15 per cent ownership share respectively in Erste Bank Hungary Zrt in 2016. The government's declared purpose with the investment is to promote the growth of lending activity and to assist in creating a stable background for the Hungarian banking system. The termination of the state interest shall be resolved by exercising predetermined sale and purchase options. The state may at any time sell the shares and Erste Group has the right to purchase the shares not earlier than five years from the acquisition date by the state.

Owing to the government's stated agenda, the credit institutions' special banking tax rate for 2017 and 2018 decreases from 0.24 per cent to 0.21 per cent and the previously introduced tax allowance for credit institutions is repealed, as well as favourable changes occurring in the calculation base of banking tax in 2017.

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.

24 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.

In the event of insolvency, basically the same measures and exceptional measures described in question 23 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 receivables of the owners 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 18).

Changes in control

25 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 20.

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.

26 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.

27 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 gives only 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 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.

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

When applying for authorisation for acquisition, 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 constitutional documents 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;
- if other than a natural person, a detailed description of the applicant's ownership structure, and if the applicant is subject to supervision on a consolidated basis a detailed description of these circumstances; furthermore the consolidated annual accounts 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.

29 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.

NAGY & TRÓCSÁNYI

Zoltán Varga **varga.zoltan@nt.hu**
Lili Gallo **gallo.lili@nt.hu**

Ugocsa utca 4/B
Budapest 1126
Hungary

Tel: +36 1 487 8700
Fax: +36 1 487 8701
www.nt.hu

India

Feroz Dubash, Sonali Mahapatra and Shruti Zota

Talwar Thakore & Associates

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, we have focused 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.

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. The CA 2013 and the Listing Regulations also provide exemptions to certain types of transactions from such compliance. For example, a transaction between a company and its WOS is exempted from the requirement of obtaining board or shareholder approval under the 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 the 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

In order to promote financial inclusion, new specialised banking licences (such as payments bank licences and small finance bank licences) are being granted by the RBI. This sector is currently evolving and from a regulatory perspective, it will be interesting to see how these specialised banks fit within the larger regulatory framework applicable to banks. The regulatory and supervisory resources would also have to be reoriented to ensure effective supervision and flexibility for operation of specialised banks.

Asset quality

The quantity of net non-performing assets (NPAs) of Indian banks has been increasing significantly. The RBI has taken various regulatory measures to revitalise stressed assets in the economy. These, among others, include issuing a 'Framework to Revitalise the Distressed Assets in the Economy' (which provides for early recognition of stressed assets, sale of such assets and steps for resolution or recovery of distressed assets) and a strategic debt restructuring mechanism, (which allow lenders to convert their debt to equity, gain control in the borrower and transfer the ownership to a new promoter).

To further strengthen the ability of Indian banks to deal with stressed assets, the RBI has recently revised the existing framework for revitalisation of stressed assets. This largely includes relaxations from the existing mechanism such as reduction in the divestment limits under the strategic debt restructuring mechanism, incentives for adherence to timelines under the joint lenders forum mechanism, etc. The RBI has also introduced a 'Scheme for Sustainable Structuring of Stressed Assets' (S4A), which provides for classification of loans as sustainable and unsustainable and allows banks to convert the unviable portion of debt into equity.

Additionally the Enforcement of Security Interests and Recovery of Debts Laws and Miscellaneous Provisions Amendment Act 2016 amends various legislations dealing with enforcement of security interests with an aim to harmonise the steps for enforcement and make the process more time-efficient.

However, these reforms are fairly new and their effectiveness will need to be seen over time.

Priority sector lending

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 heavy lending to such sectors adversely affects profitability of banks.

Separately, the agricultural sector (one of the main sectors for priority lending) has a high amount of NPAs. The new measures introduced by the RBI to reduce stressed assets, as mentioned above, do not take into account agricultural NPAs.

Technology

Banks will need to take certain sustainability measures because of the increasing competition from non-financial institutions and the entry of specialised banks. These measures may include development of new electronic payment systems, offering multiple products through such systems and enhancing safety and security of payment transactions.

Enforcement of the new insolvency regime

Previously, the framework governing corporate insolvency and personal bankruptcy in India was set out under various legislations. This encouraged forum shopping and caused delays in completion of the insolvency process. In order to streamline the existing framework, the Insolvency and Bankruptcy Code (Code) has been partly notified. As at the end of December 2015, the provisions in relation to insolvency resolution and liquidation of corporate persons (other than voluntary liquidation and the fast-track procedure for liquidation of smaller entities) are in force. In an attempt to combat the increasing level of leveraged debt and non-performing assets, the Code seeks to provide creditors with an efficient and time-bound process for realising debt. For efficient implementation of the insolvency resolution process, the Code has introduced an institutional framework comprising an insolvency regulator (ie, the Insolvency and Bankruptcy Board of India), adjudicating authorities (ie, the National Company Law Tribunal (NCLT) and the National Company Law Appellate Tribunal, Debt Recovery Tribunal, Debt Recovery Appellate Tribunal), insolvency professionals, agencies and information utilities.

With the new regime in place, all corporate insolvency matters will now be shifted to the NCLT for adjudication. With the current strength

of the NCLT and the average time taken for resolution of each case, efficient resolution of all such matters may be adversely affected. The first few insolvency cases are under way and are being keenly watched to see how the process will work and which stakeholders stand to benefit. Further, once fully notified, the Code will cause an overhaul of the existing insolvency regime, posing a challenge for the regulator, banks and the adjudicating authorities to adapt and implement the changes appropriately. Despite these teething issues, the new regime focuses on dealing with financial distress in a cohesive and comprehensive manner and is aimed at creditor protection.

Implementation of demonetisation measures

In November 2016, the GOI banned certain high-value currency notes. As a result, there has been a substantial increase in cash deposits made with banks. The RBI has taken various steps to manage the increasing liquidity and prevent destabilisation in the economy, such as imposing an incremental cash reserve ratio of 100 per cent of the deposits and issuing additional instruments (such as bonds) to park liquid cash. Demonetisation has vastly impacted the small and medium-sized enterprises, which often deal in cash. Such enterprises are likely to resume payments after a lag. Highly cash-dependent businesses are struggling to make payments and this might impact the pool of stressed loans.

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, thus 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?

Recently, there has been a further push for financial inclusion as the GOI has acknowledged the need to make banking services available to the entire population. As discussed earlier, 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 post the demonetisation in November 2016 and the Budget 2017-18 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.

The Foreign Investment Promotion Board (FIPB) is also likely to be abolished and a new framework will be created for foreign investment in India. Necessary amendments to that effect are still awaited. Major changes to FDI in this sector are not, however, expected.

Supervision

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

The RBI 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 the banks' books of accounts, loan 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 thereby requiring 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
- half-yearly 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 such review, the RBI issues directions to banks for them to comply with capital adequacy norms (see question 17). 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 anti-money laundering (AML) norms by banks: In 2013, investigations carried out by the Cobrapost media portal exposed serious violation of KYC/AML norms leading to imposition of a total fine of 500 million

rupees by the RBI on 22 banks. To combat such 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/AML policy as violations have often been attributable to the staff's lack of familiarity with, and ability to monitor compliance with, the KYC/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; and
- 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.

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 RBI issued a report in 2014 which envisaged that while all banks will eventually prepare recovery/resolution plans (RRPs) to deal with distress or failure and in the initial stages, only domestically systemically important banks (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, or has been prohibited from accepting fresh deposits, or 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, or 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 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.

The 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 as well as 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.

The 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 the 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.

Capital requirements

15 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 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 I capital, amongst others, consists of paid-up capital, stock surplus, statutory reserves and Tier II 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.

Sr No.	Type	Ratio
1.	Capital conservation buffer	2.5 per cent
2.	Counter cyclical capital buffer	0–2.5 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 will categorise some systematically important financial institutions as D-SIBs under different buckets, which will be required to maintain this additional capital. At present, two banks, namely State Bank of India and ICICI 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.

16 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 17).

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.

17 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, amongst 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.

18 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 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.

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 which the members, depositors and other creditors have in or against the banking company before its reconstruction to such 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.

19 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 15). It is envisaged that the RBI may impose similar requirements for small finance banks.

The RBI, through its draft guidelines, has proposed introducing a net stable funding ratio (NSFR) to ensure that banks maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It intends to make the NSFR applicable to banks from 1 January 2018.

Ownership restrictions and implications

20 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 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 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 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 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/NOFHC is also required to hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which 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 25).

The RBI is likely to issue separate guidelines for small sector banks in relation to entities having a controlling interest.

21 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

Update and trends

Demonetisation measures
The GOI in November 2016 declared it was replacing 500 rupee and 1,000 rupee notes and has released new currency notes of denominations 2,000 and 500 rupees to replace them. This measure was undertaken by the government in order to curb the increasing quantity of black money in the country and its use in terror financing, corruption, etc. The GOI has proposed to take additional measures in order to further reduce black money in 2017 including more stringent scrutiny over the cash deposits with banks, additional disclosures at the time of making such deposits etc.

Move towards a cashless economy
In light of the demonetisation measures undertaken by the GOI, there has been a strong push towards digital transactions over cash payments and a significant increase in the use of mobile wallets, online payments systems and cashless transactions has been observed. In order to catalyse this further, the GOI has undertaken and further proposes to undertake multiple measures to promote cashless transactions including tax benefits and differential pricing for digital payments. In addition, infrastructure to promote cashless transactions both in rural and urban areas is being set up through the use of existing government initiatives. However, due to the vast areas of unbanked sectors and the lack of internet connectivity, these measures have had smaller success. Additionally, the success of these measures may be effectively checked only after the cash supply in the economy post-demonetisation normalises.

New foreign investment framework
After undertaking an extensive liberalisation of foreign investment in India in the past few years, including in certain strategic sectors like defence and infrastructure, the finance ministry of the GOI in the Budget 2017–18 has proposed the abolition of the FIPB being the body responsible for all approvals for foreign investment in sectors that fall under the government approval route. The abolishment of the FIPB is said to be a first in a series of measures to implement a new foreign investment regime that will increase the inflow of foreign investment by making it more investor-friendly and efficient. A roadmap for the same will be announced in the next few months.

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 higher holding for a single entity under exceptional circumstances such as 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, which commenced operations in India after 2010 and which 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.

22 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.

23 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 27). 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 25. 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.

24 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).

Changes in control

25 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 20, 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.

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.

26 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 regulatory process for obtaining a banking licence are similar to those applicable to domestic players. The approval requirement discussed in question 25 applies 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 bank were a listed entity, trigger the Indian takeover regulation 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, 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.

27 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.

28 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 Inward Remittance Certificate. Upon the issuance of shares, the same must be reported by the issuing company within 30 days of issuance as per the 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 the form FC-TRS within 60 days of the receipt of remittance.

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

Any foreign investment in a private sector bank between 49 per cent and 74 per cent of the stake of the banking company will require prior approval from the FIPB. FIPB approvals usually take about 12 to 18 weeks to process. 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.

TT&A
Advocates and Solicitors

Feroz Dubash **feroz.dubash@tta.in**
Sonali Mahapatra **sonali.mahapatra@tta.in**
Shruti Zota **shruti.zota@tta.in**

3rd Floor, Kalpataru Heritage
127 Mahatama Gandhi Road
Mumbai 400 001
India

Tel: +91 22 6613 6900
Fax: +91 22 6613 6901
www.tta.in

Indonesia

Emalia Achmadi, Robert Reid and Aziizah Soerjadi
Soemadipradja & Taher

Regulatory framework

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

The Financial Services Authority (OJK) is now the responsible authority for the integrated supervision of the entire financial services industry in Indonesia, including the banking sector. OJK has the right to regulate, investigate and, when in breach of the regulations, impose sanctions on financial services players .

Bank Indonesia (BI) is responsible only for the monetary sector and has the single objective of achieving and maintaining stability of the rupiah, which mainly involves taking action to maintain stability of the rupiah's value for the purchase of goods and services; and exchange rate against other currencies.

On 15 January 2016, OJK launched its master plan for 2015–2019 for the financial services sector, which will focus on achieving the following three main targets:

- optimising the role of the financial services sector to foster improvement in national economic growth;
- maintaining financial system stability as the basis for sustainable development; and
- realising society's financial independence, and supporting efforts to enhance national development.

Each of the above main targets is then outlined into a number of strategic work programmes covering the entire financial services sector.

In its capacity as a member of G20 and other international forums (such as the Financial Stability Board and the Basel Committee on Banking Supervision (BCBS)), Indonesia is committed to adopting the recommendations generated by such forums. One of the recommendations issued by BCBS and implemented in the Indonesian banking sector by OJK is a framework for standards of bank capitalisation.

In 2015, BI also issued BI Regulation No. 17/3/PBI/2015 on the Obligation to Use Rupiah within the Territory of the Republic of Indonesia (the Current Currency Regulation). The Current Currency Regulation follows Law No. 7 of 2011 on Currency (the Currency Law) and provides further, tighter regulations on the requirement to use rupiah for financial transactions within Indonesia, and aims to limit the available exemptions. In accordance with the Currency Law, as further expanded by the Current Currency Regulation, each transaction involving settlement of financial obligations and other financial transactions in Indonesia must use rupiah (subject to certain exceptions). Importantly, the Current Currency Regulation now explicitly states that the obligation to use rupiah includes cash as well as non-cash transactions. All businesses are also required to use rupiah to quote prices for their goods and services, and the Current Currency Regulation prohibits the use of foreign currency for such purposes.

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

The Indonesian banking sector is predominantly regulated by Law No. 7 of 1992 on Banking as amended by Law No. 10 of 1998 (together, the Banking Law). The Banking Law accommodates the existence of a dual banking system in Indonesia (sharia banking and conventional banking). The sharia banking system is specifically regulated by Law No. 21 of 2008 on Sharia Banking. BI regulations and OJK regulations further regulate the banking industry, both for conventional and sharia banking, including regulations on rural banks.

3 Which regulatory authorities are primarily responsible for overseeing banks?

OJK is the primary regulatory authority responsible for overseeing and supervising financial services institutions, including banks, in Indonesia. For large and suspicious transactions, OJK will coordinate with the Financial Transaction Reporting and Analysis Centre.

In carrying out its responsibilities, OJK will coordinate with BI in relation to the monetary sector and will coordinate with the Indonesia Deposit Insurance Corporation (LPS) in relation to the guarantee of bank customer deposits and the management of failing 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.

Protection of bank customers' deposits is provided by Law No. 24 of 2004 as amended by Law No. 7 of 2009, which regulates LPS and its role in the banking industry (LPS Law). LPS is an independent institution that guarantees customer deposits and actively maintains the stability of the banking system. All banks in Indonesia are required to participate, including Rural Banks, but not including rural credit agencies. The maximum deposit that is guaranteed for each bank customer is a maximum of 2 billion rupiah. Deposits guaranteed by LPS include giro and deposit accounts, deposit certificates, savings or their equivalents. LPS collects premiums and participation fees from all participant banks.

One objective of LPS is to maintain stability in the banking system. Therefore, under the LPS Law, LPS is authorised to rescue a failing bank (that is, a bank that is facing serious financial difficulties) by taking control over, restructuring and continuing its business. However, a bank in danger of ceasing operations may no longer be restructured by OJK. In such a case, subject to certain provisions under the LPS Law, LPS may take the following actions:

- supervise, manage and take ownership of the assets already owned, or which will be owned, by the bank or the obligations of the bank;
- temporarily invest capital;
- sell or transfer the assets of the bank without the approval of the debtor customers or the bank obligations, without the approval of the creditor customers;
- assign the management of the bank to another party;
- merge or consolidate with other banks;
- assign the ownership of the bank to another party; and
- review, cancel, terminate or change any binding contract on the bank which, according to LPS, is detrimental to the bank.

Subject to certain requirements under the LPS Law, LPS must sell all the shares of the rescued bank within a period of no longer than two years (for a rescued bank that did not pose a systemic risk if it had not been rescued) or three years (for a rescued bank which would have posed a systemic risk had it not been rescued).

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 defines 'affiliated parties' as including:

- members of the board of commissioners (BoC), supervisors, board of directors (BoD) or their proxies, officers, or employees of a bank;
- members of the board of managers or board of supervisors or their proxies, or officers or employees of a bank that is in the form of a cooperative;
- parties providing their services to a bank, including public accountants, valuers, legal consultants and other consultants; and
- parties who are deemed by BI to be able to influence bank management, including shareholders and their families, as well as the families of members of the BoC, the BoD, supervisors and managers.

However, BI Regulation No. 7/3/2005 as amended by BI Regulation No. 8/13/PBI/2006 on Legal Lending Limits for Commercial Banking (Legal Lending Regulation), uses the term 'related party' (instead of 'affiliated party' as defined above) in relation to certain limitations applied to banks in their provision of portfolio funding.

Under the Legal Lending Regulation, the maximum limit of the total funding portfolio of a bank to its related parties is 10 per cent of its capital, which must be approved by the BoC of the relevant bank.

The Legal Lending Regulation specifically defines the related parties of a bank as, among others:

(i) an individual, company or legal entity controlling the bank;
(ii) a company or legal entity that is controlled by the bank;
(iii) an individual or company/legal entity controlling the company referred to in point (ii);
(iv) a company in which:
  - an individual, company or legal entity referred to in point (i) acts as controller;
  - an individual, company or legal entity referred to in point (iii) acts as controller;
(v) any members of the BoC or BoD and executive officials of the bank; and
(vi) parties who have family relations with a bank controller, members of the BoC or BoD and executive officials of the bank.

(For information on what constitutes 'control' of a bank, see question 20.)

If the bank is a public company or issuer, it will also be subject to requirements under Capital Market and Financial Institution Supervisory Agency Regulation No. IX.E.1 on Affiliated Transactions and Conflicts of Interest in Certain Transactions.

The most recent OJK Regulation No. 29/POJK.05/2014 on the Implementation of Business Activities of Finance Companies (POJK No. 29/2014) regulates the business activities of finance companies in the following specific areas:

- investment finance, by way of:
  - finance lease;
  - sale and leaseback;
  - factoring with recourse;
  - purchase with payment by instalments;
  - project finance;
  - infrastructure finance; or
  - other finance activities approved by OJK;
- working capital finance, by way of:
  - sale and leaseback;
  - factoring with recourse;
  - factoring without recourse;
  - capital facility; or
  - other finance activities approved by OJK; and
- multipurpose finance, by way of:
  - finance lease;
  - purchase with payment by instalments; and/or
  - other finance activities under OJK approval.

POJK No. 29/2014 also prohibits financial institutions from carrying out any of the following activities:

- the withdrawal of funds directly from the public in the form of giro, deposit, savings and/or other equivalent form;
- the provision of any kind of guarantee relating to the fulfilment of obligations of another party;
- the issuance of promissory notes, except as security for loans to banks that become creditors; or
- activities that cause or force other financial institutions under the supervision of OJK to violate or evade laws or regulations.

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

The principal regulatory challenge facing the banking industry is the implementation of Basel III throughout the Indonesian banking system. Basel III is a comprehensive set of reform measures developed by BCBS to strengthen the regulation, supervision and risk management within the banking sector, with the aim of:

- improving the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source;
- improving risk management and governance; and
- strengthening banks' transparency and level of disclosure.

The above reform is aimed at two complementary levels:

- micro-prudential regulation, intended to help make individual banks more resilient; and
- macro-prudential regulation, intended to address system-wide risk that can build up across the banking sector over time.

As part of Indonesia's commitment to Basel III, OJK is endeavouring to ensure that the liquidity framework (ie, the Net Stable Funding Ratio (NSFR)) provisions are implemented for what are known as 'BUKU 3' commercial banks (that is, those banks with Tier 1 capital of 5 trillion rupiah up to 30 trillion rupiah), 'BUKU 4' commercial banks (that is, those banks with Tier 1 capital of more than 30 trillion rupiah) and foreign banks. NSFR is an indicator used to calculate a bank's long-term liquidity risk by comparing the amount of stable funding available at the bank with the amount of stable funding required at the bank.

7 Are banks subject to consumer protection rules?

Bank customers are given protection under the general consumer protection law (Law No. 8 of 1999 on Consumer Protection). In addition, banks are subject to OJK Regulation No. 1 of 2013 on Consumer Protection in the Financial Services Sector (Regulation No. 1), which is administered by OJK. In 2014, OJK released a circular letter (Circular Letter of OJK No. 2 of 2014 on Services and Settlement of Consumer Complaints on Financial Services Business Actors) to implement Regulation No. 1 (collectively the Consumer Protection Regulations).

According to the Consumer Protection Regulations, Banks are required to resolve all complaints received from customers or representatives of customers, and must establish a special work unit or assign a particular employee (for example, a member of the BoD) who will be responsible for handling and resolving customer complaints.

The Consumer Protection Regulations require that settlement of a customer complaint can be either in the form of a written apology or compensation.

The relevant bank must resolve customer complaints within 20 business days after the date of receipt of a written complaint. In certain limited circumstances, banks may extend the period by another 20 business days.

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

It is anticipated that OJK will issue a series of further regulations designed to achieve the following targets:

- optimising the role of the financial services sector to support national economic growth;
- maintaining financial system stability for sustainable development; and
- enhancing society's financial independence, and supporting efforts to enhance development.

In 2017, OJK plans to issue the following regulations:
- an implementing regulation to Law No. 9 of 2016 on Prevention and Management of a Financial System Crisis, which is intended to regulate recovery plans for systemic banks, including a banking restructuring programme, and improvements in bank supervision (Law No 9/2016);
- regulations regarding NSFR; and
- regulations regarding sharia banks which will build on the previous OJK regulations.

Supervision

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

OJK has authority to supervise banks by way of off-site supervision and on-site supervision.

Off-site supervision

Off-site supervision is supervision through regular reports delivered to OJK by banks on their business activities. These reports include periodic reports (daily, weekly and monthly), corporate governance reports, annual reports, profit and loss statement reports and examination reports.

If it becomes necessary (in the determination of OJK):
- banks are also required to give any kind of information requested by OJK for the purpose of oversight;
- OJK may conduct examinations of any other relevant parties, including parent companies, subsidiaries, connected parties, affiliated parties and bank debtors; and
- OJK may assign another party to conduct an examination on its behalf.

On-site supervision

On-site supervision may take the form of: (i) general examination and special examination of a bank's financial condition; (ii) monitoring the bank's compliance with prevailing regulations; and (iii) ascertaining whether a bank engages in unsound practices that may jeopardise its sustainability.

OJK's three supervisory classifications are: routine, intensive and special.

All banks are subject to annual routine supervision. If there is a real or immediate threat to a bank's business, the bank will be placed under OJK's intensive supervision. OJK can take various measures against a bank under intensive supervision, including:
- instructing the bank to report on specific issues;
- increasing work plan assessments and adjusting them to meet specific targets;
- instructing the bank to submit a work plan to overcome the threat to the bank's business; and
- placing an on-site supervisor or assessor from OJK (if necessary).

If the bank's financial condition and management fails to improve, or OJK finds the bank's business continues to be threatened while under intensive supervision, then the bank will be placed under special supervision. During special supervision, the intensity of direct examination may escalate, especially in terms of assessing performance based on existing commitments and the work plan submitted by the bank's management to BI.

As of March 2016, OJK has implemented the following:
- compliance-based supervision:
  - supervision of banks' compliance with regulations relating to operation and management to ensure they have been operating and managed in accordance with prudential principles.
- risk-based supervision:
  - supervision using a risk-based strategy to enable bank supervisors to detect significant risks at an early stage and to take timely preventive action.

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

OJK has the right to impose sanctions in accordance with the law. Therefore, if a bank is not fully compliant with the relevant regulations, OJK may impose different sanctions for each violation, including administrative sanctions ranging from fines, business suspension and ultimately, licence revocation.

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

Some of the most common enforcement issues in Indonesia arise out of: (i) the lengthy process to validate banks' financial statements and other information after the banks have submitted their reports to OJK; and (ii) standardisation of the operational procedures of OJK officials in their supervisory dealings with the banks.

OJK will closely monitor banks and will penalise them for breaching regulations, as required. Since OJK took over the role of banking supervision in 2014 it has been expanding the number of its officers and improving their training in order to address the above enforcement issues.

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?

Banks may come under the supervision of LPS where a bank is determined to be a 'failing bank' with systemic or with non-systemic impact. In the case of a failing bank with issues that may have systemic impact, a Financial System Stability Committee (formed in accordance with Law No 9/2016) must determine the steps required to deal with the potential systemic impact before handing over supervision of the bank to LPS.

Based on the official LPS website, following the Bank Century case in 2008, there have been no systemic or non-systemic failing banks rescued by LPS. However, 68 rural banks and one conventional bank were liquidated (or are in the process of liquidation). The interests of the various stakeholders (depositors, shareholders, creditors and employees) in the case of a bank liquidation will be treated as follows:
- depositors' rights over their deposits will be guaranteed a maximum amount of 2 billion rupiah by LPS;
- any right, title, management interest or other interest of the bank's shareholders, directors and commissioners in the failing bank will be released to LPS;
- bank creditors will receive payment of the bank's liabilities from any disbursements and collection of creditors' receivables by the liquidation team; and
- the payment of employee salaries will be dealt with by the liquidation team or LPS (as the case may be).

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?

Once a bank is under the supervision of LPS as a systemic or non-systemic rescued bank, a specific shareholders' resolution of the failing bank is required to enable LPS to supervise the bank's management. The bank's management and directors will then have no further role or authority, unless the BoC, the BoD and employees of the failing bank are authorised by approval or assignment by LPS to carry out specific legal actions relating to the bank's assets and obligations. The BoC, the BoD and employees of the failing bank are obliged to provide any information required by the liquidation team.

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

If a bank failure is caused by the fault or negligence of the BoD, each member of the BoD is jointly and personally responsible for all outstanding liability of the failed bank, subject to certain statutory exceptions.

There are no specific regulations that would make bank managers liable for bank failure.

Capital requirements

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

The minimum capital requirements for commercial banks under the relevant OJK regulations require banks to satisfy the following capital requirements:

- capital quality increase through a change of the capital instrument requirements and capital components in accordance with Basel III;
- minimum capital requirements in accordance with the relevant risk profile of the bank;
- a capital adequacy ratio, which contains a tier 1 capital ratio of at least 6 per cent of risk weighted assets (ATMR) and a common equity tier 1 capital ratio of at least 4.5 per cent of ATMR, either individually or consolidated with the banks' subsidiaries; and
- providing additional capital as a buffer to cover the obligation to have capital adequacy according to the relevant risk profile. Further, the additional capital must consist of:
  - a capital conservation buffer of 2.5 per cent of the ATMR (note that this requirement only applies to banks that are classified as BUKU 3 and BUKU 4 commercial banks – see question 6 for a description of these classifications);
  - a countercyclical buffer of zero per cent up to 2.5 per cent of the ATMR (which will be determined by OJK); or
  - capital surcharge for systemic banks of 1 per cent to 2.5 per cent of the ATMR (or higher as determined by OJK).

16 How are the capital adequacy guidelines enforced?

Banks must maintain their minimum capital in accordance with ATMR percentages, which vary depending on a bank's risk profile. Each risk profile differently reflects a bank's general soundness and its ability to deal with significant negative changes to business conditions, among other external factors. Specifically, banks with a:

- level 1 risk profile (banks considered to be very healthy and highly capable of dealing with significant negative changes to business conditions, amongst other external factors) must maintain at least 8 per cent of ATMR (there being no maximum);
- level 2 risk profile (banks considered to be healthy and capable of dealing with external factors) must maintain at least 9 per cent but under 10 per cent of ATMR;
- level 3 risk profile (banks considered to be sufficiently healthy and capable of dealing with external factors) must maintain at least 10 per cent but under 11 per cent of ATMR; and
- level 4 risk profile (banks considered to not be sufficiently healthy or capable of dealing with external factors) or a level 5 risk profile (banks considered to be unhealthy and incapable of dealing with external factors) must maintain at least 11 per cent but no more than 14 per cent of ATMR.

OJK is also authorised to determine a larger amount of minimum capital if it considers a commercial bank to have potential losses that would require it to have larger capital.

Banks must self-assess their capital adequacy in accordance with their risk profile, and maintain their capital adequacy by conducting an Internal Capital Adequacy Assessment Process (ICAAP). In completing an ICAAP, banks must also determine strategies to maintain a certain percentage of ATMR (within the required range), taking into account their size and characteristics, and the complexity of their activities.

OJK may conduct a supervisory review and evaluation of the results of an ICAAP, and request a bank to alter its ICAAP. Banks are also required to regularly submit reports to OJK on implementing ICAAP outcomes.

Every foreign bank with a branch office in Indonesia must maintain a minimum of capital equivalency maintained assets (CEMA). CEMA are the business funds allocated to such a branch office, which must be fully paid up. As of the sixth day of each month, such bank's CEMA must be 8 per cent of its total liabilities for each preceding month, which in any case must equal at least 1 trillion rupiah. Further, such banks must submit monthly reports to OJK evidencing compliance with this requirement and identifying certain financial assets including, for example, marketable securities issued by the Indonesian government, which must be free of any claims or encumbrances.

If a bank, foreign or otherwise, violates any of the above requirements, OJK may:

- warn the bank in writing;
- prohibit the bank from transferring profits to the bank's overseas branches;
- prohibit any expansion of the bank's business activities;
- suspend certain of the bank's business activities;
- prohibit the opening of an office network;
- downgrade the banks' financial health rating; or
- include the bank's officers or shareholders in a list of persons prohibited from becoming shareholders of or holding management positions in a bank.

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

Under the Banking Law, if a bank becomes undercapitalised, then OJK may force the bank's shareholders to carry out any of the following actions:

- inject capital;
- replace the bank's BoD and BoC;
- nullify the non-performing credit or sharia financing and calculate the bank's losses against its capital;
- merge or consolidate with other banks;
- sell the bank to a buyer who intends to acquire all liabilities;
- hand over the management of part of or all of the bank's activities to other parties; and
- sell part of or all of the bank's assets or liabilities to other banks or parties.

If the above actions are insufficient to overcome the bank's undercapitalisation, then OJK may revoke the relevant bank's business licence and instruct the BoD to convene a general meeting of shareholders (GMS) resolving the dissolution of the bank and the formation of a liquidation team.

If commercial banks do not fulfil the minimum tier 1 capital amount, they may be required to restrict their business activities as follows:

- cease to conduct business as a foreign exchange commercial bank;
- limit the funding per debtor and/or per debtor group with the maximum amount of 500 million rupiah, not including BI Certificates and funding to the government and banks;
- limit the maximum deposit of any third-party funds that may be collected by them to 10 times the tier 1 capital amount; and
- close down their entire office network located outside the provincial territory of their head office.

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

Under Law No. 37 of 2004 on Bankruptcy and Suspension of Obligations for Payment of Debts (Bankruptcy Law), if a bank becomes insolvent, then OJK may request a suspension of debt payment obligations at the relevant commercial court.

If the bank is categorised as a failing bank, OJK may revoke its business licence. For a rescued or liquidated failing bank, please see question 12.

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

Please see question 15.

Capital adequacy requirements are still being adjusted in accordance with Basel III and will be gradually enhanced in accordance with the implementation of Basel III until 1 January 2019.

Ownership restrictions and implications

20 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?

BI Regulation No. 14/24/PBI/2012 on Single Ownership of Indonesian Banks (Single Presence BI Regulation) provides that a controlling shareholder means a legal entity or individual or business group that owns:

- 25 per cent or more of the issued shares of a bank with voting rights; or

Update and trends

Throughout 2016, OJK was very active passing new regulations to support financial services stability, national economic growth and customer protection in Indonesia. OJK has issued 77 new regulations comprising: (i) 26 banking regulations; (ii) 31 capital market regulations; (iii) 18 non-banking financial services regulations; (iv) one customer education and protection regulation; and (v) one financial technology regulation.

In general, the new banking regulations target sharia rural banks, the soundness level of commercial banks, prudential principles for commercial banks, mandatory minimum capital requirements for commercial banks, and fit and proper testing for the main parties of financial services institutions.

To support the Indonesian government's Tax Amnesty Programme in 2016, particularly in its socialisation of the Tax Amnesty Programme to financial institutions and the public, OJK also issued:

- OJK Regulation No. 25/POJK.03/2016 on the Amendment of OJK Regulation No.27/POJK.03/2015 on Bank Business Activity in the Form of Trusts; and
- OJK Regulation No. 26/POJK.04/2016 on Investment Products in the Capital Markets Sector to support the Tax Amnesty Law.

In 2016, OJK was also active in its support for the development of technology in the financial industry in Indonesia and, in order to provide some guidance in this area, OJK issued Regulation No. 77/POJK.01/2016 on Technology-Based Fund-Lending Services. This regulation provides guidelines for financial institutions that conduct peer-to-peer lending businesses (fintech companies). A fintech company is required to have paid-up capital of 1 billion rupiah when registering its business with OJK, but is required to have paid-up capital of 2.5 billion rupiah when it applies for a business operating licence. The total amount of loans permitted to be taken out by a fintech company is limited to maximum of 2 billion rupiah. Given the interest in technology-based fund-lending services, especially among young Indonesians, fintech companies are perceived to be increasingly significant.

- less than 25 per cent of the issued shares of a bank with voting rights, but it can be proven that the shareholder concerned has control of the bank, either directly or indirectly.

The controlling party may only control one bank with exceptions for:

- the controlling party of two banks, each of which operates on different principles, that is, conventional and sharia principles; and
- the controlling party of two banks, one of which is a joint venture bank.

In addition to the above, BI Regulation No. 12/23/PBI/2010 on Fit and Proper Testing (F&P Test BI Regulation) and OJK Circular Letter No. 39/SEOJK.03/2016 on Fit and Proper Testing for Prospective Controlling Shareholders, Candidates for Members of Board of Directors and Board of Commissioners of Banks (F&P Test OJK Circular Letter) provide that control over a bank can be achieved by:

- holding 25 per cent or more of the shares of the bank, either individually or collectively;
- directly managing or influencing the policies of the bank;
- holding option rights in order to own shares which, if exercised, would allow the party concerned to own or control at least 25 per cent of the shares of the bank, either individually or collectively;
- cooperating or carrying out actions simultaneously to achieve a joint purpose to control the bank (acting in concert) with or without any written agreement with another party. That is, to 'collectively own or control' (or to have an option or any other rights to own) 25 per cent or more of a bank's shares, directly or indirectly, with or without written agreement;
- controlling one or more other companies that collectively own or control 25 per cent or more of the bank's shares;
- having the authority to approve or dismiss members of the BoC and BoD of the bank;
- indirectly influencing the bank's management or policies;
- controlling the bank's holding company; and
- controlling a party that has control as described in any of the above points.

Shares 'collectively owned or controlled' by a controlling shareholder include the shares owned by:

- another party whose voting right could be used or controlled by the controlling shareholder;
- a company that is controlled by the controlling shareholder;
- an affiliated party of the controlling shareholder;
- a subsidiary of a company that is controlled by the controlling shareholder;
- another party for the interest of the controlling shareholder (nominee shares) with or without written agreement;
- another party who requires an approval from the controlling shareholder for the transfer of the other party's shares; and
- another party, other than the shares described above, which are controlled by the controlling shareholder.

Further, OJK Regulation No.27/POJK.03/2016 on Fit and Proper Test for Primary Party of Financial Services Institution (together with F&P Test OJK Circular Letter, referred to as F&P Test OJK Regulation) provides that the controlling shareholder of a bank is required to obtain approval from OJK before it can act as a controlling shareholder.

21 Are there any restrictions on foreign ownership of banks?

The maximum foreign ownership in conventional commercial banks and commercial sharia banks is 99 per cent of the respective bank's paid-up capital. Foreign entities or individuals are not allowed to become shareholders of conventional rural banks or sharia rural banks.

Foreign ownership is also subject to OJK's approval and a foreign controlling shareholder (either an individual or a foreign legal entity) must satisfy the following requirements:

- it must support Indonesian economic development through the relevant bank;
- if it is a financial institution legal entity, it must obtain a recommendation letter from the financial supervisory authority in its originating jurisdiction; and
- it must have an investment rating above a required level, depending on the investment vehicle.

The general share ownership limitations described below are applicable to foreign ownership as well as domestic ownership.

Maximum share ownership for each shareholder in a conventional commercial bank is as follows:

- 40 per cent of the bank's capital for a legal entity in the form of a bank financial institution and a non-bank financial institution;
- 30 per cent of the bank's capital for a non-financial institution legal entity; and
- 20 per cent of the bank's capital for individuals.

The above limitations (excluding for individuals) are also applicable to sharia banks. For individuals, the limitation is 25 per cent of the sharia bank's capital.

The definition of 'individual' includes Indonesian citizens and foreign citizens.

In addition, based on BI Regulation No. 56/POJK.03/2016 on Share Ownership in Commercial Banks (Share Ownership Regulation), a legal entity in the form of a bank may own more than 40 per cent of the bank's capital provided that it is approved by OJK, having satisfied the following requirements:

- financial health rating or other equivalent rating for a foreign bank;
- adequate minimum capital in accordance with its risk profile;
- maintaining a Tier 1 capital ratio of at least 6 per cent of ATMR;
- if domiciled overseas, having the recommendation of the relevant bank supervisory authority in its originating jurisdiction;
- being a public company bank;
- having a commitment to purchase equity bonds issued by the relevant bank and a commitment to own the bank for a certain minimum period; and
- having a commitment to support Indonesian economic development through the relevant bank.

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

Once becoming a controlling party, the entity will be subject to general banking regulations applicable to bank controllers, including maintaining its commitment to develop healthy banking operations as required under the F&P Test BI Regulation as well as F&P Test OJK Regulation.

In its holding company functions, the controlling party must also directly consolidate and control all activities of the relevant bank's subsidiaries.

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

Other than the requirements under the F&P Test BI Regulation and F&P Test OJK Regulation, Indonesian banking law does not regulate specific duties and responsibilities of the controlling shareholder of a bank. Please see question 20 for information on controlling shareholders.

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

See questions 12 and 18.

Changes in control

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

Based on the BoD of BI Decree No. 32/51/KEP/DIR/1999 of 1999 on the Requirements and Procedures for Mergers, Consolidations and Acquisitions of Commercial Banks (BoD Decree No. 32/1999), in order to conduct a bank acquisition, the required approvals are from the bank to be acquired, the acquirer and also OJK. The required approvals for a bank acquisition include:

- approval from the BoC of both the bank to be acquired and the acquirer of the acquisition plan;
- approval from the GMS of the bank to be acquired;
- if the bank to be acquired is listed, then it must comply with the mandatory tender offer rules; and
- approval from OJK.

In addition to the above, the following issues need to be considered in any bank acquisition.

Fit and proper test

If the acquirer (either domestic or foreign) has 25 per cent or more of the issued shares with voting rights or less than 25 per cent of the issued shares with voting rights, but has control of the bank to be acquired, either directly or indirectly, then the acquirer is classified as a controlling shareholder. According to the F&P Test BI Regulation and F&P Test OJK Regulation, the potential controlling shareholder of the bank to be acquired must pass the fit and proper test held by OJK. The test will assess the integrity and financial capability of the potential controlling shareholder. The test is carried out by way of administrative assessment or interview.

Anti-monopoly considerations

Another relevant consideration when conducting a bank acquisition is Law No. 5 of 1999 on the Prohibition of Monopoly and Unfair Business Competition Practices (Competition Law). The Competition Law prohibits mergers, consolidations and acquisitions of shares that may result in a monopoly or unfair business practices.

According to the Competition Law and relevant subordinate regulations, any acquisition of a company or bank by one or more companies, directly or indirectly, by way of a share transaction resulting in change or transfer of control comes under the jurisdiction of the Business Competition Supervisory Commission (KPPU).

The Competition Law sets out certain thresholds for any merger, consolidation or acquisition transaction that will trigger mandatory notification to the KPPU as follows:

- the transaction will result in a company with an asset value exceeding 2.5 trillion rupiah;
- the transaction will result in a company with a sales value (turnover) exceeding 5 trillion rupiah; or
- in relation to transactions involving banks, the transaction will result in a bank with an asset value exceeding 20 trillion rupiah.

If two or more of the parties to a transaction are banks, then only the asset value test applies, so that mandatory notification must be made if the combined asset value exceeds 20 trillion rupiah. However, if only one party to a transaction is bank, the asset value decreases to a threshold of 2.5 trillion rupiah.

For the calculation of the assets and sales value, Government Regulation No. 57 of 2010 on Mergers, Consolidations and Acquisitions of Shares that May Result in a Monopoly or Unfair Business Competition Practices (Competition Government Regulation) adopts the 'vertical line method' (that is, from the ultimate controlling companies to the ultimate controlled companies). This method sets out that the threshold is calculated as follows:

- for mergers or consolidations: the combined asset or sales value of the (merged or consolidated) company and any company that directly or indirectly controls or is controlled by the (merged or consolidated) company; and
- for acquisitions: the combined asset or sales value of the acquirer company and the target company as well as any company that directly or indirectly controls or is controlled by the acquirer and the target companies.

The Competition Government Regulation has adopted two systems for notification:

- mandatory post-merger notification (Notification), in which all mergers, consolidations and acquisitions, which meet the relevant threshold level must give a mandatory Notification to the KPPU within 30 business days after their completion; and

S&T Advocates
Soemadipradja & Taher

Emalia Achmadi **emalia_achmadi@soemath.com**
Robert Reid **robert_reid@soemath.com**
Aziizah Soerjadi **aziizah_soerjadi@soemath.com**

Wisma GKBI, Level 9
Jl Jenderal Sudirman No. 28
Jakarta 10210
Indonesia

Tel: +62 21 574 0088
Fax: +62 21 574 0068
www.soemath.com

- voluntary pre-merger notification (also known as Consultation) in which a merger can be voluntarily notified to the KPPU before completion.

Although consultation is voluntary, the KPPU strongly encourages the parties to the transaction to engage in consultation in order to minimise the risk of loss in case KPPU were to conclude that the merger violates the Competition Law.

KPPU Regulation No.7 of 2011 on Guidelines for article 27 of the Competition Law on Share Ownership (KPPU Regulation) stipulates that a shareholder could be deemed to be in control of a company if the shareholder has the ability to exercise control over management, or has the ability to determine the direction, strategies and policies of the company, including the ability to:

- establish policies to take certain corporate actions;
- determine members of the BoD and the BoC;
- exercise the right of veto;
- access confidential information of the company;
- control the distribution of dividends; or
- implement any merger, consolidation or acquisition.

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

As explained in the response to question 21, there is no difference between the criteria for share ownership and shareholding determination between local shareholders and foreign shareholders. However, foreign share ownership is also subject to OJK's approval and a foreign financial institution controlling shareholder must satisfy the following requirements:

- if domiciled overseas, it must support Indonesian economic development through the relevant Indonesian bank;
- it must obtain a recommendation letter from the financial supervisory regulator in its originating jurisdiction; and
- it must have an investment rating above a required level, depending on the investment vehicle.

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

Please see questions 20, 21 and 26.

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

The filings required for an acquisition of control of a bank include:

- an acquisition plan must be submitted to BI in a notarial form; and
- an implementation report on the acquisition plan must be submitted to BI, together with a copy of the relevant deed of acquisition.

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

Based on BoD Decree No. 32/1999 and BoD of BI Decree No. 32/50/KEP/DIR/1999 on Requirements and Procedures for the Share Purchase of Commercial Banks, an acquisition will be approved (or rejected) within 30 days after OJK receives 'complete and accurate' application documents. There is considerable flexibility for OJK to satisfy itself that the submitted documents are 'complete and accurate', so the 30-day period is generally longer in practice. If OJK fails to announce its decision within this time frame (after it has declared the application to be 'complete and accurate'), then it is deemed to have approved the acquisition.

Italy

Marcello Gioscia, Gianluigi Matteo Pugliese and Benedetto Colosimo*

Ughi e Nunziante – Studio Legale

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 the EU home 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 (the Italian Banking Act (TUB)) and Legislative Decree No. 58/1998 (the 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 the 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 (the 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 (the Payment Services Directive). 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;
- 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/UE 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 is entitled to set out, in regulations enacted by the Ministry, the integrity requirements for shareholders and the experience requirements for persons responsible for administrative, management and supervisory functions in banks or financial intermediaries.

The Inter-ministerial Committee for Credit and Savings (CICR) also has certain powers, strictly coordinated with the Bank of Italy.

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 Interbank 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 such limit in order to adjust it to the variation to the rate of inflation.

Some depositors (territorial entities, top 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.

During the first month of 2016 the Fondo Atlante (an alternative investment fund) was set up in support of banks. Fondo Atlante is a private fund, managed by an independent asset management company that raises capital from financial institutions, but is also capitalised for €500 million by Cassa Depositi e Prestiti, a public entity approximately 80 per cent controlled by the Ministry of Economy and Finance. Fondo Atlante aims to support future capital increases of banks and facilitate the disposal of non-performing loans.

Furthermore, it is notable that the Italian government recently set up a public guarantee system in support of banks in crisis.

Indeed, in February 2016 Law Decree No. 237/2016 was converted into law. The latter provides for the creation of a fund with capital of €20 billion aimed at providing support to credit institutions undergoing financial difficulties.

The government may draw on such public fund in order to strengthen a bank's ability to obtain liquidity, and to provide a guarantee to those banks in relation to the latter's future bonds, against payment of a fee.

Thanks to such public guarantee, the bonds issued by banks will give subscribers the degree of risk of a state bond and not that of the issuer bank. Although this guarantee is not a form of direct ownership of Italian banks on the part of the government, it allows banks to obtain smoother access to the capital market even during periods of crisis and to benefit from the possibility of finding financial resources. The abovementioned decree also provides for a burden-sharing mechanism: prior to the public funds' involvement, the par value of shares and of subordinated bonds is reduced (or converted into capital).

Law Decree No. 237/2016 also authorised the Ministry of Economy and Finance to purchase or subscribe shares of Italian banks in need of strengthening their capital after the stress-test based on an adverse scenario and conducted at national level and at European Union level.

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 that 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 20);
- 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 said implementation 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 need to bring the contractual provisions relating to payment services in line with the recent transparency regulations adopted by the Bank of Italy;
- the new structural organisation which 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 (such as, for example, 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 which 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 the 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; and
- the recent implementation of Directive 2014/59/UE, introducing a new and more incisive bank resolution framework.

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. Such 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:
- written form is required for any banking contract;
- the banks shall comply with several pre-contractual requirements such as that to inform in writing the customer, 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; 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 therein, the consumer may withdraw from the contract; and
- in case of non-compliance of 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 via a set of very 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. 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 the recent past, particular attention has been focused on the non-compliance of certain financial intermediaries and e-money institutions which 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.

Such 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.

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 forthcoming years, in addition to the implementation of European 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), CRD IV 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, 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 which are not part of a banking group but which 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 such 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 Ministry of Economy and Finance withdraw the banking licence. If the Ministry 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 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 European Central Bank (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 2015, but also contains references to data collected in the first few months of 2016. Also in 2015 the supervision activity focused on the measures taken by the banks to face the deterioration in the credit standing, as well as on the soundness of the governance and control systems.

In 2015, 49 sanction provisions were issued by the Bank of Italy (compared with 96 in 2014) against 337 natural persons and 12 legal entities, the latter mainly sanctioned because of breaches of anti-money laundering provisions. The total amount of the sanctions applied was about €9 million (while in 2014 the total amount was €31.5 million). The proceedings completed in the relevant year without application of sanctions were four. The sanction provisions issued are for 58 per cent owing to deficiencies in the organisation and internal controls of the supervised intermediaries.

During the first three months of 2016, 14 sanction provisions were issued against 130 natural persons and two legal entities, the latter mainly sanctioned because of breaches of anti-money laundering provisions, for a total amount of €4 million.

Furthermore, the Bank of Italy has started some extraordinary administration procedures against banks and other non-banking entities: at the beginning of 2015, 20 extraordinary administration procedures were in progress, referred to 15 banks, three asset management companies and two financial intermediaries.

In the course of the year, the number of proceedings initiated has decreased significantly compared with previous years.

From January to March 2016, 16 procedures were closed, and thus, at the end of the first quarter of 2016, seven extraordinary administration procedures were still ongoing, of which three referred 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 in this period of crisis, public control (both in terms of governance and participation in the capital of the bank) is relatively limited.

Starting from February 2009 (up to 31 December 2009), pursuant to article 12 of Legislative Decree 18/2008 then implemented by means of Law No. 2/2009, the 'Tremonti bonds' were introduced, which are in

essence convertible bonds issued by banks and subscribed by the state which, in certain circumstances, might lead to the participation of the latter in the capital of the relevant bank.

A bank in distress that has taken advantage of the issuance of such bonds shall than reimburse the bond loan before 29 January 2019 (that is, 10 years from the entrance into force of Law No. 2/2009). The loan can be converted into common shares by way of a capital increase, the subscription of which is reserved for the state.

The Tremonti bonds provide an indirect type of protection of the interests of certain categories of stakeholders. For instance, dividend coupons connected to the Tremonti bonds are paid by the bank only if there are actual gains to share. Hence, a bank suffering losses shall not pay the coupons so that the interests of shareholders, account holders, other creditors and stakeholders are protected.

More recently, as a result of the implementation of Directive 2014/59/UE, the Bank of Italy is now entitled to impose on banks the adoption of one or more measures in order to remove obstacles to its resolvability.

In case of 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.

The resolution measures that may be adopted are the following: the sale of business tool; the bridge institution tool; the asset separation tool; the bail-in tool. In particular, the latter, established at European level by Regulation (EU) No. 806/2014, implies that stakeholders contribute to solve the bank crisis according to the riskiness of its financial instruments.

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 (SRM) 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 an overall amount of €55 billion.

The member states shall grant bridge financing to the Single Resolution Fund and, with regard to Italy, by decrees of the Ministry of Economy and Finance, the supply of bridging finance up to €5,735 million will be disposed.

Moreover, the government, by means of e 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 15), 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, we should point 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 the implementation of Directive 2014/59/UE, 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.

Furthermore, according to the recent implementation of Directive 2014/59/UE by means of Legislative Decree No. 180/2015 (see question 16), the management of a bank shall timely inform Bank of Italy (or the ECB) 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 15) 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.

Capital requirements

15 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 (the 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.

Update and trends

In Italy, Directive 2014/92/EU is currently being implemented through the introduction in the TUB of Chapter II-ter laying down provisions relating to basic payment accounts. In particular, new transparency rules will be introduced, since the pre-contractual and ongoing information duties will be thoroughly regulated, as will the tools designed to promote comparison among offers. Furthermore, rules that require the use of a specific European standard terminology for the designation of the principal services related to the payment account will also be implemented.

The new rules also aim at increasing protections in favour of consumers. In particular, in place of providing for a compensation to the consumer in the event of non-compliance with the procedures and terms for the transfer of the payment account, the new rules provide that the customer receives a penalty, without prejudice to the payment for any further damages, also non-material. Furthermore, Chapter IV of the Directive will be implemented through the introduction of new rules providing for the right of all legally resident consumers to open a basic payment account without discrimination on the grounds of nationality or place of residence.

The provisions relating to the settlement of disputes set out in the TUB will be amended, in order to clarify that it is possible to file with the Bank of Italy petitions in place of complaints. Also, the sanction provisions provided by the TUB will be amended in order to insert the appropriate references to the new rules.

Regulatory capital is structured on three different levels (tiers). Tier I (defined as 'basic assets') and Tier II ('additional assets') are calculated on the basis of the sum of positive and negative financial items. Italian regulation also allows banks to use Tier III assets, which are constituted by medium to long-term subordinate loans, but only to cover certain kinds of market risk.

16 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.

17 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 Ministry of Economy and Finance), 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 Ministry, 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 also question 13).

Finally, if the capital adequacy infringement is exceptionally serious, the Ministry, upon proposal of the Bank of Italy, may even adopt an order for administrative forced liquidation.

18 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 Directive 2014/59/UE, this procedure contemplates that Bank of Italy, and no longer the Ministry of Economy and Finance, 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, Bank of Italy adopts a resolution program, 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.

19 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 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

20 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 which already holds a controlling interest or which 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 the majority of the corporate capital (control) or of a dominant influence on a bank located

in a country outside the European Union, which is not Japan, Switzerland, Canada or the United States.

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.

21 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 20) is carried out by an entity (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 Ministry of Economy and Finance. The ministry, upon proposal of the prime minister, may prohibit and stop the relevant acquisition.

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

See question 23.

23 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 25) shall comply with the requirements of integrity provided by the Ministry of Economy and Finance.

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.

24 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 21) becomes insolvent, the Bank of Italy can also start the extraordinary administration procedure for the leading bank.

Changes in control

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

As mentioned in question 20, 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 which 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; or
- the coordination of management of the business activity with those of other business entities for a common purpose; or
- the attribution of more powers than those directly deriving from the interest; or
- 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.

26 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.

UGHI E NUNZIANTE
STUDIO LEGALE

Marcello Gioscia **m.gioscia@unlaw.it**
Gianluigi Matteo Pugliese **g.pugliese@unlaw.it**
Benedetto Colosimo **b.colosimo@unlaw.it**

Via Venti Settembre, 1
00187 Rome
Italy
Tel: +39 06 47 48 31
Fax: +39 06 48 70 397

Via Visconti di Modrone, 11
20122 Milan
Italy
Tel: +39 02 76 21 71
Fax: +39 02 78 41 40

www.unlaw.it

In 2005 and 2006, two important Italian banks were acquired by foreign banks (BNL, acquired by BNP Paribas, and Antonveneta, acquired by ABN Amro).

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

The Bank of Italy would consider, on the one hand, 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.

On the other hand, 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.

28 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 25, 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.

29 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 20) 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.

* *The authors would like to thank Pietro Pastorello and Alessandro Corbò for their assistance with this chapter.*

Japan

Yoshiyasu Yamaguchi, Hikaru Kaieda, Yoshikazu Noma, Shuhei Oi and Ken Omura

TMI Associates

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 and thus 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 '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 planned to come into force by June 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 22);
- a bank holding company (as explained in question 22);
- 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 2016–2017 Strategic Directions and Priorities on 21 October 2016, which states that the FSA will proceed with the following efforts to improve the quality of financial intermediation function by financial institutions:

- Monitoring lending exclusion: 'the JFSA will closely monitor if lending exclusion, or unavailability of lending to companies with solid future business prospects, is observed in the Japanese market.'
- In-depth dialogue with financial institutions: 'the JFSA will conduct in-depth dialogue with senior management of financial institutions over effective financial intermediation through discussion on governance, performance goals and evaluation, and loan screening systems, with the help of the newly introduced set of benchmark indicators on banks' financial intermediation and of findings from monitoring of their initiatives.'
- Enhanced disclosure to promote competition for better financial services: 'the JFSA will encourage financial institutions to voluntarily disclose their efforts to meet customers' needs and give awards for excellent practices in order to promote active competition among financial institutions in providing high-quality financial services.'

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 sales 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 2016–2017 Strategic Directions and Priorities of 21 October 2016 states the Advisory Group on Supervisory Approaches established in August 2016 will discuss, organise and explore the following basic ideas and methods concerning new inspections and supervision.

- From form to substance: 'Dialogue on business models, better risk management and innovation added to compliance check.'
- From backward- to forward-looking: 'Sustainability of business models and adaptiveness to changing environment to be discussed in addition to past balance-sheet numbers.'
- From individual elements to Holistic view: 'Devote supervisory resources to address underlying root causes, rather than focusing on specific incidents; and to identify overall risk profile, rather than focusing on individual loan classification.'

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 17. 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 centered on strict individual asset assessment and confirmation of compliance with laws and regulations would be detrimental. Furthermore, in response 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, in accordance with the 2016–2017 Strategic Directions and Priorities dated 21 October 2016, the FSA has been working on reviewing the following inspection and supervision methods to date:

- 'respecting the judgment 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 thereon'; and
- 'discovering issues surrounding financial institutions through dialogue with client companies of financial institutions'.

Furthermore, the FSA will promote conversion to new inspection and supervision methods through the measures explained in question 8.

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 thereof).

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 regards such crime. Managers and directors will be personally liable for their failure (if any) to perform their duties as managers or directors.

Capital requirements

15 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 I capital, other Tier I capital, and Tier II capital.

The target minimum standard capital adequacy ratio is set at 8 per cent, the minimum ratio for the Tier I capital ratio is set at 6 per cent, and common equity Tier I 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–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, another buffer levels are set by the FSA in line with the Basel III framework.

Common equity Tier I capital primarily consists of ordinary shares and warrants of ordinary shares; retained earnings; and other accumulated comprehensive income and other public reserve. Other Tier I capital primarily consists of preferred shares other than the above, and preferred securities without step-ups (under certain conditions).

Tier II 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.

16 How are the capital adequacy guidelines enforced?

The capital adequacy requirements are enforced through off-site monitoring of the FSA. The FSA biannually confirms 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 actions as set out in question 17.

17 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 I capital from ordinary shares, etc, ranging from 2.25 per cent to less than 4.5 per cent, Tier I 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 I capital from ordinary shares, etc, ranging from 1.13 per cent to less than 2.25 per cent, Tier I 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 thereof;
  - 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 I capital from ordinary shares, etc, ranging from zero to less than 1.13 per cent, Tier I 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 of its capital;
  - substantial downsizing of its business operations; or
  - merger with another bank or abolition of its banking business; and
- capital adequacy ratio of Tier I capital from ordinary shares, etc, less than zero, Tier I 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 thereof. 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 I 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.

18 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 application is subject to prior approval of the FSA. The FSA grants the approval only if the merger contributes to protection of depositors, the financial assistance by the DICJ is essential for implementation of the merger and the dissolution of the bank 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 shares of the bank. If the DICJ acquires all the shares of the bank, 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.

19 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 15, and will be fully implemented by 2019.

Ownership restrictions and implications

20 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 shareholders of a bank.

Under the Banking Law, there are two categories of controlling shareholders of a bank: a major shareholder of a bank and a bank holding company.

A major shareholder of a bank 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 entity or individual, the number of voting rights of the bank held by the entity or individual includes the voting rights of the bank 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 voting rights of such bank and have agreed with such entity or individual to jointly acquire or transfer the bank's shares or to jointly exercise their voting rights, etc, as shareholders of the bank).

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 such 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 such company, meaning the company is a holding company. For the purpose of calculating the holding ratio of such company, the number of voting rights of the bank held by certain relevant entities or individuals of such company is included in the number of voting rights held by such company.

21 Are there any restrictions on foreign ownership of banks?

There is no restriction on foreign ownership of banks under the Banking Law.

22 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 major shareholder of a bank to submit reports and material concerning the operation and financial conditions of the

bank) and an on-site inspection (including interviewing the major shareholder of the bank on the operation and financial conditions of the bank as well as the major shareholder and inspecting books, records and other items of such 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 such 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 27, the FSA may order such major shareholder to take necessary measures to satisfy the requirements within a designated time frame.

Similar to major shareholders of banks, 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 thereto. Bank holding companies are limited to hold, as subsidiaries, banks, securities companies, insurance companies and companies that are engaged in certain other financial business, certain business related to finance or certain other business relating to businesses and operations of banks. 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 such 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 such 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 semiannual reports that contain consolidated statements on the status of business and property of such bank holding companies and their subsidiaries, and so on.

23 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 22, and for the primary filing obligations, see question 28.

24 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.

Update and trends

With the aim to promote the revolutionary financial services (FinTech), certain amendments were made to the Banking Act of Japan and certain other laws in 2016 and will come into force in 2017. Among others, restrictions on the banks' holding of other companies shares of stock would be eased to allow the banks to invest more in the financial service-related IT companies. Sale, purchase and exchange of virtual currencies and actions of intermediary, agency or delegation therefor and management of money and virtual currency in connection therewith would constitute the Virtual Currency Exchange Service subject to the registration requirements under the Payment Services Act. The registration requirements for the Virtual Currency Exchange Service Provider include sufficient financial, organisational and system requirements and they would be required to abide by the rules for protection of users as well as the rules for know your client under the Act on Prevention of Transfer of Criminal Proceeds. With some reference to the EU Revised Payment Services Directive, a recent report published by the Working Group on the Financial System discusses further desirable legal framework for new payment systems (open API, electronic settlement agency and the like), encouraging open-innovation through cooperation among financial institutions and fintech companies while ensuring user protection and information and system security.

Changes in control

25 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 the definition in question 22.

Documents required upon application for the prior authorisation of the FSA would include, in the case of a major shareholder of a bank, 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 of such 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 showing prospective income and expenditure and consolidated capital ratio of the company and the bank for next three fiscal years would be necessary, among other documents.

26 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 27). The regulatory process for foreign acquirers under the Banking Law is not materially different from that for Japanese acquirers.

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

When an application for 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 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.

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

When an entity or individual intends to become a major shareholder of a bank, or a company intends to become a bank holding company, an application for authorisation thereof 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 case 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 major shareholder of a bank (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 case 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 shareholders of a bank 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.

29 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 major shareholder of a bank 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 such authorisation. This time frame 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.

TMI ASSOCIATES

Yoshiyasu Yamaguchi **yyamaguchi@tmi.gr.jp**
Hikaru Kaieda **hkaieda@tmi.gr.jp**
Yoshikazu Noma **ynoma@tmi.gr.jp**
Shuhei Oi **soi@tmi.gr.jp**
Ken Omura **komura@tmi.gr.jp**

23rd Floor, Roppongi Hills Mori Tower
6-10-1 Roppongi, Minato-ku
106 6123 Tokyo
Japan

Tel: +81 3 6438 5511
Fax: +81 3 6438 5522
www.tmi.gr.jp

Korea

Soonghee Lee, Young Ho Kang and Hye Jin Hwang

Yoon & Yang LLC

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 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 govern the 'business' of the bank.

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 fin tech, 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.

- In 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.
- Establishment of comprehensive fintech support system to support fintech development, in the course of encouraging the financial regulation test bed, block chains and big data services.
- In 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.
- In 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, take appropriate measures such as administrative sanctions (cancellation of 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 mainly is conducted from the points 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 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.

Capital requirements

15 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 I) 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.

16 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 15) or that there are unsound business areas.

17 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.

18 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.

19 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. 15, it is necessary to meet the above criteria by 2019 in keeping with the timetable provided.

Ownership restrictions and implications

20 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 which exceed 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 she or he 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.*

Update and trends

An internet-only banking system, which is characterised as having no physical branches and no face-to-face services, has been introduced. In 2015, operators such as K-bank and Kakao Bank received preliminary licences. K-bank received its full licence in 2017 and Kakao Bank is in the process of obtaining full approval. Because new banking licences have been granted to internet-only banks for the first time in 24 years, the role and prospects of internet-only banks are attracting attention. In order to ensure the uninterrupted arrival of internet-only banks, amendments to the Banking Act are being considered, such as lifting certain restrictions on the stock holding limit of non-financial principals and on the minimum capital required for internet-only banks. Additionally, Korea's financial supervisory bodies are updating the regulatory framework to support banks' digital banking (fintech) and overseas expansion.

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.

21 Are there any restrictions on foreign ownership of banks?

The same share ownership restrictions apply to foreigners as discussed for question 20.

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.

22 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.

23 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.

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

If the insolvency of the bank 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

25 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 20, 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 major shareholder may be undertaken.) See the definition of a major shareholder who is a bank management person in question 20.

26 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 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 27 are considered. The principle of equal treatment applies to foreign corporations in the regulatory process and enforcement by the authorities.

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

Before approving 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 the credit extended from the bank, the possibility of contributing to the efficiency and 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.
- 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.

28 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 amount of members with limited liability and members with unlimited liability of the private equity fund participating in management;

- matters relating to the status and reasons for stock ownership or change;
- the purpose of the stockholding and matters relating to involvement in the management of the bank; 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.

29 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.

YOON & YANG
법무법인(유) 화우

Soonghee Lee **shlee@yoonyang.com**
Young Ho Kang **yhk@yoonyang.com**
Hye Jin Hwang **hjhwang@yoonyang.com**

ASEM Tower 517 Yeongdeong-daero
Gangnam-gu
Seoul 06164
Korea

Tel: +82 2 6003 7000
Fax: +82 2 6003 7800
www.yoonyang.com

Lebanon

Souraya Machnouk, Eddy Maghariki and El Sayegh
Abou Jaoude & Associates Law Firm

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; and
- 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.

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 (ie, 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.

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 (sharia), 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 sharia-compliant operations such as mudarabah, musharakah, ijara and so on, which are tailor-made financial operations structured to be sharia-compliant. A sharia board often issues a scholarly opinion to evidence compliance of a particular instrument or product with sharia 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 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, 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 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 18), 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.

Banks are not required by law to have a resolution plan.

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.

Capital requirements

15 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 I capital (composed of common equity Tier I and additional Tier I capital) and Tier II capital.

On September 30, 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-One 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-One 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.

16 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.

17 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 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.

18 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 rightholders.

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.

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

As indicated in question 15, 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

20 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 CVs (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 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 25).

21 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

Update and trends

As part of its efforts to help streamline the activities of the capital markets in Lebanon, the BDL issued on 8 November 2016, Intermediate Circular 437 whereby it prohibits banks and financial institutions from trading or dealing, on behalf of their clients, with all financial tools and products, and requires that they clear all their securities business related to the public through investment banks and financial intermediaries. However, the dealing by banks and financial institutions with securities for their own account remain allowed under the supervision and control of the CMA. The circular also imposes on investment banks the obligation to open trading accounts for their clients' operations related to the securities business that will be under the control and supervision of the CMA.

Consequently, this new regulation is causing a remarkable shift in the banking industry as many financial institutions whose main line of business consists in dealing and trading with securities related to the public are now revoking their licence granted by the BDL and applying for investment banking or financial intermediary licences.

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.

22 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 23.

23 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 which 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.

24 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 very 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

25 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 thereto. 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 thereto. 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.

26 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.

27 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.

28 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.

29 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.

Abou Jaoude & Associates Law Firm

Souraya Machnouk **s.machnouk@ajalawfirm.com**
Eddy Maghariki **e.maghariki@ajalawfirm.com**
El Sayegh **e.sayegh@ajalawfirm.com**

OMT Building
266 Sami El Solh Ave
Beirut
Lebanon

Tel: +961 1 395 555
Fax: +961 1 384 064
www.ajalawfirm.com

Norway

Klaus Henrik Wiese-Hansen and Terje Gulbrandsen

Advokatfirmaet Steenstrup Stordrange DA

Regulatory framework

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

The banking sector is regulated by the Financial Supervisory Authority of Norway (FSAN), which is Norway's combined prudential and market conduct regulator for the finance sector. Furthermore, the Financial Stability Department (FSD) of the Central Bank of Norway acts as a macro prudential regulator. The banking sector legislation and regulatory framework is within the responsibility of the Norwegian Ministry of Finance.

The FSAN is an independent governmental agency governed by the Financial Supervisory Authority Act of 1956. The main objective of the FSAN is to promote financial stability and well-functioning markets, while its expressed intermediate goals are to stimulate:

- financially sound and liquid financial institutions;
- robust infrastructure ensuring satisfactory payments, trade and settlement;
- investor protection;
- consumer protection through good information and advice; and
- efficient crisis management.

The objective of the FSAN's supervision of the banking sector is to promote solid financial institutions with sound risk awareness, management and control.

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;
- advising on measures to prevent systemic risk;
- contributing to developing a sound regulatory framework for the financial system;
- acting as the licensing authority for interbank systems and monitoring payment systems; and
- conducting research and analysis to support the department in the performance of its duties.

Norway is not part of the European Union (EU), but is a member state of the European Economic Area (EEA) and hence a part of the Internal Market. The EEA unites the EU member states and the three EFTA states, Iceland, Liechtenstein and Norway, through the EEA Agreement.

The FSAN has a permanent observer role to the European Supervisory Authorities (the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority). Norway also participates as an observer to the European Systemic Risk Board on an ad hoc basis.

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

The primary statutes currently governing the banking industry in Norway are the Financial Enterprises Act of 2015 and the Financial Contracts Act of 1999.

Other important banking sector statutes are:

- 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 above statutes are all complemented by regulations.

As of 1 January 2016, the Savings Bank Act, the Commercial Bank Act, the Financial Services Act and Guarantee Schemes Act (plus large parts of the Insurance Services Act) have been consolidated and substituted by a new Act on Financial Enterprises and Financial Groups (the Financial Enterprises Act).

The new Financial Enterprises Act has introduced a number of amendments and consists of over 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/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 regulatory authority 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 krone per depositor per bank, that is, more than twice as much as the €100,000 deposit guarantee applicable in the EU.

Pursuant to the Financial Enterprises Act, 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.

Regarding government ownership, 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. Hence, the government intends to maintain this interest. The government has 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' (ie, transactions between 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) shall be carried out on an arm's-length basis. A financial group is obligated to secure that revenues, costs, losses and profits are distributed as accurately as possible between the enterprises of 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 principal regulatory challenges facing the banking industry in Norway are the same as in the EU (ie, more stringent, complex and frequent regulations owing to the EU's ambitions on establishing an internal market with common regulations and harmonised supervision). Norwegian authorities, in this context being the FSAN, the Ministry of Finance and the Central Bank, also worry about a potential housing bubble in Norway and keep suggesting countercyclical measures for local banks.

7 Are banks subject to consumer protection rules?

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. These provisions concern, inter alia, 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, of course, 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 very large extent harmonised with that of the EU. The direct consequences for Norway of EU's ambitions will be the continuous need for evaluation and harmonisation of relevant EU regulations in Norway through the EEA Agreement, which probably will 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 by way of:

- 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 (cf 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 EU'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 under question 8, the strengthening of the cooperation between the supervisory bodies of the EU/EEA will presumably cause more frequent and coordinated supervision.

According to the FSAN's public register, there are 25 commercial banks, 102 savings banks and 39 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 2007–2010 financial crisis, as a preventive measure. In general, supervision with 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 (mis-)selling of 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?

Pursuant to the Financial Enterprises Act, the FSAN has a duty to inform the Central Bank and the Bank Guarantee Fund about a capital inadequacy incidence if the FSAN has reason to assume that:

- 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.

An assessment on whether the bank may be secured a sufficient financial basis for continued satisfactory operations will then 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.

Public administration orders are, however, extremely rare. A public administration order towards a Norwegian bank has only happened once, against Norion Bank in 1989. During the financial crisis in Norway in 1991/92, the Norwegian state however 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 said banks' share capital as a requirement from the state to re-fund the banks. No Norwegian banks were subject to public administration during the financial crisis in 2007–2010, 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.

Once a public administration order has been made against a bank, the following effects, among others, come into play:

- the bank's former governing bodies become inoperative. The appointed administration board assumes the authority vested in these bodies. The last serving board of directors shall nonetheless decide matters which cannot be deferred until the administration board has taken up its duties;
- the members of the board and of the control committee, as well as the auditor shall provide the administration board with full information on the bank's status and activities;
- the bank may not receive deposits, assume new financial obligations or expand previous financial obligations without the FSAN's approval;
- payments to depositors and other creditors may not take place without the FSAN's approval; and
- creditors holding claims established prior to the public administration order may not distrain on, or by other means secure payment by recourse to, assets belonging to the bank.

The administration board shall as soon as possible determine whether the bank may be able to continue its operations, should be subject to merger or takeover, or should be subject to wind-up. The position of shareholders and employees will hence vary accordingly.

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?

As noted under question 12 above – the bank's former governing bodies become inoperative once the public administration order is effective. The last serving board of directors shall nonetheless decide matters which cannot be deferred until the administration board has taken up its duties. The directors, the control committee and the auditor shall provide the administration board with full information on the bank's status and activities.

Norwegian banks are for the time being not required by law to have resolution plans or recovery plans, but the EU's Bank Recovery and Resolution Directive (BRRD) – which requires recovery plans for banks – is considered as EEA relevant and will hence be implemented in Norwegian law, and in October 2016, the Banking Law Commission tabled a proposal for new regulations to implement the BRDD into Norwegian law.

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.

Capital requirements

15 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 of CRD IV or the CRR has been implemented in the EEA agreement yet, but Norwegian legislation has been adapted to comply with 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/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.

16 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.

17 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.

18 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. Rather than taking a bank under public administration, Norwegian authorities will probably repeat the way they handled the financial crisis in 1991/92, which is considered highly successful. See question 12.

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

See question 15.

Ownership restrictions and implications

20 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 express legal or regulatory limitations regarding types of entities and individuals who may own a controlling interest in a Norwegian bank. 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 which provides material influence, in the bank. Such interest is referred to as a 'qualified interest'.

Any entity or individual who acquires such controlling interest will however be subject to approval by the Ministry of Finance, or the FSAN in cases which are not considered important. The applicable entity will, based on the acquirer's mandatory notification, consider the acquirer's qualification as owner and whether the acquisition is fit and proper 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.

21 Are there any restrictions on foreign ownership of banks?

There are no regulatory restrictions on foreign ownership of banks in Norway, apart from the general rules outlined in this section.

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

An entity that owns a 'qualified interest' in a bank, see question 20, is responsible for complying with the terms of the authorisation issued by the Ministry of Finance for such ownership. The Ministry of Finance may revoke such authorisation at any time if the terms of the authorisation 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 24.

23 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.

24 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

25 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 (ie, controlling more than 10 per cent of the capital or voting rights of the bank), or other interest which provides material influence, is required to notify the FSAN of such acquisition. Such notification is subject to a number of information requirements laid down in the Financial Services Act and appurtenant regulations.

The acquisition is then subject to regulatory approval by the Ministry of Finance/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 are or 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 per cent, 30 per cent 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 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.

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

As noted under question 21, 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 EU 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.

27 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 25.

28 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 25. 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;
- 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.

29 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 hence notification +60 (+20) business days for EEA acquirers, and notification +60 (+30 or more) business days for non-EEA acquirers.

Klaus Henrik Wiese-Hansen **kwh@steenstrup.no**
Terje Gulbrandsen **tg@steenstrup.no**

Cort Adelers gate 33
0254 Oslo
Norway
Tel: +47 22 81 45 00
Fax: +47 22 81 45 01

www.steenstrup.no

PO Box 1829 Vika
0123 Oslo
Norway

Peru

Juan Luis Avendaño*
Miranda & Amado Abogados

Regulatory framework

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

The current Peruvian banking legal framework is in compliance with the Basel Core Principles for Effective Banking Supervision published by the Basel Committee on Banking Supervision in 1988. It has also been in compliance with the standards set by Basel II since 2009.

The Superintendency of Banks, Insurance Companies and Private Pension Fund Managers (SBS) is currently evaluating the impact of the changes proposed in Basel III and its implementation into the Peruvian financial system.

The Peruvian financial system operates under the following general principles.

Equal treatment for foreign investments
Foreign investors in Peruvian financial companies will have the same treatment as that afforded to local investors.

Prohibition of discriminatory treatment
The general provisions issued by the Peruvian Central Bank (the Central Bank) or SBS in the exercise of its powers may not include special treatment that will discriminate between:

- companies of similar nature;
- companies of a different nature, concerning the same type of transaction;
- companies established in Peru against similar foreign companies; and
- foreign individuals and companies domiciled in Peru against Peruvian individuals and companies, with respect to the granting of loans.

Non-participation of the state in the financial system
The Peruvian state may not participate (compete) in the financial system, except for its full equity holdings in Banco de la Nación (the bank in charge of administering the sub-accounts of the National Treasury and providing the government with the financial services it requires to manage public funds, and which generally operates in marginal territories where there are no private banks); Banco Agropecuario (a bank created for granting credits to small and medium-sized agricultural producers); Corporación Financiera de Desarrollo and Fondo MiVivienda (institutions that serve as channels for governmental promotional credits). In addition, the Central Bank performs the traditional tasks of a central bank, including the issuance of banknotes, implementation of the government's monetary policies, regulation of money supply, management of official gold and foreign exchange reserves and running the interbank clearance system.

Authorisation for financial intermediation
Only entities that are licensed by the SBS may enter into the banking business in Peru. More specifically, only licensed entities can receive deposits from the public for purposes of granting loans. Illegal banking is deemed a criminal offence.

Free-market interest rates, fees and charges
Companies in the financial system may freely set interest rates, fees and charges that they charge or pay their clients.

Freedom to hold and dispose of foreign currency
Individuals and companies may execute transactions in foreign currencies and may even agree for mandatory payments in any foreign currency. US dollars are still widely used in Peru, although the current tendency is to transact in nuevos soles, the Peruvian currency, because of the current appreciation. Euros are also used in some local transactions. Inbound and outbound wire transfers into and out of Peruvian territory occur directly from and into bank accounts without participation of the Central Bank or any foreign currency control whatsoever. Money-laundering regulations are applicable, however.

It should be noted that the Peruvian Congress has enacted a Banking Services Consumer Protection Act, through which certain protections have been stressed in favour of bank customers, from the perspective of consumer protection.

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

Constitutional economic framework
From an economic perspective, the Peruvian Constitution enacted in 1993 has established a favourable legal framework for the purposes of attracting national and foreign investments into the country in order to boost necessary development.

Accordingly, the Peruvian Constitution recognises the following guarantees:

- prohibition of discriminatory treatment against foreign investors;
- free and open market orientation;
- private property rights protection;
- freedom to hold and dispose of foreign currency;
- consumer protection; and
- safety and soundness of banking system as effective means for protecting depositors.

Foreign investors, and the local target companies in which they invest 'new money', may execute legal stability agreements with the government (through the Peruvian Investment Promotion Agency (ProInversión)) for a 10-year period. Stability agreements are only available when foreign investment exceeds US$10 million.

The following guarantees are granted by the state through a stability agreement:

- to the foreign investors, legal stability regarding:
  - the income tax system;
  - the free availability of foreign currency;
  - the right to remit profits or dividends out of the country;
  - the right to use the most favourable exchange rate existing in the market for any currency exchange operation; and
  - the right to receive non-discriminatory treatment in relation to national investors; and
- to the company receiving the investment, legal stability regarding:
  - the income tax regime; and
  - the hiring of workers under special employment contracts.

Legal framework of the Peruvian financial system

The regulatory banking legal framework in Peru is set out in Law No. 26,702 (the Banking Law), as amended, which contains the main guidelines for banking regulation in Peru. Also, both the SBS and Central Bank regularly issue regulations governing banking activity.

3 Which regulatory authorities are primarily responsible for overseeing banks?

Peruvian banking and financial institutions are primarily overseen by the SBS, which is constitutionally charged with protecting depositors. Banks are also overseen by the Central Bank, mainly for monetary policies and more specifically for regulating the level of mandatory reserve requirements.

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.

Bank deposits are protected by the Deposit Insurance Fund (the FSD) against bank failure. Specifically, savings deposit accounts maintained by individuals, savings deposit accounts maintained by non-profit entities and current accounts in general are covered in full up to the equivalent, at the current level of coverage and exchange rate, of around US$35,000 per person per bank.

The financial resources available to the FSD pursuant to the Banking Law include the original contribution from the Central Bank, insurance premiums paid by banks, unclaimed bank deposits (10 years), fines imposed by the SBS for non-compliance with the Banking Law and extraordinary contributions from the treasury.

As Peru was not severely affected by the financial crisis, the Peruvian government generally remained on the sidelines and, therefore, did not take any ownership interest 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.

Notwithstanding other applicable legal lending limits established in the Banking Law, the total amount of credits (whether direct or contingent), financial leases and investments that a Peruvian bank may enter into with related parties may not be higher than 30 per cent of its regulatory capital. All transactions with related parties must be on an arm's-length basis.

As for the effects of the aforementioned limitation, 'related party' means any person or company holding, whether directly or indirectly, more than 4 per cent of the ownership of a bank, or that may have a 'significant influence' in a bank's management. The following persons will be deemed to have significant influence in a bank's management:

- persons belonging to the same economic group; and
- unless the contrary has been duly demonstrated, a person or company that maintains management relations with the bank, arising from any of the following situations:
  - when a person or company is the final borrower of a credit granted to the other person or company;
  - when a person or company is represented by the other person or company;
  - between companies that have the same directors, managers, counsels or principal officers;
  - when the resources for the activities of a company come, directly or indirectly, from another company;
  - between companies with the same shareholders that have the ability to designate or remove at least one member of the board of directors (or equivalent board) of such companies;
  - between a person and a company when such person is a director, manager, counsel or principal officer of said company, or has been one of them at any time during the past 12 months; or
  - between a person and an economic group when such person is director or manager of a company belonging to such economic group, or has been one of them at any time during the past 12 months.

A bank may not grant to, or to the account of, a person or company (which includes all of its affiliates), whether directly or indirectly, credits, investments or contingent funds in excess of 10 per cent of its regulatory capital. This limit may be raised to 15, 20 or 30 per cent, depending on the type of collateral securing the excess over such limit, as established in articles 207, 208 or 209 of the Banking Law.

Permissible and prohibited activities

Under article 221 of the Banking Law, banks and financial institutions may carry out the following operations and services:

- receive both demand and time deposits;
- grant advances or overdrafts on current accounts and give secured or unsecured direct loans;
- discount and grant advances on bills of exchange, promissory notes and other documentary evidence of debt;
- grant mortgage and security loans and, in connection therewith, issue negotiable instruments, mortgage and pledge instruments, both in domestic and foreign currency;
- grant guarantees, bonds and other guarantees in favour of other financial institutions;
- issue, confirm and negotiate letters of credit, in line with international practice;
- grant syndicated loans;
- acquire and negotiate certificates of deposit issued by a company, mortgage instruments, warrants and bills of exchange from trading;
- carry out factoring transactions;
- conduct credit operations with companies in the country and place deposits with them;
- conduct credit operations with banks and foreign financial institutions, as well as placing deposits with each other;
- buy, hold and sell shares of banks or foreign institutions operating in financial intermediation or in the stock market, or ancillary to one or the other, in order to give international scope to their activities;
- issue and place bonds, domestic or foreign, including regular, convertible, leasing and subordinated bonds of various types and in various currencies, as well as promissory notes, negotiable or non-negotiable certificates of deposit and other instruments representing obligations, provided they are of its own issuance;
- accept bills of exchange term, originating in business transactions;
- carry out transactions in commodities and financial derivatives such as forwards, futures, swaps, options, credit derivatives or other derivative instruments or contracts, according to the standards issued by the SBS;
- acquire, hold and sell equity securities that are traded in a centralised mechanism for negotiation and private debt instruments, according to the rules issued by the SBS;
- acquire, hold and sell shares of companies providing complementary or auxiliary services to the bank or its subsidiaries;
- acquire, hold and sell, as investors, quotas in mutual funds and investment funds;
- buy, hold and sell securities in public debt, internal and external, as well as obligations of the Central Bank;
- buy, hold and sell bonds and other securities issued by multilateral lending agencies of which Peru is a member;
- serve as agent for the placement and investment in the country of external resources;
- buy, hold and sell securities for government debt, according to the standards issued by the SBS;
- trade in foreign currency;
- issue foreign currency bank certificates;
- purchase or sell portfolios;
- perform structured finance operations and participate in securitisation transactions, subject to the provisions of the Securities Market Law;
- acquire property, plans and equipment;
- make payments, receipts and transference of funds and issue drafts against their own offices or correspondent banks;
- issue cashier's cheques, travellers' cheques and issue payment orders;
- carry out agency and trust services;
- receive securities, documents and objects in custody as well as renting out safe deposit boxes;
- issue and manage credit cards and debit cards;

- carry out leasing operations;
- promote foreign trade operations and provide comprehensive advice in this area;
- carry out securities underwriting activities;
- provide financial advisory services without handling clients' money or investment portfolios on their behalf;
- act as trustees;
- buy, hold and sell gold;
- provide pawn loans;
- act as originators in securitisation processes through the transfer of property, real estate, credit or money, being empowered to establish special purpose companies; and
- all other operations and services, provided they meet the requirements established by the SBS, with prior opinion of the Central Bank.

Notwithstanding other prohibitions contained in the Banking Law and its implementing regulations, banks and financial institutions may not:

- give credit to guarantee their own shares;
- grant credits with the purpose, directly or indirectly, of acquiring shares of the company;
- give credit to finance political activities;
- give guarantees, or otherwise support obligations of third parties, for an undetermined amount or term;
- guarantee mutual money operations to be concluded between third parties, unless one of them is another company in the financial system, or a bank or foreign financial entity;
- guarantee the assets of their fixed assets, excluding those that are affected in support of leasing, and mortgage companies to issue property capitalisation;
- accept endorsements, guarantees or warranties issued by their directors and employees in support of operations of credit to related persons;
- acquire shares in companies outside the financial system, which, directly or indirectly, are shareholders of the company, unless they are traded in the stock market;
- negotiate certificates of deposit with their subsidiaries and commitments that give rise to the obligation to repurchase such certificates;
- accept deposits on behalf of financial institutions authorised to operate in the country; or
- use information not disclosed to the market, natural or juridical persons, whether or not customers, in order to foster self-dealing or third parties to apply the provisions of the Securities Exchange Act.

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

Peru still has very low penetration of banking services set against a consistently rising GDP, so Peru's banking industry stands to grow strongly in the next few years. In order to maintain healthy capital ratios, Peruvian banks will need to continue increasing their capital base through profit capitalisation and through innovative hybrid subordinated instruments.

Since 2009, when the Peruvian regulatory framework adapted to Basel II standards, Peruvian banks are now subject to greater capital requirements. Moreover, if Basel III standards are implemented in Peru, Peruvian banks will be subject to greater liquidity coverage requirements.

Finally, Peruvian banks will have to be prepared to expand internationally – not necessarily opening foreign offices but doing cross-border lending (especially to go along increasingly expanding ventures of Peruvian companies) and raising capital or issuing debt on the international securities markets. This would probably require a thorough revision of the applicable legal tax framework.

7 Are banks subject to consumer protection rules?

Peruvian consumer protection laws are applicable to: consumer relationships concluded in Peruvian territory; or, consumer relationships with effects in Peruvian territory.

The place of celebration of the consumer contract (which originates the consumer relationship) shall be determined according to the law applicable to the contract chosen by the parties. According to the Peruvian Civil Code (the Civil Code), a contract is concluded, in the place and moment, where and when the acceptance is known by the party who made the offer to conclude such contract. In consequence, if the contract was concluded through remote means out of Switzerland and the acceptance was received in Peru, such contract, according to the Peruvian legal framework, would be concluded in Peru. It must be also noted that, in Peru, there are no clear guidelines or judicial precedents that would conclusively assert in what circumstances an acceptance made by electronic means would be considered as being received in Peru.

Although the consumer relationship is not concluded in Peru, Peruvian consumer protection laws will be applicable if such relationship has effects on Peruvian territory. In consequence, for example, if the consumer contract (which originates the consumer relationship) was concluded on Swiss territory, but some services are rendered on Peruvian territory, the Peruvian consumer protection laws would apply. With regard to this, it must be noted that the Consumer Code does not indicate whether it will only apply if the consumer relationship 'main effects' reach Peruvian territory. In consequence, if the consumer relationship has any effect on Peruvian soil, Peruvian consumer protection laws will apply.

Formerly, in Peru, the definition of 'consumer' was only applicable to individuals and micro-enterprises. Upon the issuance of the Consumer Protection and Defense Code, by means of Law No. 29571 (the Consumer Code), the definition of 'consumer' applies to natural or legal persons acting in an area out of a business or professional activity and micro-enterprises entering into transactions out of the scope of their ordinary business activities. Pursuant to the Consumer Code, a 'consumer relationship' is considered a relationship by means of which a consumer acquires a product or service from a provider in exchange for an economic benefit.

According to this, the consumer protection laws will not apply to a natural or legal person that does not qualify as a consumer when the consumer relationship is not concluded on Peruvian territory; or, when the consumer relationship has no effects on Peruvian territory.

It must be noted that there are special provisions applicable to the financial services provided by entities under the supervision of the SBS. Said specific legal framework is basically composed of: special provisions in the Consumer Code; Law No. 28587, Complementary Law to the Consumer Code in financial services matters (the Complementary Law); and SBS Regulation No. 8181-2012, Transparency Regulation and provisions for contracting with users of the financial system.

It must be also noted that the Consumer Code establishes special provisions applicable to the credit services provided, under any modality, by entities that are not under the supervision of the SBS, considering that some provisions of the Complementary Law are also applicable. (These provisions related to the modification of contracts, interests, commissions and expenses.)

With respect to the regulation of commercial publicity of products and services, the applicable legal framework basically compises: the Consumer Code; and Legislative Decree No. 1044, the Unfair Competition Law, which is applicable to acts with real or potential effects on Peruvian territory.

The Consumer Code approves a wide range of rules intended to protect consumers in all the sectors of the economy. In that sense, it has established different dispositions to reduce the situation of asymmetric information between the consumers and the providers of products and services. For that purpose, the dispositions in the Consumer Code aim to assure that the consumers can take informed decisions about the services and products that are offered to them. In that vein, the Consumer Code has established, among others, the following rights in favour of the consumers: the right to access to adequate, truthful and complete information, the right to not being discriminated, the right to reparation and compensation of damages and the right to associate.

With respect to the financial services provided by entities under the supervision of the SBS, the Consumer Code, the Complementary Law and the Transparency Regulation establish specifics dispositions in order to assure the provision of adequate and precise information to the financial consumers about, among others, interest rates, commissions, expenses and modifications of contracts.

The Banking Law, regulates bank secrecy and states, as a general rule, that the Peruvian Financial System entities may not provide to third parties any information regarding the liability operations without having the client´s express and written authorisation. In addition, Law No. 29733, the Data Protection Law, limits the sharing and transference

of 'personal data' (defined as any individual's information that identifies it or makes it identifiable through means that can be reasonably used) to third parties by considering as mandatory the attainment of the previous, informed, express and unambiguous consent of the owner of such data. It also establishes that, in the case of 'sensitive data' (which includes, among others, personal data related to economic income), such approval shall also be in writing.

Finally, the Unfair Competition Law regulates the legal framework applicable to commercial publicity of products and services in Peru. In that sense, the Unfair Competition Law states that advertising is governed by the principles of authenticity, legality, social adequacy and accuracy.

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

The introduction of Basel II standards is very recent. Basel III is, however, already being implemented in the local regulation; measures such as countercyclical reserves and limits on liquidity risk were implemented during 2013 and it is expected that during 2014 and 2015 the SBS will continue to implement additional Basel III standards.

Supervision

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

Banks are required to provide the SBS, on an ongoing basis, with all relevant information that is necessary to allow for off-site evaluation of its financial performance, including annual audited and interim financial statements on a consolidated basis, board of directors' reports, auditor's reports and other reports that reflect the operations of the banks' businesses. Under current practice, such reporting is required on a daily, weekly, monthly, quarterly, semi-annual and annual basis, depending on the nature of the information to be reported.

The SBS is also responsible for conducting on-site examinations of banks once a year. During these inspections, the SBS examines all operations and analyses the relationships between assets, liabilities, net worth, profit and loss accounts and all other factors affecting the banks' financial and capital structure, in order to verify compliance of the bank with Peruvian banking regulations.

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

The SBS has the power to impose administrative sanctions on banks and their directors, officers and employees upon infringement of the rules that govern the activities of the Peruvian financial system. Sanctions may vary from monetary fines to licence cancellation, depending on the gravity of the breach.

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

There is a good level of communication and close coordination between banks and the SBS. Most issues arise when other government agencies, such as the Consumer Protection Agency (Indecopi) or the National Congress, intend to regulate the banking business. Complaints over high interest rate loans refresh the debate on free market policies. It is also not uncommon to hear voices from Congress complaining about collection methods used by banks against defaulting debtors, especially in the agricultural sector. During the past few years, the SBS has successfully forced banks to be more transparent in publishing the terms and conditions of their products and in drafting standard contracts that contain reasonable protection for consumers.

New players are now entering the banking industry due to good macroeconomic indicators and current credit expansion. These new players will place stress on current credit valuation standards, as their plans involve obtain market share by attracting those who do not use banks from the poorer sectors of the population, and this will also challenge SBS's capacity to oversee a larger banking industry.

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 it is further explained in question 17, banks in Peru may be subject to an intervention regime by the SBS upon breaching certain regulatory obligations, including failing to meet capital requirements and incurring a certain level of losses. This situation is strictly regulated (see question 17).

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?

As explained in questions 17 and 18, if a bank enters into a surveillance regime, a recovery plan must be drafted by the bank and approved by the SBS. Said plan is drafted after the notice of surveillance regime is communicated to the bank, and must contain the measures to be taken by the bank in order to overcome the failure. In addition, a recovery agreement must be made between the bank and the SBS, containing several commitments by the bank including new capital contributions.

If the situation does not improve over the course of the surveillance regime, the SBS will commence an intervention regime after which the bank is dissolved by resolution of the SBS.

If this were to happen, the obligations of the bank undergoing liquidation will be paid in the following order: first, labour obligations; second, obligations originating from financial intermediation such as deposits or other modalities, not covered by deposit insurance (see question 4); third, tax obligations; and fourth, other obligations.

This order is established by the Banking Law and therefore, mandatory. In this context, the bank's management and directors must act according to the instructions of the SBS, following the directives it may dictate during the surveillance regime as well as during the intervention regime, which may include the appointment of a new board of directors, further capital contributions, among others.

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

Managers and directors of a bank could be subject to administrative, patrimonial and criminal liability, if they approve credit transactions knowing deliberately that such approval is in violation of the applicable legal lending limits. The sanctions are stricter if any such credit transaction is granted in favour of a manager or director of the bank or in favour of an affiliate of the bank, and moreover if as a consequence of approving such transactions the bank enters into a resolution situation.

Capital requirements

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

Under article 199 of the Banking Law, the regulatory capital of a bank may be no lower than 10 per cent of its total weighted assets, which is equivalent to:

- 10 times the regulatory capital allocated to cover market risks;
- 10 times the regulatory capital allocated to cover operational risks; and
- the total amount of credit risk-weighted assets.

16 How are the capital adequacy guidelines enforced?

Banks are required to prepare and submit to the SBS, on a monthly basis, several reports regarding compliance of capital adequacy regulations.

Furthermore, banks are required to send reports to the SBS regarding consolidated capital adequacy and consolidated regulatory capital on a quarterly and annual basis.

Under current regulations, Peruvian banks are not required to make contingent capital arrangements.

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

Surveillance

When a bank fails to meet the capital requirements established by the SBS, it is subject to a surveillance regime by the SBS. The surveillance regime will last for 45 days and may be extended for an additional 45 days.

During the surveillance regime, the competence and authority of the governing bodies of the bank are maintained without any limitations other than those imposed by the SBS, but a recovery plan or agreement must be reached in order to overcome the crisis. Such agreement is notified to the Central Bank, which is kept informed of its implementation.

The effects of a surveillance regime on a bank are the following:

- permanent inspection of the bank by the SBS, as per the powers conferred upon it by the Banking Law;
- prohibition from establishing or accepting trusts;
- suspension of voting rights that would otherwise be exercised in a shareholders' meeting or other meetings of equivalent bodies, with respect to any shareholders who may have acted as directors or managers at the time the bank was submitted to the surveillance regime;
- the SBS must immediately convene a general shareholders' meeting for the implementation of the necessary agreements to overcome the causes of the submission to the surveillance regime and especially for the implementation of the capital contribution that may be required by the SBS to the shareholders of the bank, as established by article 99 of the Banking Law; and
- other measures deemed necessary by the SBS.

Intervention

If, among other reasons, the recovery agreement referred to above or the particular provisions of the SBS are not complied with during the surveillance regime, positions subject to credit risk or market risk represent 25 times more than the total regulatory capital of the bank, or there is a loss or reduction of more than 50 per cent of the regulatory capital of a bank, such bank will be the subject of intervention by the SBS.

The effects of the intervention are the following:

- powers and authority of the shareholders' meeting will be limited exclusively to the issues related to the intervention, as established by law;
- suspension of the bank's business;
- application of the necessary portion of the bank's subordinated debt, if applicable, to absorb losses;
- application of the following prohibitions:
  (i) initiating any judicial or administrative processes with respect to collections from the bank;
  (ii) pursuing the execution of any court orders issued against the bank;
  (iii) granting liens over any of the bank's assets as a guarantee against any existing obligations;
  (iv) making payments or advances or providing compensation or assuming obligations on the bank's behalf, with any funds or assets it owns and that are in the possession of third parties, except for compensation to be made between companies of the financial and insurance system and compensation of reciprocal obligations arising from repo and derivative transactions executed with local or foreign financial and insurance institutions; and
  (v) other provisions that the SBS may deem necessary; and
- others that the SBS may deem relevant.

The intervention will last for 45 days, extendable once for an identical period. Once this period has expired, the corresponding resolution will be issued, ordering the dissolution of the company and the commencement of the relevant liquidation process.

The intervention procedure may finish before the end of the aforementioned term, whenever the SBS deems it convenient. The corresponding resolution must be previously notified to the Central Bank.

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

In addition to the intervention events referred to in question 17, a moratorium on payment of the obligations of the company may result in intervention by the SBS, with the effects detailed above.

Once the intervention period has expired, the process of dissolution – and liquidation – of the company will begin.

Other causes for liquidation of a bank are the grounds cited in the relevant articles of the Peruvian Corporations Law approved by Law No. 26,887, as applicable.

It must be taken into consideration that the resolution for dissolution does not end the legal existence of the bank, which will remain until the liquidation process is completed and, as a result thereof, the extinction is recorded before the corresponding Public Registry. Notwithstanding the above, upon the publication of the resolution for dissolution, the bank may not be a subject of credit in the Peruvian financial market, will be exempted from any taxes and may not be subject to the obligations prescribed by the Banking Law for active banks. Furthermore, the prohibitions (i) to (v) listed in question 17 will also be applicable as of the date of the publication of the SBS resolution for the dissolution of the bank.

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

No. As discussed previously, the Peruvian legal framework was revisited and amended in 2009 in order to conform to Basel II standards. If Basel III standards are adopted in Peru, then Peruvian banks may be required to significantly adjust their regulatory capital requirements in order to arrive at an appropriate level and quality of regulatory capital.

Ownership restrictions and implications

20 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 article 50 of the Banking Law:

> *Any individual or legal entity directly or indirectly purchasing stock of a company equivalent to 1 per cent of the capital stock throughout a period of 12 months, or which with the said companies attain a share equal to or greater than 3 per cent, shall be under the obligation of supplying the SBS any information it may request in order to identify their main economic activities and the structure of their assets. This includes revealing the names of shareholders in the case of companies issuing bearer shares.*

Among others, the following persons may not be shareholders of a bank:

- those convicted for illegal drug-trafficking, terrorism, attempting to commit a crime against national security, treason and other crimes;
- those declared bankrupt or those who are currently following an insolvency proceeding;
- those who, as directors or managers of a company, have been found to be administratively responsible for acts deserving sanctions in the previous 10 years;
- those who, in the previous 10 years, were majority shareholders, directors, managers or main executives of companies or private fund managers that were intervened by the SBS; and
- those who, according to the SBS evaluation, do not meet the solvency or moral integrity requirements.

Moreover, according to article 54 of the Banking Law, public officials and employees, as well as their spouses, may not hold shares of a company of the financial system in excess of 5 per cent of the company's capital stock.

Likewise, the chairman of the Securities Market Superintendency (the securities market regulator or SMV), the superintendent of the SBS, employees of any of those institutions, as well as their spouses, may not hold shares of a company of the financial system at all. Such limitation shall not apply in the case of shares acquired prior to their assuming the position or function, provided this is included in the corresponding sworn declaration of assets and income. Also exempted are shares that, without altering the pre-existing percentage, may be subscribed in the cases of capital increases.

Finally, according to article 55 of the Banking Law, any person who is, directly or indirectly, a majority shareholder of a bank or of the insurance system may not, directly or indirectly, be a holder of more than 5 per cent of the stock of another company of the same nature.

Regarding the definition of 'control', article 9 of SBS Resolution No. 445-2000 establishes that control is the preponderant and continuous influence in the decision-making process of a company. Control may be direct or indirect. A person is deemed to have direct control on a bank if such person exercises more than half of the voting rights of the general shareholders' meeting, through direct or indirect property, liens, trust, syndication or any other means. On the other hand, a person is deemed to have indirect control on a bank if such person has the ability to designate or remove most of the members of the board of directors (or equivalent corporate body), in order to exercise the majority of the voting rights on a board of directors' meeting (or equivalent assembly), or for the purposes of governing the operating or financial policies of the bank, even if such person does not have the majority of voting rights in the shareholders' meeting.

21 Are there any restrictions on foreign ownership of banks?

No. The Peruvian Constitution has established an attractive legal framework for foreign investment. Pursuant to article 5 of the Banking Law, foreign investors are to be provided with the same treatment afforded to local capital.

Moreover, any discriminatory treatment from the regulators to either local or foreign entities is expressly prohibited.

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

As mentioned in question 20, any person who is directly or indirectly a major shareholder of a bank or of an insurance company may not directly or indirectly be a holder of more than 5 per cent of the stock of another company of the same nature. Other than that, there are no express limitations to the business activities that entities that control banks may carry out.

Banks that belong to a financial (or mixed) conglomerate that performs its activities mainly in Peru will be subject to consolidated supervision by the SBS. They must comply with capital requirements for all activities being carried out by the companies comprising the conglomerate. Failure to comply with these requirements may result in restrictions or the suspension of activities of the bank.

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

The SBS is empowered to request from supervised banking and financial institutions financial statements and other relevant financial information on an individual or consolidated basis. The main purpose of the consolidated supervision is to carry out preventive measures aimed at lessening any possible risks with regards to transactions with other entities comprising the conglomerate or their common clients.

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

As mentioned in question 17, controlling and other shareholders may be required by the SBS to work on and approve a recovery plan or agreement and perform capital increases, as necessary.

Changes in control

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

Article 57 of the Banking Law establishes that prior authorisation from the SBS must be obtained in order to acquire shares in excess of 10 per cent of the capital stock of a bank.

If a legal entity domiciled in Peru is a shareholder of a bank with a percentage greater than 10 per cent, its shareholders must have prior SBS authorisation in order to assign any rights or shares of the aforementioned legal entity in a proportion higher than 10 per cent. If the shareholder is a non-domiciled legal entity, it is obliged to inform the SBS in the event of any changes in its ownership in the proportion of the excess of the aforementioned percentage, indicating the name of the shareholders of such non-domiciled legal entity.

As the bank acknowledges such situation, it must inform the SBS about the purchase of any part of its stock by a non-domiciled legal entity, indicating the names of the shareholders of the latter.

Furthermore, banks have to register their shares with the SMV and list them on the Lima Stock Exchange before starting business in Peru. In the event an existing shareholder or other investor increases its participation to a 'significant participation' or acquires a 'significant participation' in voting shares issued by a bank, said shareholder or investor must comply with the rules and regulations set for public tender offers (OPAs) (OPA Regulations) as approved by the SMV, in addition to the requirements established by the SBS.

In that regard, the current OPA Regulations state that the acquisition of a 'significant participation' in a company listed in Peru triggers the obligation of the acquirer to launch a post-acquisition OPA. The OPA Regulations consider the following situations as acquiring 'significant participation' in a listed company:

- having, directly or indirectly, a voting interest equal or higher to the following thresholds: 25, 50 or 60 per cent of the capital stock;
- the power of a person or a group of persons, without having direct or indirect participation, to exercise voting rights for 25 per cent or more of the capital stock; or
- having, directly or indirectly, voting rights in a percentage that will allow the acquirer to remove or appoint the majority of the target company's directors or amend the target company's by-laws.

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

The regulatory process is the same for local and foreign investors.

MIRANDA & AMADO

Juan Luis Avendaño **jlavendano@mafirma.com.pe**

Av. Larco 1301, 20th Floor
Miraflores
Lima
Peru

Tel: +51 1 610 4730
Fax: +51 1 610 4748
www.mafirma.com.pe

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

In addition to the requirements in question 25, investors seeking to acquire control of a bank must be recognised for their moral integrity and financial capacity.

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

Authorisation for acquiring more than 10 per cent of a bank stock must be requested from the SBS, by filing the relevant application together with a sworn statement declaring that the investor has no impediments to becoming a shareholder, in accordance with the relevant provisions of the Banking Law.

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

The SBS must resolve the authorisation request described above within 30 calendar days of filing.

* *The information in this chapter is correct as of March 2016.*

Philippines

Jose Florante M Pamfilo

SyCip Salazar Hernandez & Gatmaitan

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, 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: (i) ownership, control or power to vote of at least 20 per cent of the outstanding voting stock; (ii) interlocking directorship or officership; (iii) 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; (iv) 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 (v) 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.

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. 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 – all subject to pertinent rules promulgated by the Monetary Board.

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 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 financial technology into their systems and structures, and ensuring cybersecurity.

With the recent 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.

7 Are banks subject to consumer protection rules?

Banks are subject to the recently promulgated BSP Regulations on Consumer Protection, 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 ASEAN integration;
- strengthening anti-money laundering regulations to address weaknesses exposed by recent 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.

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 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?

Enforcement issues mostly relate to compliance by banks with BSP regulations on safe and sound banking practices in connection with the offering and provision of bank services and products.

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 18, 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 it 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 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 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.

Capital requirements

15 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 I (going concern) capital and Tier II (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.

16 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.

17 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.

18 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.

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

See question 15. 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

20 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.

21 Are there any restrictions on foreign ownership of banks?

See question 20.

22 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.

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

See question 22. 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 stockholding in such bank, under the Securities Regulation Code.

24 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 equity contribution to such bank.

Changes in control

25 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 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.

26 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.

27 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.

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.

28 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 notification to the PCC, 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.

29 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 notification to the PCC, parties to the transaction are prohibited from consummating the transaction before the expiration of the relevant periods provided in the regulations.

SyCip Salazar Hernandez & Gatmaitan

Jose Florante M Pamfilo **jfmpamfilo@syciplaw.com**

SyCipLaw Center
105 Paseo de Roxas
Makati City
1226 Metro Manila
Philippines

Tel: +63 2 982 3500 / 3600 / 3700
Fax: +63 2 817 3896
www.syciplaw.com

Singapore

Krishna Ramachandra and Gabriel Lee
Duane Morris & Selvam LLP

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. There are different licences granted by the Monetary Authority of Singapore (the MAS).

Full banks may provide the whole range of banking activities permitted by the Banking Act. There are currently five 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. Currently, there are 55 wholesale 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. Currently, there are 37 offshore banks.

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 (Chapter 19 of Singapore). 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 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 which 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 which 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.

In Singapore, the following are the prohibited or regulated activities of banks:

- Banks are prohibited from carrying on any non-financial business.
- Banks in Singapore cannot hold or acquire any equity investments in a single company the value of which exceeds 2 per cent of the capital funds of the bank without prior approval by the MAS.
- Banks must obtain the prior approval of the MAS before it holds or acquires, directly or indirectly, a major stake in any company. 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 immoveable property the value of which exceeds 20 per cent of the capital funds of the bank.
- 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 recent findings of the investigations 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.

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 thus a real regulatory challenge as 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 materials.

7 Are banks subject to consumer protection rules?

In Singapore, the Consumer Protection (Fair Trading) Act (Chapter 52A of Singapore) (the 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: (i) customers have confidence that they deal with financial institutions where fair dealing is central to the corporate culture; (ii) financial institutions offer products and services that are suitable for their target customer segments; (iii) financial institutions have competent representatives who provide customers with quality advice and appropriate recommendations; (iv) customers receive clear, relevant and timely information to make informed financial decisions; and (v) 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, thus indirectly protecting consumers.

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

Currently, financial technology (fintech) is becoming more prevalent, resulting in the emergence of financial products or services that utilise fintech. 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 that utilise 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. Thus, regulations relating to such financial services or products that utilise fintech is expected to undergo some changes in the future.

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 of the auditors of the banks, reports of the directors of the bank, interim profit and loss statements and more.

The MAS also has the power to, from time to time, 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 in Singapore 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 which is 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 available 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 mentioned, 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 breaches of 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 such part of the business of a foreign-incorporated bank in the following circumstances:

Update and trends

The MAS has recently issued a consultation paper in relation to payment systems. Currently, Singapore's payment regulations consist of the Payment Systems (Oversight) Act and the Money-Changing and Remittance Businesses Act, which govern stored value and remittances respectively. However, owing to technological advances, the lines between payments and remittance are blurring and new payment providers that do not fit neatly into either category are emerging. The MAS is thus proposing a new payments framework that will supersede the current regulations and bring them under a single framework that will provide for the licensing, regulation and supervision of all payments services, including stored value facility holders, remittance companies, and virtual currency intermediaries. One of the objectives of the new payment framework is the levelling of the playing field between banks and non-banks in the payments industry. The new proposed payments framework is expected to result in significant regulatory changes when it does come into force.

- 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 is 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 to the MAS quarterly statements 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 which is or is likely to become insolvent or is or is likely to be unable to meet its obligations is required to immediately inform the MAS of that fact. Thus, it would follow that the responsibility is on the bank's management and directors to ensure that this is done.

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.

The MAS has also, in April 2016, proposed changes to the Monetary Authority of Singapore Act that relate to resolution plans of banks. The new amendment, which include a new MAS Notice, will require banks to establish a recovery plan, put in place processes to update the recovery the recovery plan at least annually, ensure that the recovery plan is approved or endorsed by the board of directors, and submit the recovery plan to the MAS.

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 on 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 officer of the company 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 may be compelled to repay or restore such property or be made to contribute such sum to the assets of the company by way of compensation.

Capital requirements

15 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 Singapore.

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 have also a capital adequacy ratio of at least 12 per cent as required by the Banking Act.

Further, the 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;
- mnimum total CAR of 10 per cent; and
- minimum capital conservation buffer of at least 1.25 per cent in 2017, 1.875 per cent in 2018, and 2.5 per cent in 2019.

In addition, Singapore-incorporated banks must maintain, pursuant to MAS Notice 639, a Singapore dollar liquidity coverage ratio of at least 100 per cent and 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.

Banks incorporated outside Singapore

Foreign-incorporated banks are required by the Banking Act to have a minimum paid-up capital of S$200 million.

16 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.

17 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.

Further, where the MAS is satisfied that a director of the bank 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 such directors.

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

Under the Banking Act, any bank which is or is likely to be insolvent is required to immediately inform the MAS. Any bank which fails to do so is guilty of an offence.

Under the Monetary Authority of Singapore Act (Chapter 186 of Singapore), 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 such of the business as the MAS may determine; or
- assume control of and manage such 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 (Chapter 50 of Singapore) if it is insolvent. A company may be wound up under an order of the court on the application of the bank itself, any creditor, any contributory, or of the MAS. In addition, the Banking Act prescribes that certain liabilities of the banks shall have priority over all unsecured liabilities of the bank, 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 the paying any remainder to the liquidator of that foreign company for the place where it was formed or incorporated.

19 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 mentioned above, the requirements are expected to be further strengthened as seen by the requirement 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

20 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 total votes in the bank.

Also, a person must first obtain the approval of the Minister before becoming: (i) a 12 per cent controller; (ii) a 20 per cent controller; or (iii) 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.

21 Are there any restrictions on foreign ownership of banks?

There are currently no restrictions on foreign ownership of banks. However, as stated above, any acquisition which 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 prior approval of the MAS.

22 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 cent controller or indirect controller of Singapore-incorporated banks, if he 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. 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 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 which the MAS may require for the purpose of ascertaining or investigating into the control of shareholding or voting power in the bank.

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

As stated above, 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 associates where the Minister is satisfied that that person is not a fit and proper person or if, having regard to the

DuaneMorris® & SELVAM LLP
A JOINT LAW VENTURE

Krishna Ramachandra **kramachandra@duanemorrisselvam.com**
Gabriel Lee **glee@selvam.com.sg**

16 Collyer Quay #17-00
Singapore
049318

Tel: +65 9822 5011
Fax: +65 6311 0058
www.duanemorrisselvam.com

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. Thus, there is an implicit duty on the entities or individuals that control banks to be a fit and proper person, and to not negatively influence the bank such that it is no longer likely to conduct its business prudently or to comply with the provisions of the Banking Act.

24 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 such of the business of the bank as the Authority may determine. This may have implications on the shareholders.

Changes in control

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

See question 20.

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

As stated above, there are currently no restrictions on foreign ownership of banks. However, any acquisition which 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 prior approval of the MAS. One of the conditions listed in the Banking Act relating to such approval is that the Minister must be satisfied that it is in the national interests to approve the acquisition. Thus, this might have an impact on foreign acquirers.

27 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 interests to grant such approval.

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

As stated above, 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.

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

The time required for regulatory approval would depend on the facts of the circumstances including the characteristics of the potential acquirer.

Spain

Fernando Mínguez and Miguel Sánchez Monjo

Cuatrecasas

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 financial crisis 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, and increasingly, influenced and determined by 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 Act 10/2014, on organisation, supervision and solvency of credit institutions. The purpose of this Act is twofold: implementing Directive 2013/36/EU (CRD IV) into Spanish law and recasting Spanish banking regulation into one single set of provisions. This Act governs regulatory requirements and the authorisation process for incorporating banks and for acquiring significant holdings, requirements applicable to directors and senior officers (suitability, incompatibilities and limitations), corporate governance (including remuneration policies and internal functions), solvency, supervision and the discipline regime. Act 10/2014 is developed by Royal Decree 84/2015, which regulates the aspects governed by it in more detail. Together with Act 10/2014, the pillar of financial stability is Act 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 Act 16/2011 (consumer credit), Act 16/2009 (payment services) and Order 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?

Banco de España (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, 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 Banco Mare Nostrum, SA and 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 shall 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

such 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.

The rest of the 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
- crowdlending platforms, whose activities are limited to promote and manage the crowdlending 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?

Spanish regulation has taken important steps to consolidate the banking sector in recent years. 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 of the Spanish banking sector have a practical nature. In particular, three aspects should be reviewed and consolidated in the coming years:

- coordination between the ECB and the Bank of Spain under the SSM so that both regulators may have a clear picture of their respective roles and responsibilities;
- determining how the prudential regulation on bank resolution and restructuring may apply in relation to the new stage of consolidation of the Spanish banking sector, which should result in fewer and bigger banking institutions; and
- the adaptation of the Spanish banks to the legal framework which may approved in the coming years, either at EU or local level, in relation to the application of disruptive technologies to financial services (fintech).

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 1/2007, approving the recast text of the Act on the Protection of Consumers and Users. Legislative Royal Decree 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 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 remarkable. 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 such 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 shall be provided to clients on a pre-contractual basis. First, the 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; second, 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. Finally, 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 shall 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 Act 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 Act 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 Act 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 Act 16/2009, which also provides obligations on the information to clients and their rights; and
- investment services, subject to the Securities Market Act (Legislative Royal Decree 4/2015) and Royal Decree 217/2008, implementing the European 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 recently approved and implemented by way of directly applicable EU regulation (ie, SSM and CRR) and its local developments. Any further change will be conducted at European level.

With respect to other aspects of the banking business, Spanish regulation has been reinforced in the recent past 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 and recovery plans and early intervention.

The way 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. Particularly, the ECB is responsible for direct supervision of significant institutions or groups, while the Bank of Spain (as the national competent authority) is responsible for direct supervision of 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. In any event, Spanish significant institutions – by application of the size criterion – account for over 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 the implementation of 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 the supervision of entities that are not 'credit institutions' (ie, those not authorised to take deposits), non-EU institutions operating through branches or free to provide services, receiving of 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 mainly 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 massively 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 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 law courts because of the misleading information provided. However, the most relevant case is the massive 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 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 Act 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 20 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 Act 11/2015.

Additionally, credit institutions may be intervened in the cases provided by Act 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.

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, and as a preventive measure under Act 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 significant deterioration of 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 shall 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.

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, shall 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 shall 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 shall 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 management of the business, destruction of required documentation, 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.

Capital requirements

15 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:

- common equity Tier 1 (CET1) capital ratio of 4.5 per cent;
- 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 84/2015, which sets the levels of countercyclical capital buffer and systemic risk buffer, and Circular 2/2016 of the Bank of Spain.

In addition, Spanish banks shall 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.

16 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 17.

17 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.

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

If, despite the measures mentioned in question 17 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 Act 11/2015.

Banks are not exempted from ordinary, court-driven insolvency proceedings (eg, under the general Insolvency Act 22/2003). Banks may end up filing for bankruptcy if the FROB decides, under Act 11/2015, that it is not worthwhile to resolve the bank otherwise, or subsequent to the application of special resolution or recovery tools under

Act 11/2015, an institution (with its legacy assets) may be rerouted to the bankruptcy court.

19 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 has also been approved in Spain recently by way of Act 10/2014, Royal Decree 84/2015 and Circular 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

20 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.

21 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.

If, however, once the transaction is completed, 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.

22 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 23.

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.

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

In addition to question 22, 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.

24 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

25 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.

26 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 mentioned in question 21, 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 recently accepted the purchase 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.

27 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 shall 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.

28 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;
- information about the transaction: purpose, price and payment terms, impact on the distribution of voting rights, 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.

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

The Bank of Spain/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.

CUATRECASAS

Fernando Mínguez **fernando.minguez@cuatrecasas.com**
Miguel Sánchez Monjo **miguel.sanchez@cuatrecasas.com**

Almagro 9
28010 Madrid
Spain

Tel: +34 915 247 100
Fax: +34 915 247 124
www.cuatrecasas.com

Sweden

Magnus Lindstedt, Kiran Singh and Neha Prakash
Advokatfirman Cederquist KB

Regulatory framework

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

The banking sector in Sweden is regulated by the Swedish Financial Supervisory Authority (SFSA). The task of macro prudential supervision is shared between the SFSA and Sweden's central bank (the Riksbank), where the SFSA has the direct responsibility for the supervision of individual financial institutions and the Riksbank has the overall responsibility to monitor the stability of the financial system. In addition, the SFSA together with the Riksbank, the Swedish National Debt Office (SNDO) and the Ministry of Finance are parties of the Financial Stability Council, which is a joint forum for issues concerning financial stability and financial crisis management.

Legislation covering the banking sector is within the responsibility of the Ministry of Finance, which has the objectives of:

- a stable financial system, characterised by a high level of confidence and with efficient markets that meet the needs of households and businesses for financial services, while maintaining a high level of consumer protection;
- a financial system that contributes to a sustainable development; and
- central government financial management that is conducted efficiently.

The official policy of the government with regard to banking regulation emphasises the importance of consumer protection and transparent information to consumers of financial services.

The Riksbank is organised as an independent central bank hierarchically established under the Swedish parliament. Its main objectives are to promote financial stability and a safe and efficient payment system as well as to enforce a monetary policy in order to maintain price stability. The SFSA on the other hand, is a governmental authority, hierarchically established under the Ministry of Finance, and governed by the Government's regulation (2009:93) with instructions for the SFSA. The main objectives of the SFSA are to promote a financial system that is stable and characterised by a high level of confidence with efficient markets to meet households and businesses needs for financial services and ensures a high level of consumer protection.

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

The primary legislation governing the banking sector in Sweden is the Banking and Financing Business Act (2004:297), implementing the European banking directives, containing the core provisions relating to banking and financing business. In addition, banks in Sweden have to comply with the Directive 2013/36/EU (CRD IV) implemented through the Credit Institutions and Securities Companies (Special Supervision) Act (2014:968) and the Capital Buffers Act (2014:966), and the Regulation (EU) 575/2013 (CRR) of the European Parliament and the Council.

It should be noted that the Banking and Financing Business Act (2004:297) defines credit institutions as either banks, conducting banking business, or credit market companies, conducting financing business. Thus, the national Swedish banking regulation provides for two types of credit institutions: the bank category includes limited liability banks, savings banks and co-operative banks, whereas credit market companies can only be limited liability companies or cooperative associations.

The definition of 'banking business' stipulates two criteria that trigger the need for a banking licence, and which banks must fulfil, namely that a bank must take part in a general payment transfer system and accept deposits that are readily available for depositors (within 30 days).

The definition of 'financing business' also stipulates two criteria that trigger the need for a credit market company licence, and that a credit market company must fulfil, namely that a credit market company must accept repayable funds from the public and grant credits, provide guarantees for credits or provide leasing for financing purposes.

Thus, a difference between a bank and a credit market company is that a bank must take part in a general payment transfer system, whereas a credit market company may take part in such a system. Another key difference is that a bank must accept deposits that are readily available for depositors (within 30 days), whereas a credit market company does not have to consider any time frame for making deposits available for depositors. If, however, a credit market company takes part in a general payment transfer system and grants credits, etc, then it must not accept deposits readily available for depositors as that would require a banking licence. If not stated otherwise in our answers below, what applies to banks also applies to credit market companies.

Other important statutes and regulations include the following acts:

- the Consumer Credit Act (2010:1846);
- the Deposit Guarantee Act (1995:1571);
- the Money Laundering and Terrorist Financing (Prevention) Act (2009:62);
- the Payment Services Act (2010:751);
- the Preventive Government Support to Credit Institutions Act (2015:1017);
- the Resolution Act (2015:1016); and
- the Consumer credit agreements regarding residential immovable property Act (2016:1024).

As for the detailed regulations and guidelines issued by the SFSA, they are found in the SFSA rulebook (FFFS), including, inter alia, FFFS 2014:1 on Governance, Risk Management and Control in Credit Institutions. The SFSA publishes both regulations that are binding on the credit institution and guidelines that are not binding, but generally complied with. If a bank decides not to comply with such non-binding guidelines, the bank must be able to explain its non-compliance upon request by the SFSA, including how the objective of the guideline was met in another manner than by complying with the guideline.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The main authority responsible for overseeing banks in Sweden is the SFSA. The SFSA is responsible for authorisations, prudential supervision and conduct of business issues. The Riksbank, on the other hand, is responsible for the overall stability of the financial system and overseeing the payment system. In addition, the SNDO is the competent resolution authority and is also responsible for the deposit guarantee scheme in Sweden.

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 deposit guarantee scheme in Sweden is a state-provided guarantee managed by the SNDO that covers deposits in accounts that are approved by the SNDO, which typically includes most types of bank accounts and accounts with credit market companies. If an institution goes bankrupt, or if the SFSA so decides as it deems the non-repayment of a deposit to be caused by the financial situation of the institution, then each customer (including individuals as well as legal persons) of that institution has the right to recover up to 950,000 kronor or €100,000 from the deposit guarantee. In addition, a customer can recover up to an amount of 5 million kronor for certain deposits such as deposits resulting from real estate transactions relating to private residential properties or deposits that are linked to particular life events including divorce, retirement or death. All institutions that are part of the deposit guarantee scheme pay a yearly fee to the deposit guarantee fund.

During the global financial crisis, in November 2008 the SFSA revoked Carnegie Investment Bank's banking licence and the bank was subsequently taken over by the SNDO in a joint effort by the SNDO, the SFSA and the Riksbank. In February 2009, Carnegie Investment Bank was sold to private investors, and the state currently has no holding in the bank. Following the Swedish financial crisis of the 1990s, the government had an ownership in Nordea Bank AB, which was divested in September 2013.

Currently, the government owns SBAB Bank, focusing on mortgage loans. SBAB was authorised by the SFSA as a bank in November 2010. Even though debated from time to time, there is currently no official intention to sell the government's ownership in SBAB.

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 SFSA has opted to exclude transactions between affiliates from the exposure limitations set forth in the CRR and thus, according to regulation FFFS 2014:12 on Supervisory Requirements and Capital Buffers, the limitations shall not apply for banks when calculating exposures against affiliates. For the purpose of this regulation, affiliates are deemed to mean companies within the same group on a consolidated basis in accordance with the CRR.

With regard to transaction limitations between related parties, such limitations are applicable to a bank's transactions with natural or legal persons that are closely related to the bank, namely:

(i) board members;
(ii) employees to which the board has delegated powers to make credit decisions;
(iii) employees in executive management positions;
(iv) shareholders other than the state that have a holding representing no less than 3 per cent of the total share capital;
(v) a spouse or partner to a person referred to in (i)–(iv) above; and
(vi) a legal person where a person referred to in (i)–(v) has a substantial interest as owner or member.

Related parties may only enter into agreements with the bank on terms that are commercially motivated.

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

The European Council is preparing a new regulation on a banking structural reform pursuant to the Liikanen report in order to improve the resilience of EU credit institutions. The regulation is currently under negotiation and no final proposal has yet been delivered. The Commission has presented a draft proposal on the new regulation where the largest banks in Europe (banks that are deemed too big to fail), would be obligated to separate their banking business from their trading activities, including market-making activities. If such rules become applicable to Swedish banks, it could entail reorganisation of some of Sweden's largest banks, and could potentially affect the financial market in Sweden as Swedish banks provide liquidity through market-making, especially with regard to government bonds and other fixed-income securities.

Pursuant to the CRD IV and the CRR, tougher capital requirements in the form of the leverage ratio requirement are expected to be implemented during 2018. The leverage ratio requirement sets a floor for how low the capital adequacy requirement can fall in relation to the bank's total assets. The purpose of the leverage ratio is that there should be a capital buffer for bad times. It is expected that the leverage ratio requirement will have a level of 3 per cent. The SFSA expects that a leverage ratio could give the banks an incentive to increase the risk level in their assets. As a leverage ratio would not take into account the risk weight of the assets held by the banks, and the banks would thus have an incentive to reduce their low-risk assets such as government bonds and covered bonds in favour of high risk assets.

New regulatory regimes covering other financial sector entities will also impact the Swedish banking sector, such as the implementation of Directive 2014/65/EU (MiFID II), for example, when giving advice on financial services and products, as well as the implementation of Directive 2016/97/EU (IDD) when distributing insurances. In addition the implementation of Directive 2015/2366/EU (PSD 2) could impose an impact on the Swedish banking sector. The directive obligates banks to offer third-party providers (TTP) greater access to their payment accounts services.

7 Are banks subject to consumer protection rules?

All businesses in Sweden, including banks, are subject to general consumer protection rules covering, for example, standard contract terms, electronic commerce, sales of goods and services and marketing. The Swedish Consumer Agency (SCA) is the main authority for the handling of consumer issues; however, certain responsibilities with regard to financial services are shared between the SCA and the SFSA. Banks are especially subject to consumer protection rules with regard to consumer credit and financial advice. While the SCA is responsible for consumer issues, disputes and marketing issues, the SFSA has the responsibility for overseeing the banks' compliance with applicable laws and regulations, and also with regard to consumer protection, and may thus take direct action against banks under its supervision for non-compliance with consumer protection laws and regulations.

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

Since the financial crisis of 2008 and the European debt crisis of 2011, several EU regulatory frameworks covering the banking sector have been implemented in Sweden, including the CRD IV and the CRR. The current belief is that this will continue to impact the financial sector in Sweden during the coming years. The steps at EU level on implementing banking structural reform may have a regulatory impact on Swedish banks, even though we do not know to what extent yet, as there is no final proposal on such regulation. Also new regulatory regimes covering other financial sector entities, such as MiFID II, IDD and PSD 2, will impact the Swedish banking sector (see question 6). The government has proposed a higher resolution fee to be implemented during 2018. The banks currently pay an annual resolution fee to the resolution reserve which has been proposed to be raised from 0.09 per cent of debts minus guaranteed deposits to 0.125 per cent. The higher resolution fee would, according to the proposal, strengthen the resolution reserve as well as the public finances.

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 SFSA. The supervision is risk-based, meaning that the banks will be classified based on their respective risks. If the SFSA would deem a bank to have inherent risks, or if the SFSA in its assessment of a bank identifies issues that could have major negative consequences on the financial stability or for consumers, the bank will be classified by the SFSA as a high-risk bank and will be supervised and assessed by the SFSA accordingly. The SFSA further bases its risk assessment on the financial stability as a whole, including the state of

the financial markets. The banks have been divided into four categories by the SFSA:

- Category 1 consists of banks that have been identified as systematically important institutions;
- Category 2 consists of other large or medium-sized banks with more complex or more comprehensive cross-border activities, or both;
- Category 3 consists of medium-sized or small banks without comprehensive cross-border activities and with limited complexity; and
- Category 4 consists of small banks with a small impact on the financial markets in which they operate.

Category 1 (Nordea Bank, Svenska Handelsbanken, SEB and Swedbank) and Category 2 banks are regularly supervised by the SFSA, whereas Category 3 and 4 banks are not supervised as regularly. However, all banks are reviewed at least yearly. During its ongoing supervision, the SFSA relies on the frequent reports of financial and other data, which the banks are obligated to submit to the SFSA. The supervision by the SFSA consists of a continuous surveillance and evaluation of risks and the banks' compliance with applicable regulations. The governance and risk management, capital situation, financial products and consumer relations of the banks are regularly monitored by the SFSA.

To get a more extensive knowledge of the banks, the SFSA does often use market studies and surveys as part of its supervision. A survey could be directed to all banks or individual banks. In some cases the purpose of the surveys is to obtain information from the banks, and in some cases these surveys involve on-site inspections by the SFSA. The surveys aim to find information that normally does not appear in the ongoing supervision.

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

If the SFSA identifies a breach of any regulation governing the banking sector, the SFSA may decide on sanctions against the bank. The SFSA has various sanctions at its disposal, including remarks of non-compliance (whether non-public or made public), fines or banning orders. Further, the SFSA may issue a formal warning, normally combined with fines, or ultimately withdraw the banking licence altogether (which can also be combined with fines).

The SFSA also has the possibility to address administrative pecuniary penalties against natural persons. Such natural person must be a member of the board or a director of the bank. The administrative pecuniary penalty presumes that there has been serious violation of article 67 of the CRD IV, and further, that the violation depends on a wilful act or an act of gross negligence. The penalty can consist of pecuniary penalty of up to €5 million or a temporary ban from exercising functions in financial institutions, or both.

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

It is difficult to point to any common enforcement issue with regard to Swedish banks. The SFSA would normally refer to deficiencies in a bank's internal governance and control when motivating its sanctions, regardless of the enforcement issue at hand. During recent years, the SFSA has had some focus on banks' compliance with the Anti-Money Laundering (AML) regulatory framework. In 2015, Nordea Bank and Svenska Handelsbanken were both subject to sanctions from the SFSA because of insufficiencies in their AML routines. Nordea Bank received a warning and a fine of 50 million kronor. Handelsbanken received a remark and a fine of 35 million kronor. Furthermore, Nordea had already received a warning and a fine for having inadequate AML routines in 2013.

Another enforcement issue that the SFSA has focused on recently are the banks' routines for identifying and handling conflicts of interest. One Category 1 bank is currently under review by the SFSA with regard to conflicts of interest related to its senior 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?

Sweden has implemented the European Bank Recovery and Resolution Directive 2014/59/EU (BRRD) through the Resolution Act (2015:1016) and the Preventive Government Support to Credit Institutions Act (2015:1017), which came into force in February 2016. In Sweden it is the SNDO that is the competent national resolution authority and is responsible for resolution actions. Under these acts, the Swedish government may provide support to banks and assume the rights of the shareholders of a bank. It is, however, not common for the government to intervene in banks, and the example referred to in question 4 (Carnegie Investment Bank) is one of very few examples.

The SFSA shall notify the SNDO, and the SNDO shall decide if the bank needs to resolve, if the SFSA (by its own initiative or after instructions by the SNDO) finds that:

- a bank will fail, or is likely to fail;
- there are no alternative measures that could remedy or prevent a bank failing; and
- resolution is necessary in the public interest.

If the government has taken over the ownership of a bank, the shareholders will lose their voting rights (ie, they will lose their right to decide in decisions regarding the bank). The SNDO can decide that creditors may be prohibited from redeeming securities or call for collateral, etc, held by the bank, once the bank is under resolution.

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 accordance with the Resolution Act (2015:1016), the SNDO has the right to, and should, replace the management and directors in the case of resolution. The management and directors only have the right to maintain their positions if they have necessary information and knowledge about the bank that the SNDO cannot obtain in another way, meaning that the general rule is that the management and the directors should be replaced. The management and directors of the bank are obligated to cooperate with the SNDO and shall assist with all information that is necessary to reach the objectives of the resolution.

A resolution plan must be in place for each bank and the SNDO is responsible for establishing such resolution plans and for updating the plans yearly. A resolution plan must describe how the bank should be managed in the event of resolution. The SNDO and the SFSA will assess whether the bank could resolve from an economic perspective. If there are significant difficulties that make it impossible for the bank to resolve, the SNDO may demand that the institute take necessary steps to make resolution possible. In addition, banks must maintain a recovery plan identifying the measures to be taken in order to recover from a situation of financial stress.

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

A bank failure does not automatically result in liability for the managers and the directors. However, if the bank fails because of breaches of regulations or misconduct or negligence from the management or directors, the management or directors may face administrative disciplinary actions, criminal prosecutions or civil liability. Administrative pecuniary penalty may be relevant if the institute has seriously breached a financial regulation and the breach is because of gross negligence by the management or the directors.

Capital requirements

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

Swedish banks are subject to the capital requirements pursuant to the CRD IV and CRR, based on the Basel III framework. According to the Banking and Financing Business Act, a company applying for a banking licence shall have a minimum starting capital of €5 million. In

Update and trends

As mentioned above, the banking sector will continue to be impacted by new regulations on national and EU level. With regard to national regulations, the proposed raise of the resolution fee is currently a much discussed topic. The higher resolution fee would, according to the proposal, strengthen the resolution reserve as well as the public finances but critics say that Sweden already has one of the largest resolution reserves in the EU and fear that the higher fees would eventually be paid for by the customers through increased banking fees. The proposed regulation on a structural banking reform may impact systemically important Swedish banks, if the final regulation entails the separation of banking activities from the banks' trading activities. In addition, new rules such as MiFID II and IDD may impact the banking sector, for example, when giving advice on financial instruments or distributing insurances. Furthermore the banking sector will have to conform with the new obligations set out in PSD 2 by giving TTP access to their payment accounts services.

accordance with the CRD IV and CRR, a bank must hold a minimum capital in relation to its risk weighted assets (RWA), set out as Tier 1 capital at minimum 6 per cent of RWA and Tier 2 capital at maximum of 2 per cent of RWA.

Tier 1 capital includes common equity Tier 1 capital (CET 1) at minimum 4.5 per cent of RWA, including equity capital and profits after deduction of items such as goodwill and taxable income, and additional Tier 1 capital (AT 1) at maximum of 1.5 per cent of RWA, including subordinated debt instruments that fulfil certain requirements of the CRR. Tier 2 capital is mainly set up of supplementary capital instruments that fulfil the requirements of the CRR.

In addition to the minimum capital requirements, according to CRD IV and CRR, a bank must maintain capital buffers, including the capital conservation buffer, the countercyclical buffer, the systemic risk buffer, the global systemic risk buffer and the other systemic institutions buffer. The capital conservation buffer shall be at a minimum of 2.5 per cent of RWA, comprising of CET 1 capital. The countercyclical buffer shall be applied during times of rapid credit growth, meaning that banks shall maintain a buffer in accordance with a percentage set by the SFSA on a quarterly basis, between zero and 2.5 per cent of RWA.

Also, the SFSA may apply systemic buffers on financial institutions that are deemed to be systemically important, and the SFSA has therefore decided that Sweden's four largest banks, including Swedbank, Nordea Bank, Svenska Handelsbanken and SEB, shall apply an additional 3 per cent systematic risk buffer of CET 1 capital and additional 2 per cent CET 1 capital pursuant to Pillar 2 of the CRD IV and CRR.

16 How are the capital adequacy guidelines enforced?

Compliance with the capital requirements is overseen by the SFSA, and the banks have to report their capital situation to the SFSA on an ongoing basis.

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

If a bank becomes undercapitalised, the SFSA could order the bank to, within a specified timeframe, limit its business, limit its risks or take other actions in order to comply with the capital requirements. The bank then has to comply with the SFSA order, and if it does not, the SFSA may impose sanctions and ultimately revoke the bank's banking licence.

If a bank fails to maintain any capital buffer required, the bank will have to report a capital conservation plan to the SFSA within five business days, specifying how the bank will satisfy the buffer requirement. If the SFSA does not deem such capital conservation plan to be sufficient, the SFSA shall order the bank to strengthen its capital. The SFSA may also take other actions, including imposing sanctions.

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

If a bank becomes insolvent, the SNDO and the SFSA shall decide that the bank shall resolve. It is the SFSA that initiates the process, but the SNDO that makes the final decision in the matter. When the SNDO has made a decision that a bank shall resolve, the SNDO assumes the right to vote for the shares of the bank. The SNDO should further appoint a new board and new directors of the bank (see questions 12 and 13). During resolution, only the SNDO may apply to the court for an order to dissolve and wind up a bank. If so, the liquidation will be handled in accordance with ordinary insolvency proceedings.

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

The capital requirements for banks changed in 2014 because of the implementation of the CRD IV and the CRR coming into force. Pursuant to the CRD IV and the CRR, a minimum leverage ratio is yet to be implemented (see question 6).

Ownership restrictions and implications

20 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 express legal or regulatory limitations regarding types of entities and individuals who may own a direct or indirect controlling interest in a Swedish bank.

The Swedish rulebook is in relation to ownership assessment focused on holders of a qualifying holding rather than control, where a qualifying holding is defined as a direct or indirect holding of 10 per cent or more of the share capital or voting rights of the bank, or a holding that otherwise renders it possible for the acquirer to exercise a significant influence over the management of the bank. An entity or individual who decides to acquire, alone or together with certain defined closely related parties, such a qualifying holding in a Swedish bank must undergo an ownership assessment before the SFSA, thereby obtaining consent to the acquisition from the SFSA in advance. The same ownership assessment procedure and obtaining of consent must also be undertaken if a qualifying holding is increased beyond the thresholds of 20, 30 and 50 per cent of the share capital or voting rights of the bank. If the entity or individual omits to obtain such consent, the SFSA may prohibit the acquirer from exercising its voting rights and impose sanctions, including punitive fines. See question 28.

21 Are there any restrictions on foreign ownership of banks?

There are no regulatory restrictions on foreign ownership of banks in Sweden.

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

Any change in a qualifying holding (see question 20) must be reported to the bank and to the SFSA if the change entails that the holding reaches, exceeds or falls below any of the thresholds mentioned under question 20. Also, entities that are owners of a qualifying holding in a bank must notify the SFSA of changes to its management.

Further, the SFSA may order that an owner of a qualifying holding of shares or votes in a bank may not represent more shares or votes at the general meeting than correspond to a non-qualifying holding where:

- the holder impedes or can be anticipated to impede the operations of the bank being conducted in a manner that is compatible with statutory instruments governing the bank's operations;
- the holder has, to a material degree, breached its obligations in business operations or other financial matters or has otherwise committed a serious crime;
- the holder is a financial or mixed financial holding company and its management does not satisfy the requirements placed on the management of such a company pursuant to special supervisory legislation; or
- there is reason to believe that the holding has a connection to, or can increase the risk of, money laundering or financing of terrorism.

Additionally, such an owner of a qualifying holding may be ordered by the SFSA to sell such a portion of its shares so that the holding thereafter no longer constitutes a qualifying holding or to pay a punitive fine, or both.

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

An owner that has decided to sell a qualifying holding in a bank, or a sufficiently large portion thereof so that the interest thereby falls below the thresholds indicated under question 20, must notify the SFSA thereof. A legal person that holds a qualifying holding must also report any changes in its management to the SFSA.

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

If the SNDO decides that a bank should resolve, the SNDO may assume the rights of the shareholders of the bank (see questions 12 and 13). A bank may also under company law be obligated to go into involuntary liquidation because of capital deficiency. A shareholder who participates in a decision to continue the bank's operations with knowledge of the bank's obligation to go into liquidation is jointly and severally liable together with the bank's representatives for such obligations as are incurred by the bank after the date on which the board of directors of the bank should have petitioned the court for a liquidation order.

Changes in control

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

As per our response to question 20, an entity or individual that acquires a qualifying holding in a Swedish bank, or increases it beyond certain thresholds, must undergo an ownership assessment process before the SFSA and obtain consent from the SFSA in advance of the acquisition. Approval may also be required under national or EU competition law. If the shares of the bank are admitted to trading on a regulated market, the Swedish takeover rulebook would apply to any public takeover offer for the shares of such a publicly traded bank (primarily the rules set out in the Stock Market (Takeover Bids) Act and the takeover rules issued by the stock exchange in question).

26 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. If the acquirer is authorised as a credit institution, electronic money company, insurance undertaking, securities company or management company licensed to conduct business pursuant to the provisions of Directive 2009/65/EC, in a country within the EEA, is a parent company of such an undertaking or is a natural or legal person that controls such an undertaking, the SFSA must consult the relevant home-state regulator before issuing consent to an acquisition. Also, in the case of foreign acquirers other than authorised institutions, the SFSA typically consults relevant home-state authorities such as tax agencies and company registration offices.

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

When assessing if consent shall be granted for an acquisition or increase of a qualifying holding in a Swedish bank, the SFSA conducts an ownership assessment in order to determine if the acquirer is deemed suitable to exercise a significant influence over the management of the bank and if it can be believed that the anticipated acquisition is financially sound. Consideration shall be taken to the acquirer's likely impact on the business of the bank. In conjunction with this assessment, the acquirer's reputation and financial strength shall be taken into consideration. The SFSA shall also take into consideration whether:

- any person who, as a result of the acquisition, will become a member of the board of directors of the bank or act as managing director has sufficient insight and experience and is otherwise suitable for the task, as well as whether the board of directors, taken as a whole, has sufficient expertise and experience to run the bank;
- there is reason to believe that the acquirer will impede the operations of the bank in such a way as is compatible with statutory instruments which regulate the business of the bank; and
- there is reason to believe that the acquisition has a connection with or can increase the risk of money laundering or terrorist financing.

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

Applicants for consent to an acquisition or increase of a qualifying holding are recommended to use the SFSA prescribed forms, which are available online, as further described in the SFSA regulation FFFS 2009:3, regarding ownership assessment when submitting the required information to the SFSA. There are different forms depending on whether the acquirer is a natural or legal person. Where the acquirer is a legal person, a separate form shall be used to provide information about board members, deputy board members, managing directors and deputy managing directors of the acquiring legal person. Also, indirect owners who will acquire an indirect qualifying holding through the acquirer must provide this information to the SFSA.

Completion of the forms requires supporting documentation such as a description or chart of the entire ownership chain, documentation that supports the financing of the acquisition or increase of a qualifying holding, and, where the ownership subsequently will exceed 50 per cent of equity or voting capital, the application for consent shall also include a business plan. The business plan shall contain:

- a strategic development plan;
- forecasts for the bank for the coming three years;
- a description of how the acquisition will impact the governance and organisation of the bank;
- a solvency or capital adequacy calculation; and
- a specified list of large exposures held by the acquirer at the time of the acquisition.

Where the acquisition or increase of a qualifying holding will lead to an ownership exceeding 20 but not 50 per cent, a business plan is not

CEDERQUIST

Magnus Lindstedt **magnus.lindstedt@cederquist.se**
Kiran Singh **kiran.singh@cederquist.se**
Neha Prakash **neha.prakash@cederquist.se**

Hovslagargatan 3
111 96 Stockholm
Sweden

Tel: +46 8 522 065 00
Fax: +46 8 522 067 00
www.cederquist.com

needed. However, the information set out in the three last bullets above must be submitted to the SFSA.

The SFSA may also require additional information from the acquirer.

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

The SFSA shall, within two working days from the receipt of a complete application, send a confirmation to the acquirer that the application has been received. As a general rule, a decision by the SFSA regarding a question of consent to an acquisition shall be issued within 60 working days after the confirmation has been sent (the evaluation period). If, however, the SFSA requests supplementary information from the applicant 50 working days before the evaluation period has lapsed, the evaluation period will be extended. The maximum extension of the evaluation period is 20 working days (or 30 working days in certain circumstances). This applies equally to domestic and foreign acquirers.

Switzerland

Patrick Hünerwadel, Shelby R du Pasquier, Marcel Tranchet and Maria Chiriaeva

Lenz & Staehelin

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 (and not to the managers or to the 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 is 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 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 (the Swiss Federal Council) and by FINMA. Furthermore, FINMA issued a series of circulars setting out its interpretation of the regulatory framework.

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 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 true in particular as regards 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, which was revised in December 2008 in reaction to the financial crisis. 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 now 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 December 2008 revision of the Swiss deposit protection scheme eventually led in 2011 to a series of amendments to the Federal Banking Act. In addition to these amendments, the revision also introduced other changes to the Federal Banking Act, dealing, in particular, with reorganisation procedures, prompter repayment of preferential deposits and the continuation of basic banking services during insolvency proceedings.

It should be noted that on 15 February 2017, the Swiss Federal Council instructed the Federal Department of Finance to prepare, by the end of November 2017, 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.

Following Lehman Brothers' filing for bankruptcy in autumn 2008, FINMA required Switzerland's two largest banks, Credit Suisse and UBS, to increase their capital basis in order to ensure their financing capacity and restore market confidence. UBS, which had experienced significant losses in the US sub-prime markets, was not able to raise sufficient capital from private investors to reach the required ratio. As a result, the Swiss Confederation decided to make a capital injection into UBS through the subscription of mandatory convertible bonds for 6 billion Swiss francs (see also question 12). In August 2009, the Swiss Confederation exercised its right to convert such convertible bonds into UBS shares, which it subsequently resold to institutional investors.

In parallel, the Swiss National Bank (SNB) set up a stabilisation fund, which, from December 2008 to April 2009, purchased around US$39 billion-worth of UBS's illiquid assets. The purchase primarily took the form of a loan extended by the SNB to UBS for a period of eight to 12 years. In addition, the SNB held a warrant on 100 million UBS shares, representing approximately 2.8 per cent of the bank's share capital, which the SNB could exercise should it incur a loss on its loan when liquidating the assets of the stabilisation fund. The loan granted by the SNB was repaid in full on 15 August 2013, as a result of which the SNB warrant expired. The entire process was eventually completed in November 2013 with the purchase of the stabilisation fund by UBS.

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 capital.

Under Swiss banking laws, entities are considered as '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 which 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.

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 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 thus 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. Since then, more than 50 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, since its 2009 decision, the Swiss government has been analysing different strategies to facilitate administrative assistance in tax matters, including through the implementation of an automatic exchange of information (AEOI). In this context, the Swiss Federal Council expressed, in late 2013, a willingness in principle to implement an automatic information exchange standard provided notably that such standard is internationally recognised, ensures reciprocity and strictly complies with the principle of speciality. 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 Federal Council adopted the dispatches on the OECD/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 Parliament on 18 December 2015. Following this, the 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 will take place in 2018 as regards information from 2017 between the relevant foreign countries (including all the EU countries, in accordance with the agreement of 27 May 2015 as regards the amendment to the EU Savings Tax Agreement with Switzerland).

Anti-money laundering regulation and implementation of the latest recommendations of the Financial Action Task Force

Between 2013 and 2014, the Swiss government worked on a revision of 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 the following measures:

- the obligation for holders of bearer shares of an unlisted company to disclose their identities to the company or to a financial intermediary appointed by the company;
- the obligation for shareholders whose participation reaches or exceeds 25 per cent of the share capital or voting rights of an unlisted company to disclose the identity of their beneficial owner to the company or to a financial intermediary appointed by the company;
- 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;
- the extension of the concept of 'politically exposed persons' to persons exposed at the local level and within intergovernmental organisations;

- the further due diligence obligations for financial intermediaries who receive cash exceeding 100,000 Swiss francs within a commercial transaction;
- the addition in the Swiss Criminal Code of certain aggravated tax offences to the list of predicate offences for money laundering and terrorism financing; and
- a two-stage mechanism following the reporting of suspicions to the Money Laundering Reporting Office (MRO), 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, so as 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.

It should also be noted that 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 new 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 also Update and trends).

Insider trading

Following the recommendations of an expert commission on market abuses, the Swiss government worked on a revision of the provisions dealing with insider trading and market-manipulating behaviour. The relevant amendments entered into force on 1 May 2013 in the SESTA. One of the main purposes of the revision was to include 'aggravated insider trading' and 'aggravated market manipulation' on the list of relevant crimes for money-laundering purposes. The revised provisions also extended the scope of insider trading and market manipulation behaviour prohibited by Swiss criminal law, so that they cover not only certain qualified investors but all market participants. In addition, the provisions governing the obligations to disclose participations and to tender public offers were strengthened. In this context, FINMA was granted the power to apply supervisory instruments (extension of disclosure obligation, precautionary measures, suspension on voting rights, confiscation) to all market participants, not only to those under its supervision. Since 1 January 2016, the relevant provisions on insider trading are set out in the FMIA (see below).

Protection of investment advisory and wealth management clients

In 2009, FINMA completed its investigations on the Madoff and Lehman cases. The analysis of FINMA identified loopholes in the regulatory framework dealing with investors' protection. In particular, FINMA stressed the inadequate level of information given to clients as regards potential returns and risks of loss, as well as inappropriate risk diversification practices. FINMA examined the issue further and published its findings on 10 November 2010 in a comprehensive report entitled 'Regulation of the production and distribution of financial products to retail clients – status, shortcomings and courses of action' (the Distribution Report). In the Distribution Report, FINMA proposes several key regulatory measures for discussion. Based on the feedback and comments of the industry and other interested parties, FINMA issued a position paper (FINMA Position Paper on Distribution Rules) in February 2012, in which specific policy proposals are set out to improve investment advisory and wealth management clients' protection under Swiss law. A certain number of these proposals were formulated in the draft legislation on financial services (see below).

New proposed Swiss legislation on financial services and financial institutions

On 27 June 2014, the Swiss Federal Council published two new drafts of the Financial Services Act (FinSA) and the Financial Institutions Act (FinIA). The publication of these drafts is a response in particular to the 'third country rules' provided by the EU Financial Services Directive (MiFID 2). While the purpose of the draft FinIA is to provide for 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.

The introduction of the new FinSA and the 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 EU 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); and
- 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.

Following the hostile reaction of participants on certain aspects during the consultation procedure, the Federal Council requested that the Federal Finance Department 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 drafts are currently being debated within the Parliament. At this stage, it is difficult to assess, though, how long the legislative procedure will take prior to the entry into force of the FinSA and the FinIA, which is currently not expected before July 2018.

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. Second, it aims at harmonising Swiss financial legislation with international recommendations and standards (including Europe's MiFID 2, MiFIR and EMIR), in particular as regards the regime applicable to negotiation platforms, central counterparties, central securities depositories, payment and securities settlement systems and derivatives trading. The introduction of a new Financial Market Infrastructure Act 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 the EU MiFID II were expected to become. As this date has been postponed by a year, the Federal Council decided to accordingly extend the corresponding transitional period to 1 January 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 will enter into force in July 2017.

The purpose of the 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 as regards 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 that a majority of committee members must be independent (eg, absence of links with the institution, which may lead to a situation of conflict of interest). Finally, it is worth noting that smaller banks will in the future be allowed to have a combined audit and risk committee, instead of two separate committees.

Tax disputes between Swiss banks and the United States and preparation for the implementation of FATCA

Following the US tax and regulatory investigations initiated against several Swiss banks, as well as the initiation of criminal proceedings against Wegelin & Co on counts of aiding and abetting tax evasion and tax fraud, the US Department of Justice (DoJ) announced a programme for Swiss banks to avoid potential prosecution related to deemed non-tax-compliant US client accounts (the US Programme). Further material clarifications were issued on 5 November 2013. The US Programme was endorsed by the Swiss government and FINMA, which strongly recommended participation. For purposes of the US Programme, Swiss banks were divided into four categories:

- those already under investigation by the DoJ, which were not eligible to participate;
- those with reason to believe they may have committed tax-related offences, which requested a non-prosecution agreement and were subject to a penalty payment;
- those without reason to believe they may have committed tax-related offences, which requested a non-target letter; and
- those purely domestic banks that are deemed compliant under the Foreign Account Tax Compliance Act (FATCA) because they merely have a local client base, which requested a non-target letter.

Participation in category 2 had to be announced to the DoJ by 31 December 2013. More than one hundred Swiss banks announced their participation in the US Programme in category 2. Swiss banks wishing to participate in categories 3 and 4 must have filed their request by 31 December 2014. As of 27 January 2016, all remaining category 2 Swiss banks (representing 78 banks) had concluded a non-prosecution agreement with the DOJ settling their tax dispute with the United States. As a result, the DOJ collected more than US$1.36 billion in penalties. On 29 December 2016, the DOJ confirmed that all applications from category 3 Swiss banks have been reviewed and five non-target letters have been issued in this context. The DOJ further stated that none of the category 4 Swiss banks has received a non-target letter.

In parallel, the Swiss and US governments signed on 14 February 2013 an agreement for cooperation to facilitate the implementation of FATCA (the 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. Swiss participating and deemed-compliant financial institutions were to register with the IRS by 25 April 2014. On 8 October 2014, the Federal Council adopted a specific mandate to discuss with the US a changeover to Model I. The new agreement implementing Model I is not expected to enter into force prior to 2018.

7 Are banks subject to consumer protection rules?

Generally speaking, Swiss regulatory law does not provide for a specific consumer protection legal framework. That being said, within a certain type of credits, Swiss financial institutions are to observe mandatory provisions which cannot be varied 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 three-month CHF 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 information absent which they are null (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 consumer credit granted, 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 a 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, and as indicated above, 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, one may expect that the implementation of the automatic exchange of information will 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 during the course of 2018 (see questions 15 and 19).

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 so-called 'long-form reports' addressed to the members of the board of directors of the concerned bank 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 rely exclusively 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 granting of the licence, any of the licence requirements is no longer satisfied, FINMA may take administrative measures aimed at ensuring that 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?

In our view, the most common enforcement issues encountered in the practice of FINMA may be 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, 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 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.

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 by means of the Swiss Confederation's subscription of mandatory convertible bonds (see question 4) 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 17).

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. Systemically important financial institutions (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; and
- order a temporary stay of a counterparty's right to enforce a debt against the bank.

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.

Capital requirements

15 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 Capital Adequacy Ordinance (CAO), the revised Liquidity Ordinance and FINMA Circular 2015/2 'Liquidity risks – banks' (see question 19).

The current regime provides for minimum capital requirements that call at all times for an aggregate (Tier I and Tier II) capital ratio of 8 per cent of the bank's risk-weighted assets. Risk-weighted positions must, in addition, be covered at a ratio of 4.5 per cent with common equity Tier I (CET I) capital and at a ratio of 6 per cent with Tier I capital. Furthermore, banks are to have, from 1 January 2016, a capital buffer in the form of CET I capital of 2.5 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. Finally, if FINMA deems risks not adequately covered by these capital requirements, it can order banks to maintain additional capital.

As regards quantitative liquidity requirements applied to non-systemic banks, the Liquidity Ordinance (LiqO) was revised as of 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 requirements of the LCR as of 1 January 2015. 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 requirements of the LCR for 2018 (phase-in until 1 January 2019). The NSFR will be implemented in January 2018 following a test reporting phase and requires non-systemic banks to have sufficient stable funding available to cover illiquid assets.

As regards 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 4.5 per cent, in line with the Basel III minimum requirements applicable to all banks, an additional equity cushion of 8.5 per cent and an additional progressive component determined on the basis of a progressive rate set yearly by FINMA. While 5.5 per cent of the additional equity cushion must be held in the form of common equity, the remaining 3 per cent and the additional 6 per cent progressive component may be covered by contingent convertibles. SIFIs also have to satisfy countercyclical equity buffers and leverage ratio requirements. In addition to capital, liquidity, organisational and risk diversification requirements, the new regime also entails provisions that would allow the government to order adjustments to the remuneration system of a bank which would have to rely on government funding. The requirements introduced by the 'too big to fail' reform will have to be gradually implemented by the relevant SIFIs by the end of 2018.

16 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).

17 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 at recapitalising the bank, for example, through a conversion of 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 for up to 48 hours if such contractual termination right would otherwise be triggered by officially ordered restructuring or protective measures and to declare such stay as final. In this context, banks are requested to seek contractual consent to such termination right for contracts that are not subject to Swiss law or the jurisdiction of Switzerland. This obligation will be further specified in the revised FINMA-Bank Insolvency Ordinance which should enter into force in March 2017.

18 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 17 for the intervention tools that are available to FINMA.

19 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 systemically important banks (see question 15), FINMA implemented capital adequacy and liquidity rules in line with international standards in 2013 (see question 15). 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 out to 2018. On 1 January 2015, the liquidity coverage ratio requirement entered into force according to the revised LiqO and the updated FINMA Circular 2015/2 'Liquidity risks – banks' (see question 15). FINMA issued a new circular 2015/3, which entered into force on 1 January 2015, on the calculation methodology of the leverage ratio and which corresponds to the minimum standards of Basel III, as defined in the document entitled 'Basel III leverage ratio framework and disclosure requirements' of January 2014.

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 thereto. 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.

On 10 January 2017 FINMA launched a consultation on the partial revision of the Circular 2015/2 'Liquidity risks – banks' aiming at introducing technical provisions for the implementation of the NSFR and simplifying the way in which the LCR requirements are applied to small banks.

Update and trends

Since 2015, FINMA focus has been on adapting the applicable legal and regulatory framework to the needs of the financial technology (fintech) sector. According to the Swiss regulator, regulation in this context should be based on the following principles:

- the neutral nature of the regulation as regards technological change (see question 6 as regards the revision of the AML framework in relation to the video and online client identification);
- the use of a principles-based approach (as opposed to a rules based approach); and
- preclude the emergence of technology-based regulatory gaps which undermine client protection and the system as a whole.

In order to promote innovation in the financial sector, FINMA is fostering a new licensing category with less stringent requirements than those currently provided in the Banking Act. This type of licence would, however, presuppose (i) a low level of the volumes concerned (on the basis of threshold to be determined) and (ii) the prohibition for FinTech companies to transform maturities (ie, offering of long-term loans based on short-term deposits).

In this context, the Federal Council instructed on 2 November 2016 the Federal Department of Finance to prepare a consultation draft aiming at relaxing certain licensing requirements for FinTech companies. To this end, the Federal Council recommended to use a threefold approach consisting of:

- 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);
- the creation of an innovation area called a 'sandbox', where companies are allowed to accept public deposits up to a total amount of 1 million Swiss francs and without the need to request a banking licence; 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 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 francs.

On 1 February 2017, the Swiss Federal Council issued for consultation proposed amendments to the Banking Act and the Banking Ordinance reflecting the above approach. The consultation procedure ends on 8 May 2017. The draft will then be submitted to the Parliament for its approval. Fintech regulation is therefore expected to enter into force in 2018, at the earliest.

The Swiss banking regulatory framework is expected to remain in a state of flux for the years to come which changes aiming at equally strengthening client protection (see question 6) and promoting innovation in the financial sector.

Ownership restrictions and implications

20 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 will not have any negative impact on the prudent and reliable business activities of the bank. Thus, the bank's shareholders and their activities can well be of relevance 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.

21 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 the laws of Switzerland, 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 their domicile must grant 'reciprocity', that 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 it is, thus, in particular not applicable to the member states of the World Trade Organization. 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.

If a bank incorporated under the laws of Switzerland 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 it has its registered office within Switzerland, is controlled by individuals as defined in the first bullet above.

22 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 as long as the conditions for the granting and maintenance of the licence (see question 20) are complied with. Generally, transactions between the (controlling) shareholders of a bank and the bank itself may be subject to specific requirements, for example, the granting of loans to significant shareholders must be in compliance with generally recognised principles of the banking industry.

23 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 the fact that its participation reaches, exceeds or falls below certain thresholds (see question 28). 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 overindebted, 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 also question 17).

24 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 17.

Changes in control

25 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 28), 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.

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

The notification requirements outlined in question 28 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 21.

27 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.

28 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 the laws of Switzerland. This notification duty also applies if a foreigner increases or reduces its qualified participation and thereby 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 25, 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.

29 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 the workload of FINMA. 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 member state of the World Trade Organization, the process may take much longer. FINMA will have to assess whether such 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.

LENZ & STAEHELIN

Patrick Hünerwadel **patrick.hunerwadel@lenzstaehelin.com**
Shelby R du Pasquier **shelby.dupasquier@lenzstaehelin.com**
Marcel Tranchet **marcel.tranchet@lenzstaehelin.com**
Maria Chiriaeva **maria.chiriaeva@lenzstaehelin.com**

Brandschenkestrasse 24
8027 Zurich
Switzerland
Tel: +41 58 450 80 00
Fax: +41 58 450 80 01

Route de Chêne 30
1211 Geneva 6
Switzerland
Tel: +41 58 450 70 00
Fax: +41 58 450 70 01

Avenue du Tribunal-Fédéral 34
1005 Lausanne
Switzerland
Tel: +41 58 450 70 00
Fax: +41 58 450 70 01

www.lenzstaehelin.com

Taiwan

Abe T S Sung and Eddie Hsiung
Lee and Li, Attorneys-at-Law

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, 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 a policy of the Taiwanese government 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, such 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 transacations other than extension of credit

If a bank is a subsidiary of a financial holding company, such 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 such responsible person or major shareholders concurrently serves as the responsible person or representative;
- the financial holding company's affiliates or any of such affiliate's responsible person or major shareholder; and
- the financial holding company's bank subsidiary, insurance subsidiary, securities subsidiary or any of such subsidiary's responsible persons.

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

Similarly to other jurisdictions, Taiwan's financial regulations have been also putting much emphasis on supervision of complex financial products since the financial crisis in 2008. The FSC recently amended certain regulations in response to the reported significant losses investors suffered on currency-related financial derivatives mainly because of the volatility of the yuan exchange rate in recent years. The amendments to the relevant derivatives regulations include: enhancing the thresholds for the qualifications of certain types of customers, requiring more stringent know-your-customer (KYC) procedures, prohibitions or limitation on trading of certain complex financial products by certain types of customers, etc. Specifically, starting from September 2016, the FSC required that providing complex financial products to retail investors (ie, investors other than institutional investors and high net-worth corporate investors) be subject to FSC's review.

Another regulatory challenge facing the banking industry is owing to the new amendments to anti-money laundering (AML) laws. The 'Money Laundering Control Act' (to take effect in June 2017) and the 'Directions Governing Anti-Money Laundering and Countering Terrorism Financing in Banking Sector' were newly amended in December 2016, mainly to reflect the 40 Recommendations of Financial Action Task Force. The main amendments include, among others: (i) expanding the definitions of anti-money laundering, related crimes, and criminal gains; (ii) strengthening the KYC procedures to be conducted; (iii) requiring the necessary transaction records be kept for five years; and (iv) increasing the level of punishments.

We believe that such 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 2015) 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 such 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 questions 6 and 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 financial technology (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 early 2017, the FSC announced a draft bill for a regulatory sandbox in order to enable the fintech businesses to test their financial technologies. According to the draft bill, 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 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. Even if the result is positive, the sandbox entity will still be required to apply to the FSC in order to formally conduct the activities as previously tested in the sandbox. Currently, the proposed regulatory sandbox is still a draft bill.

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 17.

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 on banks in 2017 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 complex high-risk financial products;
- AML and anti-terrorism such as compliance with the reporting requirements;
- personal data protection such as a bank's measure for maintenance of the security of the personal data; and
- financial consumer protection such as KYC assessment procedures and implementation of internal control and risk management systems for financial 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 due 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 such deficit within three months.

According to the latest statistics as of 31 December 2016 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 Taiwan's Executive Yuan (the cabinet of the Taiwan government), 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 the time span of 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 back then needed additional bank channels at a consideration that the FSC agreed to pay to the assuming banks certain amount of compensation. The depositors and employees suffered little hurt, but the shareholders and non-deposit creditors generally received nothing back after 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 in 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 receiver as appointed by the FSC. 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.

Capital requirements

15 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	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

The said 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.

16 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 such 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.

17 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.

The said four categories are defined based on the relevant ratios as described under question 15, and the ratios increase year by year until 2019. Take 2017 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	9.25 per cent or more	7.25 per cent or more	5.75 per cent or more
Inadequate capital	7.25 per cent (inclusive) to 9.25 per cent (exclusive)	Less than 7.25 per cent	Less than 5.75 per cent
Significantly inadequate capital	2 per cent (inclusive) to 7.25 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 such 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 the prior approval of the FSC 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.

18 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 such 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.

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

As described in questions 15 and 17, 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

20 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 21) and prior approvals (see question 25).

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), such person should apply to the FSC for setting up a financial holding company (to indirectly hold stakes in such bank, securities firm or insurance company), subject to certain exceptions. 'Controlling interest' means:
- holding more than 25 per cent of the issued voting shares of such bank, securities firm or insurance company; or
- otherwise having the direct or indirect power to appoint the majority of the directors of such bank, securities firm or insurance company.

21 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 (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 such 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 such 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.

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

See question 25 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.

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

See question 25 for the FSC's prior approval required for acquisition of a bank, and question 28 for required filing for an 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.

24 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

25 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 voting shares of a bank 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; or 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 such person or the related party.

See question 20 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 21 for the PRC ownership restriction.

26 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 21.

There is no major difference for acquisition of a Taiwanese bank by a foreign acquirer (compared with a local acquirer) except for the PRC ownership restriction as described in question 21 and the prior approval from the IC) as described under question 25.

27 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 25), 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 20 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.

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

See question 25 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, such investor shall report such fact to the bank. This notification need only be made to the bank, and such notification need not be made to 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 voting shares of a bank, it shall report such fact to the FSC within 10 days. Thereafter, in the event of any 1 per cent cumulative change (increase or decrease) in the said shareholdings, further reporting is required to be made to the FSC within 10 days of such 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; or 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 such 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 the voting shares of a bank should report its shareholding changes during the preceding month to the bank, and the bank should report such information to the Taiwan Stock

Exchange or Taipei Exchange and make the required announcement by the 15th day of each month.

29 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 around two months for the FSC to grant its approval.

For a foreign acquirer, FSC and IC approvals are both required. It would typically take around three to four months to receive both of the approvals.

See question 25 for the requirement for prior approvals.

The above time frame 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.

理律法律事務所
LEE AND LI
ATTORNEYS-AT-LAW

Abe T S Sung **abesung@leeandli.com**
Eddie Hsiung **eddiehsiung@leeandli.com**

7F, 201 Tun Hua N. Road
Taipei 10508
Taiwan

Tel: +886 2 2183 2232 / +886 2 2183 2162
Fax: +886 2 2514 9841
www.leeandli.com

Tanzania

Charles Rwechungura, Rugambwa Cyril Pesha and Albert Lema
CRB Africa Legal

Regulatory framework

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

The government policy towards the banking sector is to ensure that the banking sector maintains price stability and general trust in the currency by controlling the supply of money, often targeting an inflation rate or interest rate, and creates a conducive environment towards the balanced and sustainable growth of the national economy of Tanzania.

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

The primary piece of legislation is the Constitution of United Republic of Tanzania, which has the force of supreme law such that any law that is inconsistent with it is invalid.

The specific primary statutes that govern the banking sector in Tanzania are:

- the Bank of Tanzania Act 2006;
- the Banking and Financial Institutions Act 2006 (BFIA);
- the Foreign Exchange Act 1992;
- the Anti-Money Laundering Act 2006;
- the Companies Act No. 12 of 2002;
- the Anti-Money Laundering Act 2006;
- the National Payment Systems Act 201; and
- the Finance Act 2016.

Regulations

- The Banking and Financial Institutions (Publication of Financial Statements) Regulations 2008;
- the Banking and Financial Institutions (Independent Auditors) Regulations 2008;
- the Banking and Financial Institutions (Microfinance Companies and Micro-credit Activities) Regulations 2005;
- the Foreign Exchange (Bureaux de Change) Regulations 2015;
- the Banking and Financial Institutions (Tanzania Mortgage Refinance Company) Regulations 2011;
- the Banking and Financial Institutions (Development Finance) Regulations 2011;
- the Bank of Tanzania (Credit Reference Databank) Regulations 2012;
- the Bank of Tanzania (Credit Reference Bureau) Regulations, 2012;
- the Banking and Financial Institutions (Mortgage Finance) Regulations 2015;
- the Banking and Financial Institutions (Consolidated Supervision) Regulations 2014;
- the Banking and Financial Institutions (Disclosures) Regulations 2014;
- the Banking and Financial Institutions (External Auditors) Regulations 2014;
- the Banking and Financial Institutions (Microfinance Activities) (Amendment) Regulations 2015;
- the Banking and Financial Institutions (Microfinance Activities) Regulations 2014;
- the Banking and Financial Institutions (Prompt Corrective Actions) Regulations 2014;
- the Banking and Financial Institutions (Liquidity Management) Regulations 2014;
- the Banking and Financial Institutions (Physical Security Measures) Regulations 2014;
- the Banking and Financial Institutions (Licensing) Regulations 2014;
- the Banking and Financial Institutions (Foreign Exchange Exposure Limits) Regulations 2014;
- the Banking and Financial Institutions (Credit Concentration and Other Exposures Limits) Regulations 2014;
- the Banking and Financial Institutions (Management of Risk Assets) Regulations 2014;
- the Banking and Financial Institutions (Internal Control and Internal Audit) Regulations 2014;
- the Banking and Financial Institutions (Financial Leasing) Regulations 2011;
- the Banking and Financial Institutions (Capital Adequacy) Regulations 2014;
- the Banking and Financial Institutions (Capital Adequacy) (Amendment) Regulations 2015;
- the Payment Systems Licensing And Approval Regulations, 2015; and
- the Electronic Money Regulations 2015.

3 Which regulatory authorities are primarily responsible for overseeing banks?

The Bank of Tanzania (BOT) is the central bank of the United Republic of Tanzania. It is responsible for overseeing all banks in Tanzania and issuing the national currency, the Tanzanian shilling. The BOT was established by the Bank of Tanzania Act, 1965, which was passed by the National Assembly in December 1965. Subsequently, the Bank of Tanzania Act 1965 was first amended in 1995 and ultimately repealed and replaced by the Bank of Tanzania Act 2006. The BOT currently operates under the said 2006 Act.

The BOT is governed by a board of directors consisting of 10 persons, four of whom are executive directors appointed by the president. In addition, there are two ex officio members, and, four non-executive directors appointed by the Minister of Finance of the United Republic. The secretary to the board is also an ex officio member, responsible for provision of legal counsel and secretarial services.

The current composition of the board is as follows:

- the governor (the chairman);
- three deputy governors, deputy chairpersons in the order determined by the governor;
- the representative of the Ministry of Finance of the Government of the United Republic and Principal Secretary to the Treasury of the Revolutionary Government of Zanzibar;
- four non-executive directors; and
- the secretary to the board.

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 government has established the Deposit Insurance Board (DIB) to protect the interests of depositors to the tune of 1.5 million shillings for

each depositor, less any liability of the customer to the bank or financial institution.

The government is a shareholder in some of the banks. It has 30 per cent of the shares of the National Bank of Commerce, 99.098 per cent of the shares of the Tanzania Investment Bank and 30 per cent of the shares of the National Microfinance Bank.

As a general policy, the government is eventually aiming to reduce its shareholding in certain banks by incrementally offering its shares in these banks to the public through the Dar es Salaam Stock Exchange.

Simultaneously with the reduction of its direct equity interest in the banking sector, the government is enhancing its role in developing and formulating appropriate banking sector policies in the Tanzania Development Vision 2025, which outlines the goals of sustainable livelihood and sustained economic growth. Accordingly, the government's vision for the development of rural financial markets is rooted in four policy strategies, namely, national microfinance policy, rural development strategy, agriculture sector development strategy and a cooperative development policy. The government has also put in place a credit guarantee facility to encourage agricultural lending.

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 no limitations on a bank when transacting business between it and its affiliates. The usual banking rules apply, but the BOT has powers, whenever it determines that it is necessary to implement supervision on a consolidated basis whether the bank operates within or outside Tanzania, to demand information on a group company or affiliate.

'Affiliate' means a company that directly or indirectly controls, or is under common control of, a bank or financial institution. The permissible activities under the BFIA that can be conducted directly by banks include all the activities of banking business, that is, the business of receiving funds from the general public through the acceptance of deposits payable upon demand or after a fixed period as well as other allied activities. The other activities under the BFIA that can be conducted indirectly by banks through their affiliates include issuing of securities, underwriting insurance and issuance of payment cards. The prohibited activities under the BFIA include single-person lending that results in such single lending exceeding 25 per cent of the core capital of a bank, lending against the security of the bank's shares, lending to connected parties beyond the limits set by the BOT and investment in fixed assets other than for the purposes of conducting bank business.

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

One of the major challenges facing the BOT in realising its vision and mission is the problem of coping with the fast-changing technological advancements in the world economy in general and financial system in particular.

Another challenge is unpredictability of government budgetary flows coupled with large and unpredictable expenditure. This makes it difficult to match monetary policy actions with actual flows.

The presence of multiple regulatory bodies in the financial sector is another challenge. Apart from banks, other players in the financial sector, such as pension funds, are regulated by the Social Security Funds Authority, insurance is regulated by the Tanzania Insurance Regulatory Authority and capital markets are regulated by Capital Markets and Securities Limited. The presence of different bodies regulating these sub-sectors, which are interlinked at the same time, poses a challenge in the event of bank failure.

7 Are banks subject to consumer protection rules?

Yes, banks in Tanzania are subject to consumer protection rules. The Complaints Resolution Desk (the Desk) was established by the BOT in 2015 as a cost-effective and efficient mechanism to resolve complaints between banking institutions and their customers. The BOT has issued Guidelines on Complaints Resolution under the provisions of section 71 of the Banking and Financial Institutions Act 2006. The Guidelines require banking institutions to set up complaints-handling mechanisms within their institutions, and mandate the Desk to resolve complaints if they are not resolved at the level of the banking institution. The Tanzania Bankers Association Code of Banking Practice, 2014 also recognises the mandate of the Desk to resolve banking consumers' complaints.

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

According to the Monetary Policy Statement of June [2016], the BOT intends to maintain price stability and financial stability. During 2016/17, economic development priorities of the government focus on sustainable development as promulgated in the Second Five Year Development Plan (FYDP II 2016/17 – 2020/21) and successor to MKUZA II. The main emphasis is on strategically mobilising and organising national resources for human and industrial development needed to transform Tanzania into a middle income economy. The BOT also intends to improve transparency of monetary policy operations, keep inflation checked and ensure that liquidity level is consistent with demands of various economic activities.

The BOT generally intends to continue reviewing relevant regulations and guidelines to take into account new developments and challenges to safeguard financial stability and promote financial inclusion.

Supervision

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

The BOT extensively uses both on-site and off-site inspection supervisory methodologies in supervising banks and financial institutions in Tanzania.

On-site inspection

This is full scope or targeted examination of individual banks or financial institutions. The risk management frameworks of the individual bank or financial institution, especially credit, liquidity, interest rate, foreign exchange and operational risks, are reviewed. Apart from the risk framework review of the five key components of the institutions, that is capital adequacy, asset quality, management quality, earnings capability and liquidity, at least once-a-year supervision for every institution is done on-site. In addition, supervisors do verify compliance with laws and regulations and assess the effectiveness of the institutions' internal control systems.

Off-site inspection

In the off-site inspection, assessment of financial soundness through analysis of the statistical and other returns covering key areas of the institutions is done. From the analysis, an early warning report is produced. The statistical returns are submitted periodically (ie, daily, weekly, bi-weekly, monthly, quarterly, semiannually and annually or on ad hoc basis if the circumstances so demand).

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

Significant instances of non-compliance disclosed by supervisory inspections that are contrary to regulations result in censure and penalties. Penalties that are enforced for non-compliance include such measures as fines, imprisonment, disbarment of directors or senior officials from involvement in the banking sector and winding-up in extreme cases.

Sanctions for infringing the bank rules include suspension or revocation of a licence, imposition of default fines, prosecution of the bank or financial institution and its directors and officer, and upon conviction, payment of fine or imprisonment and liquidation, seizure and reorganisation.

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

The most common enforcement issue is has been failure of some banks to comply with the minimum capital requirement, which was raised from 5 billion shillings to 15 billion shillings.

The BOT has now extended the deadline for all banks to meet the minimum capital requirement of 15 billion shillings by 2017.

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 BOT may take over management and operations of the bank if:

- the bank or financial institution refuses to comply with an order or directive of the BOT;
- the bank or financial institution refuses to submit to, or otherwise obstructs, any inspection by the BOT;
- the licence of the bank or financial institution has been revoked;
- the bank or financial institution ceases to be an insured institution by the DIB;
- the bank or financial institution has been found guilty of an offence by a court under the Proceeds of Crime Act or Prevention of Terrorism Act 2002;
- the Bank has not approved voluntary liquidation; or
- where, in the opinion of the BOT, the following facts exist, namely, the capital of the bank or financial institution has fallen below the minimums required; or the bank or financial institution is insolvent; or the bank or financial institution is conducting its business in violation of any law or regulation, or is engaging in an unsafe or unsound practices that are likely to cause insolvency or substantial dissipation of assets or serious prejudice to the interests of depositors or the deposit insurance fund;
- where, in the opinion of the BOT, any bank or financial institution is undercapitalised, and has no reasonable prospect of becoming adequately capitalised or has failed to become adequately capitalised when required to do so by the BOT or has failed to submit a capital restoration plan acceptable to the Bank when required; or having submitted a capital restoration plan and has failed to materially implement the capital restoration plan accepted by the BOT;
- the BOT determines that the assets of a bank or financial institution that is under voluntary liquidation may not be sufficient for the full discharge of its obligations; and
- where the BOT determines that completion of liquidation of the operations of a bank or financial institution is unduly delayed.

Between 1995 and 2016, the BOT took over the possession and management of six banks because of bank failure in Tanzania. The banks were: Housing Bank (1995), Meridian Biao Bank (T) Ltd (1995), Greenland Bank (T) Ltd (1999), Delphis Bank (T) Ltd (2003), FBME Bank Tanzania (2014) and Twiga Bancorp (2016).

In the *Tanzania Housing Bank* case, the bank was closed in 1995 and placed under voluntary liquidation. The DIB was not involved and the government paid all the depositors.

In the *Meridien Biao Bank (T) Ltd* case, depositors of the said bank were given the option of being fully compensated or continuing to be depositors of the new bank, Stanbic Bank (Tanzania) Limited. Many depositors opted to remain customers of the new bank.

In the case of Greenland Bank (T) Ltd, the DIB was appointed by the BOT as a liquidator. All the depositors of the failed bank were fully compensated by the government.

In the *Delphis Bank (T) Ltd* case, following its closure in 2003 and placement under liquidation, the DIB was appointed as the liquidator. All depositors were assumed by the new bank and no one lost money.

In the G*reenland Bank (T) Limited* case, the bank was put under statutory management by the BOT and subsequently liquidated in 1999. The DIB was appointed by the Bank of Tanzania as a liquidator. All depositors of the failed bank were fully compensated by the government.

In the case of FBME, the BOT took over the management of the bank headquartered in Tanzania to ensure safety of customer deposits, and it announced to the public that bank's operation would continue. Accounts that were opened in Tanzania by Tanzanians are operational and depositors are accessing their funds in full. Accounts of foreign residents opened with the affiliate of the bank in Cyprus continue to be inaccessible to account holders because the affiliate is in liquidation, thus making them inaccessible to the BOT.

In the case of Twiga Bancorp, the BOT took over the administration of Twiga Bancorp because it was undercapitalised. After assessing the situation, the bank allowed Twiga Bancorp to resume some of its services. The decision on whether to reorganise, restructure or liquidate Twiga Bancorp is yet to be made.

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 case of bank failure, the bank or its management and directors are required to submit a capital restoration plan, which if implemented will ensure that the bank or financial institution becomes adequately capitalised within such period as may be prescribed by the BOT. The plan is prepared after the failure or non-compliance has been determined but while the bank is under management of the BOT, and in that sense the capital restoration plan does not amount to a will.

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, including the Companies Act 2002, the Bank Tanzania Act 2006, the Banking and Financial Institutions Act 2006 and the Guidelines for Boards of Directors of Banks and Financial Institutions 2008, which all together set out rules according to which the board and supervisory board members are required to act with due care and diligence. The board and supervisory board members are both personally and functionally responsible for any damages and failure they have caused by either breaching the rules or failing in their managerial duties.

Capital requirements

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

The capital adequacy requirements as stipulated in the BFIA and Banking Financial Institutions (Capital Adequacy) Regulations, 2014, have been amended by the Banking and Financial Institutions (Capital Adequacy) (Amendment) Regulations 2015, and currently banks are required to maintain at all times a minimum core capital as described below:

- fully fledged banks:
  - commercial banks: 15 billion shillings; and
  - cooperative banks (nationwide network): 15 billion shillings;
- limited scope banks:
  - microfinance banks: 5 billion shillings;
  - community banks: 2 billion shillings; and
  - cooperative banks (regional): 5 billion shillings; and
- specialised institutions:
  - development finance institutions: 50 billion shillings;
  - finance lease companies: 1 billion shillings;
  - housing finance companies: 15 billion shillings;
  - Tanzania Mortgage Refinance Company: 6 billion shillings;
  - merchant banks: 25 billion shillings; and
  - Islamic banks: 15 billion shillings.

In addition, a bank or financial institution shall at all times maintain a minimum core capital of not less than 12.5 per cent of its total risk-weighted assets and off-balance-sheet exposure; and total capital of not less than 14.5 per cent of its total risk-weighted assets and off-balance-sheet exposure. Banks are therefore required to make contingent capital arrangements plans to ensure that they comply with prescribed minimum limits.

16 How are the capital adequacy guidelines enforced?

Capital adequacy guidelines are enforced through periodical returns to the BOT, which are submitted daily, weekly, monthly, quarterly, semiannually, annually or on an ad hoc basis if the circumstances so demand. Also, banks are required to submit annual audited accounts to the BOT, which state and comply with the capital position as prescribed by the Banking and Financial Institutions Act and Banking and Financial Institutions (Capital Adequacy) Regulations 2014.

Update and trends

The emerging trend in Tanzania is the rapid development of e-banking and cybercrime.

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

When, a bank or financial institution is undercapitalised, the BOT is empowered to intervene and take measures prescribed in the Banking and Financial Institutions (Prompt Corrective Actions) Regulations 2014 to address the undercapitalisation, and they include the following:

- to direct the bank or financial institution to submit within 30 days of the date of the directive or such period as the BOT may specify, a capital restoration plan that will ensure that the bank or financial institution becomes adequately capitalised within such period as may be prescribed by the BOT;
- to prohibit the bank from declaring and paying dividends, awarding bonuses or increasing salaries;
- to intensify oversight and monitoring; and
- to initiate suspension or removal of any director, officer or other persons in management.

When a bank or financial institution is significantly undercapitalised, the BOT is enjoined to:

- prohibit the bank or financial institution from all transactions with related parties, except for repayment of any outstanding credit accommodation or any transaction specifically permitted by the BOT to facilitate recapitalisation;
- prohibit the bank or financial institution from awarding any bonuses or increments in the salary, emoluments and other benefits of its directors and officers; and
- prohibit the bank or financial institution from opening any branches or undertaking expansion of operations.

Where a bank or financial institution is critically undercapitalised, the BOT is obliged to:

- require a bank or financial institution to obtain prior approval before doing certain actions, including:
  - entering into any material transaction not within the scope of an approved capital restoration plan;
  - extending credit for transactions deemed highly leveraged by the BOT;
  - amending the bank or financial institution's memorandum and articles of association, except to the extent necessary to comply with any law, regulation, guideline or directive; and
  - making any material change in accounting methods and policies; and
- appoint a statutory manager or liquidator within 90 days of such determination, except where:
  - core capital is greater than 2 per cent of its total risk-weighted assets and off-balance-sheet exposures; and
  - the bank or financial institution is operating in compliance with a capital restoration plan accepted by the Bank.

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

Where the BOT determines that a bank or financial institution is insolvent, the bank is prohibited from taking any deposit and the BOT will appoint the DIB to be the liquidator. The said appointment will be published in a widely circulated local newspaper and the Official Gazette. The appointment is to have the same effect as the appointment of any other liquidator by a court, and such liquidation is to proceed in accordance with the provisions of liquidation regulations. The law prevents the appointment of any other liquidator of the bank or financial institution under the provisions of the Companies Act and Companies Decree of Zanzibar if the DIB has already been appointed as a liquidator.

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

There have been some changes to the capital adequacy guidelines, in the past two years. The first change was done by the Banking and Financial Institutions (Capital Adequacy) Regulations 2014, which revoked the Banking and Financial Institutions (Capital Adequacy) Regulations 2008. The second change followed a year later through the passage of the Banking and Financial Institutions (Capital Adequacy) (Amendment) Regulations 2015. No further changes are expected in the near future.

Ownership restrictions and implications

20 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, the law restricts control to not more than 20 per cent of voting shares of any bank except where a bank is opening a subsidiary; however, such limit may be exceeded if the BOT grants approval.

'Control' shall be presumed to exist when a person directly or indirectly:

- owns, controls, or has the power to vote more than 50 per cent of the voting shares of another person;
- controls in any manner the election of a majority of the directors of another person; or
- has the power to exercise a controlling influence over the management or policies of another person.

21 Are there any restrictions on foreign ownership of banks?

There are no restrictions on foreign ownership of banks in the sense of prohibiting or limiting the extent to which a foreigner can invest in a Tanzanian registered bank. However, where the investing entity is a foreign bank, financial institution or a holding company, the BOT must satisfy itself that such entity is effectively and adequately supervised in its home country, is in good standing and the home country supervisory authority has approved the investment, before permitting such foreign entity to own a bank in Tanzania.

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

Entities and persons that control banks are not subject to any direct legal and regulatory controls under the Banking and Financial Institutions Act and the Regulation thereunder. However, in performing its role as supervisor of banks, certain legal and regulatory controls on these banks relate to entities and persons that control banks. As an example, the requirements relating to compliance with the capital adequacy of banks by necessary implication require injection of capital by the shareholders to maintain the required capital levels in those cases where the control is by virtue of share ownership to the level specified in the Act.

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

An entity controlling a bank is under obligation to run it in compliance with the requirements of the BFIA and the regulations made thereunder so that the interests of the depositors are not prejudiced.

A person who intends to engage in banking business must obtain a licence from BOT by applying for it to the BOT with a letter in the form prescribed in the Second Schedule of the Banking and Financial Institutions (Licensing) Regulations 2014; the application must be signed by the directors of the applicant or a person authorised by the applicant. Before submitting the said application, that person or company must apply for a pre-filing meeting with the BOT. The application must be accompanied by:

- a letter of application in the prescribed form;
- authenticated legal documents or board resolution authorising the signatory;
- banker's cheque or any other document acceptable to the BOT evidencing payment of a non-refundable application fee of 10 million shillings or any other amount as may be determined by the BOT;
- proposed memorandum and articles of association (unregistered);
- proof of source and availability of funds for investment as capital of the proposed institution;
- a list of subscribers and proposed members of the board of directors and chief executive officer;
- proof of citizenship of every subscriber and every proposed director and senior management officer. This includes detailed a curriculum

vitae, photocopy of the pages of the passport that contain personal information and two recent passport-size photographs;
- an audited balance sheet, income statement and cash flow for the last three years of every subscriber who owns 5 per cent or more of the share capital of the proposed institution engaged in business;
- credit reference reports for every significant subscriber and every proposed director and senior management officer;
- certified copies of annual returns of every subscriber who owns 5 per cent or more of the share capital of the proposed institution and every proposed member of the board of directors and chief executive officer together with accompanying schedules or financial statements filed during the last three years with relevant authority;
- certified copies of tax returns of every subscriber who owns 5 per cent or more of the share capital of the proposed institution and every proposed member of the board of directors and chief executive officer together with accompanying schedules or financial statements filed during the last three years with relevant tax authorities together with respective tax clearance certificates;
- statements from two persons who are not relatives vouching for the good moral character and financial responsibility of the subscribers who own 5 per cent or more of the share capital of the proposed institution and the proposed directors and senior management;
- home country regulator certification if the applicant is a foreign bank or financial institution;
- declaration that the funds to be invested have not been obtained criminally or are associated with any criminal activity;
- a business plan for the first four years of operations, including strategies for growth, dividend payout policy, career development programme for the staff and budget for the first year;
- explicit strategies for outreach through use of branches, agents, mobile banking and other appropriate channels indicating numbers and locations for the first four years;
- projected balance sheets, income statements and cash flow statements for the first four years of operation; and
- a brief description of economic benefits to be derived by Tanzania and the community from the proposed bank or financial institution.

Within 90 days of the receipt of an application or, where further information has been required, of receipt of such information, the BOT can either grant the licence or reject it. The BOT only grants a licence when it is satisfied that the applicant has met the licensing criteria.

After the licence has been given and the bank or financial institution commences its business, it must at all times exhibit the licence in a conspicuous position in the public part of its principal place of business and similarly exhibit copies of such licence in each of its banking units.

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

When a bank or financial institution becomes insolvent, then it will be wound up voluntarily (subject to the approval and supervision) or be wound up compulsorily by the BOT (through seizure of the insolvent bank by the BOT). The implications for a controlling entity or individual include:
- the continuation of the shareholders' liability for uncalled or unpaid subscriptions to the capital stock of the bank until all claims of the creditors have been discharged;
- in the case of seizure by the BOT, the duty to account to the BOT for all the property of the insolvent bank; and
- the right of the shareholders to the distribution of the assets of the company after the bank has discharged all its obligations to the creditors.

Changes in control

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

The BOT has to grant prior approval of any transfer of ownership or control of a beneficial interest in shares of a bank or financial institution that results in ownership or control of 5 per cent or more of voting shares to any other entity or individual otherwise the transfer is void.

Control under the Banking and Financial Institutions Act is presumed to exist when a person directly or indirectly:
- owns, controls, or has the power to vote more than 50 per cent of the voting shares of another person;
- controls in any manner the election of a majority of the directors of another person; or
- has the power to exercise a controlling influence over the management or policies of another person.

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

Regulatory authorities have liberalised the start-up and ownership of banks and financial institutions and therefore foreign acquisition is encouraged. The regulator applies a similar or identical process to a foreign acquirer as it does to a Tanzanian acquirer, meaning it is receptive to foreign ownership.

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

The BOT, inter alia, considers its ability to effectively supervise entities (both separately and on a consolidated basis), the financial condition and ownership structure of the investing bank or financial institution, any risks to the bank or financial institution in which the interest is acquired that could arise from such ownership or control and proven good track record as may be ascertained by a regulatory board under which the bank or financial institution operated for at least 10 years.

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

The BOT may require, inter alia, the following information:
- the name and address of every subscriber, shareholder, board director, chief executive officer and any officer directly reporting to the chief executive officer;

CRB AFRICA LEGAL
Advocates, Notaries Public, Commissioners for Oaths and Corporate Law Consultants

Charles Rwechungura **c.rwechungura@crbafricalegal.com**
Rugambwa Cyril Pesha **c.pesha@crbafricalegal.com**
Albert Lema **l.albert@crbafricalegal.com**

Plot 60 Ursino Street, Regent Estate
PO Box 79958
Dar es Salaam
Tanzania

Tel: +255 754 507 429 (Charles)
Tel: +255 754 312 851 (Cyril)
Tel: +255 769 152 111 (Albert)
www.crbafricalegal.com

- information that may be prescribed by the BOT for purposes of assessing solvency and trustworthiness of each shareholder with a significant interest;
- such financial data, business plans and other documents and information as the BOT may require in order to conduct the investigation during review of the application;
- an applicant's proposed memorandum and articles of association or other charter or instrument of formation required by applicable law; and
- a statement of the address of the head office, location of the principal and other places where it proposes to do business and, in the case of a mobile agency, the area to be served.

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

Acquisition of a bank in Tanzania, whether by a domestic or foreign acquirer, is regulated by two pieces of legislation, namely the BFIA and the Fair Competition Act (FCA).

Under the BFIA, any bank or financial institution is required to obtain prior written authorisation from the BOT in order to:

- effect any voluntary merger, consolidation or other reorganisation of its business or affairs with another bank or financial institution; or
- transfer to any other institution the whole or any of its assets or liabilities in the United Republic of Tanzania.

The BFIA does not spell out the time frame for this authorisation. The FCA requires approval of the Fair Competition Commission (FCC) for mergers and acquisitions that meet the turnover or assets value thresholds spelt out in the FCA and are therefore considered to be notifiable transactions. The acquiring entity is obliged to make a notification of the intended acquisition to the FCC. Upon receipt of the notification, the FCC will issue a notice of complete or incomplete filing within five working days and after the issuance of a notice of complete filing will proceed to determine whether the proposed merger or acquisition should be examined within 14 working days. If no response is received from the FCC within 14 days that it wishes to conduct an investigation, the parties are free to proceed with the transaction. If the FCC determines that the proposed merger or acquisition should be examined, such merger or acquisition will not be allowed to take place for a maximum of 90 days to allow the FCC to complete its investigation. The duration of the review process can be further prolonged if the FCC decides that it has been delayed in obtaining information from any of the parties, but either way the decision should be produced within 90 working days.

United Arab Emirates

Bashir Ahmed and Vivek Agrawalla
Afridi & Angell

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 the 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 of 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 (for example 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 therewith. 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 moveable 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 immoveable property for its own account, except immoveable property required for the conduct of the bank's business or for housing or amenities for its staff, or immoveable 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 which would raise the bank's holding thereof 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 (for discussion on which please 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 the immediate future, the continuing slump in oil price is likely to have its impact on the deposits and asset quality of the banks.

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 the requirements of the IGA.

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.

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. The successful completion of a decade by the Dubai International Financial Centre (DIFC) in the Emirate of Dubai, with its own jurisdiction and body of modern laws, and its widening jurisdictional approach, is precipitating changes to the wider UAE legal and regulatory policies. Following the success of DIFC, a new financial free zone in Abu Dhabi, ADGM, became operational from the second half of 2015.

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 20 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.

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 and 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 for 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 the consent of the SCA. 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 depositors of the bank. 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 the laws of the UAE.

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.

Capital requirements

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

Pursuant to Circular No. 13/93 issued by the UAE Central Bank all banks are obliged to maintain a minimum capital base relative to the total of their risk-weighted assets, as measured by the risk assets ratio.

The capital base of a bank is defined as the sum of Tier I capital and Tier II capital, less certain prescribed deductions.

Tier I capital shall be the paid-up share capital and published reserves of a bank. Profits of the current period are not allowed to be included except in certain exceptional cases at the discretion of the UAE Central Bank. Goodwill and other intangible assets, own shares held, shortfall in provisions, current-year losses and others (as may be prescribed by the UAE Central Bank from time to time), must be deducted from Tier I capital.

Tier II capital comprises undisclosed results, revaluation of assets limited to a maximum of 45 per cent of the excess of the market value over their net book value (revaluation reserves in respect of a bank's property assets are not to be included), hybrid (debt or equity) capital instruments and subordinated term loans.

The prescribed deductions from the aggregate of the Tier I and Tier II capital are investments in unconsolidated subsidiaries, investment in associate companies, investments in other banks or financial institutions and any other deductions as may be prescribed by the UAE Central Bank from time to time.

Risk weighting of assets is prescribed by the UAE Central Bank from time to time.

The risk assets ratio to be maintained by banks at all times is a minimum of 10 per cent, in which Tier I capital must reach a minimum of 6 per cent of total risk-weighted assets and Tier II capital must not be more than 67 per cent of Tier I capital.

Pursuant to Notice No. 3735/2006 dated 27 August 2006, the UAE Central Bank implemented the Basel II Accord. The implementation was to be in stages. In the first stage, the banks were required to be compliant with the standardised approach for credit risk by 31 December 2007. Furthermore, banks were required to adopt their own procedures for operational risk and to adopt the 1996 Amendment to Basel I for Market Risk.

Further to the above, as mentioned in question 7, in 2009 the UAE Central Bank issued guidelines for implementation of the Basel II Capital Accord. These state that the minimum capital adequacy ratio of banks will be set at 11 per cent, rising to 12 per cent from 30 June 2010, as specified in Notice No. 4004/2009 dated 30 August 2009 of the UAE Central Bank. This notice provides as follows:

- banks should work towards increasing their capital adequacy to 11 per cent at the latest by 30 September 2009, of which Tier I capital must not be less than 7 per cent;
- banks must increase their capital adequacy once more to 12 per cent at the latest by 30 June 2010, of which Tier I capital must not be less than 8 per cent; and
- these percentages will be applied on a temporary basis and will be re-examined at the beginning of 2011 to determine whether they will continue. The notice shall become effective on 31 August 2009.

In July 2012, the UAE Central Bank issued a circular on liquidity regulations as part of a phased implementation of Basel III. The regulations lay down qualitative requirements, quantitative requirements and reporting requirements as part of liquidity risk management at banks. The qualitative requirements require banks to comply with 12 criteria when setting up their liquidity-risk-management and governance frameworks. The quantitative requirements require compliance with four ratios in a phased manner; a liquid assets ratio, a uses (of funds) to stable resources ratio, a liquidity coverage ratio and a net stable funding ratio. As per one of the important quantitative requirements, banks are required to hold 10 per cent of their liabilities in 'high-quality liquid assets'. Under the reporting requirements, the banks will be required to complete a liquidity report to enable the UAE Central Bank to monitor effectively the liquidity positions at banks and to take appropriate and timely action on early signs of a liquidity stress. The implementation of some of the above regulations was to commence from 1 January 2013 but has been postponed pending further consideration by the UAE Central Bank. The UAE Central Bank announced that it aims to have Basel III fully implemented by the end of 2018. We cannot confirm if this will be followed or the date will be extended further.

There is no specific requirement for contingent capital arrangements. However, article 81 of the Banking Law provides that should a commercial bank's capital fall below the minimum requirement provided for in the Banking Law, the deficiency must be met within a period that was to be defined by the executive committee of the UAE Central Bank, which period shall not exceed one year from the date the bank concerned is notified of the deficiency. The executive committee alone may determine the extent of the deficiency. Article 82 of the Banking Law provides in material part that commercial banks and branches of foreign banks shall have to allocate at least 10 per cent of their annual net profits for the establishment of a special reserve until the said reserve equals 50 per cent of the commercial bank's capital or, in the case of branches of foreign banks, of the amount allocated as capital.

16 How are the capital adequacy guidelines enforced?

Pursuant to Circular No. 13/93 issued by the UAE Central Bank, all banks are required to report to the UAE Central Bank on prescribed banking return forms on a quarterly basis no later than 14 days following the end of each quarter, based on the end-of-quarter figures.

The UAE Central Bank has also issued Basel II Standardised Approach-Returns (including the capital adequacy calculation) which need to be filed by banks. In view of this, the status of Circular No. 13/93 is not clear.

Though the Basel III norms introduced by the UAE Central Bank are yet to be fully implemented, the banking system in the UAE generally seems to be stable.

17 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.

18 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 or 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 or private joint-stock companies or 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 any locally incorporated banks face bankruptcy situations, they have been merged with other banks.

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

See question 15.

Ownership restrictions and implications

20 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 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.

21 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.

22 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 acquisition of control. However, there are no formal restrictions on such entity carrying on any other business.

23 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.

24 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

25 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). Thus 'control' should mean a majority shareholding interest in the bank, a right to exercise control through representation at the board of such bank, or both. Any change in such controlling entity requires the prior written approval of the UAE

AFRIDI & ANGELL
LEGAL CONSULTANTS

Bashir Ahmed **bahmed@afridi-angell.com**
Vivek Agrawalla **vagrawalla@afridi-angell.com**

Jumeirah Emirates Towers
Office Tower, Level 35, Sheikh Zayed Road
PO Box 9371
Dubai
United Arab Emirates

Tel: +971 4 330 3900
Fax: +971 4 330 3800
www.afridi-angell.com

Central Bank. Upon receipt of such approval subsequent approvals of the local licensing authorities of the emirate where the bank is incorporated must also be obtained.

26 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.

27 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. A majority 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.

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

See questions 25 and 26.

29 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.

United Kingdom

Selmin Hakki and Ben Kingsley

Slaughter and May

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. Prior to 1 March 2017, the PRA was a subsidiary of the Bank of England. 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. Prior to 1 April 2013, the Financial Services Authority (FSA) had been the UK's combined prudential and conduct regulator for banks.

The work and purpose of these regulators is 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. An updated version of the PRA's paper setting out its approach to banking supervision was published in March 2016.

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. The FPC publishes a biannual Financial Stability Report. It also has statutory powers under the Bank of England Act 1998 (as amended) to give directions to the PRA and the FCA to reduce emerging systemic risks including the ability to set a counter-cyclical capital buffer as well as the power to adjust sectoral capital requirements in certain areas.

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

The primary statute governing banking in the UK is the Financial Services and Markets Act 2000 (FSMA 2000). Extensive amendments were made to FSMA 2000 by the Financial Services Act 2012 that abolished the FSA and established the PRA, FCA and FPC as regulatory bodies. Further changes were made by the Financial Services (Banking Reform) Act 2013 to implement certain recommendations made by the Independent Commission on Banking and the Parliamentary Commission on Banking Standards. Outstanding provisions of the Banking Reform Act are due to come into force on various dates between now and January 2019.

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 include dealing in investments as principal, dealing in investments as agent, arranging deals in investments, managing investments, safeguarding and administering investments (ie, custody), 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.

Responsibility for consumer credit regulation transferred to the FCA from the Office of Fair Trading (OFT) on 1 April 2014. The primary regulatory framework for consumer credit activities is set out in FSMA 2000 and in various retained provisions of the Consumer Credit Act 1974 (as amended).

A Special Resolution Regime (SRR) to facilitate the orderly resolution of banks in financial difficulties can be found in the Banking Act 2009 (largely amended by legislation implementing the EU Recovery and Resolution Directive in the UK – see question 13). The Banking Act 2009 also established a new bank insolvency regime and formalised the Bank of England's supervisory role in respect of interbank payment systems. A parallel insolvency regime applies to investment banks (including banks carrying on investment banking activities) under the Investment Bank Special Administration Regulations 2011 (see question 18, 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 18). As mentioned, the FPC acts as a macro-prudential regulator

responsible for identifying and taking action to reduce systemic risks. The Payment Systems Regulator was established as the regulator for retail payments systems on 1 April 2014 and has been fully operational since 1 April 2015. 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, though the scope of that funding is currently under review.

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 is currently £85,000, subject to certain exceptions for temporary high balances. The rules for compensation relating to deposit claims under the Scheme are based on, and implement, EU legislation in the form of the recast EU Deposit Guarantee Directive (2014/49/EU). 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.

Government recapitalisation of the banking sector

At the height of the 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 I capital significantly. RBS Group plc (RBS) and Lloyds Banking Group (Lloyds), 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 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 and currently owns 71.5 per cent of total voting rights. In October 2016, it was announced that HM Treasury's shareholding in Lloyds Banking Group plc would continue to be sold over the subsequent 12 months through a pre-arranged trading plan, originally announced in December 2014. Its stake in Lloyds is now under 7 per cent of total voting rights. In addition, the government's support to banks involved the nationalisation of failed mortgage lenders Northern Rock and Bradford & Bingley. Following a good bank/bad bank split the viable part of Northern Rock's business was sold to Virgin Money in November 2011. A £13 billion portfolio of former Northern Rock mortgages was sold in November 2015 such that the UK government has now exited over 85 per cent of its initial interest in that 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.

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 exposures'. A large exposure is an exposure of 10 per cent or more of a bank's Tier I and Tier II capital (after deductions from capital) to a single counterparty or a group of connected clients. Large exposures must be reported periodically to the PRA. Exposures of more than 25 per cent of a bank's capital are prohibited. This limit may, however, be exceeded in respect of intra-group transactions where the excess arises in respect of trading activity and the bank holds additional capital. Intra-group exposures are captured by the definition of a 'group of connected clients'. This means either: (i) two or more persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or (ii) two or more persons between whom there is no relationship of control as set out in (i) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or others would also be likely to encounter funding or repayment difficulties. The purpose is to limit the application of the restrictions on intra-group exposures to situations where parties are so interconnected that if one entity were to experience financial difficulties the other would also do so.

The application of the large exposures rules is modified where a bank forms part of a core UK group (a group or subgroup of wholly owned UK companies that satisfy certain requirements) or a non-core large exposures group. The effect is to relax the limits on intra-group transactions provided that certain conditions are met. A waiver is required from the PRA to apply either of these regimes. In particular, the PRA applies a 100 per cent limit on exposures between members of a core UK group and members of the non-core large exposures group. Non-regulated members of the core UK group must also enter into a capital support agreement in favour of the regulated banks. 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.

There are no specific statutory restrictions on the types of business that a non-ring-fenced bank can undertake, although if a bank wishes to engage in other activities that are regulated under FSMA 2000 (see question 2) it must obtain permission from the PRA, which would require it to satisfy the PRA (and, where relevant, the FCA) that it could meet the relevant regulatory requirements. A bank may not carry on insurance business as 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 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?

Many of the principal regulatory challenges facing the banking industry have arisen from the financial crisis and have been manifested in a surge of complex regulatory reforms. One of the most pressing challenges for banks is anticipating and assessing the potential impact of these regulatory reforms on their operations and development plans. Such reforms have recently included a new Senior Managers and Certification Regime for individuals performing a senior management function and other employees, which has applied to banks since 7 March 2016 (see question 8). UK banks are at the same time preparing for a number of

other significant reforms, including the implementation of requirements under MiFID II/ MiFIR.

A particular area of focus during the past year 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 the Financial Services (Banking Reform) Act 2013 (the Banking Reform Act). 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. The PRA has now published several consultation papers on its ring-fencing rules, including on the legal, economic and operational independence of a ring-fenced bank and on the proposed framework to require firms to ensure continuity of critical shared services to facilitate recovery action, resolution or post-resolution restructuring. Other key elements of the ring-fencing regime include requiring ring-fenced banks to hold a systemic risk buffer consisting of core equity Tier 1 capital.

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 cyber-security 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).

Finally, the outcome of the referendum on the UK's membership of the EU raises significant uncertainty for the UK's banking industry. The UK government has now announced definitively that the UK will no longer be a member of Europe's single market; the UK will, therefore, for regulatory purposes, be a 'third country' and UK businesses, including banks, will no longer have unfettered access to EU markets. However, 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 considering or accelerating restructuring plans for their EU business or seeking deposit-taking licences in multiple jurisdictions. A cross-border regime for services provided from outside the EU into an EU member state may become available under MiFID II from January 2018, but this will not apply to deposit taking or lending. Brexit could, absent agreements as to equivalence, 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 (for instance, through restrictions on the ability of a UK bank to act as a depositary of an EU UCITS fund or alternative investment fund). In the meantime, banks are expected to continue to comply with requirements derived from EU law and to continue with implementation of 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 exists in the UK a significant number of pieces of legislation providing for the protection of 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, protects consumers from unfair or unclear contractual terms and mandates how businesses must contract with consumers under certain circumstances (such as distance selling) or when 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, the main provisions of which came into force in October 2015. The Act reformed the law on unfair terms in consumer contracts, rights and remedies in relation to contracts for goods and services, extended the 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 the EU Consumer Rights Directive, there is a ban in the UK on excessive payment surcharges attached to certain methods of payment and rules on distance and doorstep selling.

In April 2015, the FCA acquired new competition powers to enforce prohibitions on anticompetitive behaviour in relation to the provision of financial services. These powers are exercised concurrently with those of the CMA. The FCA also has powers to carry out market studies and to refer markets to the CMA for in-depth review. Recent work in this context has included the CMA's investigation into the supply of retail banking services to personal current account customers and to small and medium-sized enterprises. The FCA has also explored competition in investment banking and corporate banking, publishing in October 2016 its final report, which put forward a targeted package of remedies to address the concerns identified.

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.

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

Changes in regulatory policy in the UK are being driven principally by the need to respond to the lessons of the financial crisis. In broad terms, the PRA's and FCA's policy for supervising banks and banking activity has hardened since the 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 elsewhere in this questionnaire, the implementation of ring-fencing for banks – the regime will separate critical banking services from wholesale and investment banking services – will remain a top priority. In January 2016, banks in scope submitted near-final plans for implementing ring-fencing to their PRA and FCA supervisors. 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 Regulation amending the EU Capital Requirements Regulation and the proposed Directive amending the Capital Requirements Directive IV (CRD V Directive) adopted by the European Commission in November 2016. These 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.

We anticipate that debates around the fair treatment of customers will continue to lead to discussions around the competitiveness of the UK banking sector. See question 7 for details of the CMA's investigation into the supply of personal current accounts and banking services to SMEs. In January 2016, the PRA and FCA launched the New Bank Start-up Unit, a joint initiative from the UK's financial regulators giving information and support to newly authorised banks and those thinking of becoming a new bank in the UK.

Following the 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. It 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.

Finally, of particular importance over the next few years will be the way in which regulatory policy responds to the development and commercialisation of new financial business models and technology and its impact on banks, or 'fintech'. Investment by banks 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, particularly in relation to the customer interface and market infrastructure. Innovative uses of technology are bringing benefits to the risk management of banks, as has been recognised by the UK regulators. We expect the use of artificial intelligence and algorithmic solutions in areas such as advice and investment management to continue to gain traction.

Supervision

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

The PRA 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). The PIF assessment is derived from the risks faced by a firm and its ability to manage them: 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 PRA does not routinely disclose to firms in which stage they sit as this could destabilise firms in times of stress. Banks have annual internal stock-take meetings with the PRA to discuss the major risks that they face, the supervisory strategy and any proposed remedial actions, including guidance about the appropriate level of capital and liquidity. The PRA also sends an annual letter to the board outlining key risks that are of greatest concern and in respect of which action is required. A firm's PIF stage is accordingly reviewed at least annually, and in response to relevant, material developments.

Senior management of the firm 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 (see question 13). 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 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 question 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). The Coroners and Justice Act 2009 enhanced the ability of the regulators to prosecute financial crimes including protection for whistle-blowers and powers to engage in plea bargaining. In 2015/16, the FCA pursued a number of criminal prosecutions and secured nine convictions, 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?

During the past year 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 title have been the attempted manipulation of financial benchmarks and failings in PPI complaints handling processes.

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 Deparment 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.

In October 2016, the FCA fined Sonali Bank (UK) Limited £3,250,600 and imposed a restriction preventing it from accepting deposits from new customers for 168 days. It has also fined the bank's former money laundering reporting officer, Steven Smith, £17,900 and prohibited him from performing the money laundering reporting officer or compliance oversight functions at regulated firms. The FCA found that serious and systemic weaknesses affected almost all levels of the bank's AML control and governance structure, including its senior management team, its money laundering reporting function, the oversight of its branches and its AML policies and procedures.

In April 2016, the PRA imposed a fine of £1,384,950 on QIB (UK) Plc (QIB), for significant failings in assessing, maintaining and reporting to the regulator on its financial resources. It found that, from 30 June 2011 to 31 December 2012, QIB (a UK subsidiary of an overseas firm) failed to recognise that it had to comply with regulatory requirements relating to the assessment and maintenance of financial resources and capital. As a result, the firm did not undertake a regular assessment of its capital as it was required to by rules in force at the time.

In August 2015, the PRA publicly censured the Co-op Bank for, among other things, failing to have in place adequate risk management systems. The PRA found that the Co-op Bank's failings had the potential to weaken the firm and reduce its resilience. Subsequently, in January 2016, the PRA took enforcement action against former Co-op Bank individuals, prohibiting Barry Tootell, the former chief executive

(CEO) of the Co-op Bank and Keith Alderson, the former managing director of the Co-op Bank's Corporate and Business Banking Division, from holding a significant influence function in a PRA-authorised firm for breaches related to the running of the Co-op Bank. The PRA has also fined Mr Tootell £173,802 and Mr Alderson £88,890.

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 18. A number of stabilisation powers are exercisable in relation to a bank under the Banking Act 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.

Nationalisation of banks is very uncommon in the United Kingdom and has only occurred to protect the stability of the financial system. Non-systemic banks are subject to insolvency proceedings (mainly, bank insolvency and administration; see question 18). Northern Rock was nationalised on 22 February 2008. Bradford & Bingley was nationalised on 28 September 2008, although the deposits and branch network was at the same time 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 Nationwide Building Society. Previous nationalisations include Johnson Matthey Bankers in 1984 and the Bank of England itself in 1946. The government's shareholding in Lloyds 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 FSCS 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 the Banking Act 2009. Certain employee claims rank as preferred debts if a bank is wound up.

Under the Banking Act 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. The European Court considered that it was entirely legitimate for the United Kingdom 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 United Kingdom'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.

HM Treasury published a Code of Practice on the use of tools under the SRR in March 2015. This is supplemented by the Bank of England document, 'The Bank of England's approach to resolution', which was published in October 2014 and provides guidance on the Bank's statutory responsibilities as the UK resolution authority.

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, the elimination of dividends, liability management or the sale of the firm. While recovery plans are the responsibility of the bank, their adequacy is evaluated by the PRA. Resolution plans will assist the authorities to wind down a firm if it fails for whatever reason. 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 Banking Act 2009 and so reduce the risk that taxpayers' funds will be required to support the resolution of the bank. 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 mentioned in question 9, the PRA's PIF will indicate where on the spectrum a firm lies as well as the measures that should be taken to address the potential risk of the firm failing. Resolution plans will be prepared by the PRA based on information provided by the bank. Where necessary, the PRA will require banks to take steps to reduce the risk of firm failure. A key part of the PRA's ongoing work in this area is to ensure cooperation with the main overseas authorities from countries in which those banks operate.

The PRA's framework for recovery and resolution plans is based on parts of an EU Directive for the recovery and resolution of banks and investment firms (the BRRD), 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 HM Treasury's SRR Code of Practice (see question 12).

The Banking Reform Act 2013 introduced a criminal offence of reckless misconduct in the management of a bank which is limited to individuals covered by the Senior Managers regime. The maximum sentence for the offence is seven years in prison or an unlimited fine (or both)(see further below question 14).

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 24. 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, etc. 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 HBOS 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 judgments 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.

As mentioned earlier, a 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 (for example, 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 Banking Reform Act, which introduced a criminal offence relating to decisions taken by senior managers that cause a bank to fail. The offence applies 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.

As noted in question 11, in January 2016 the PRA fined and prohibited senior individuals who held positions at Co-op Bank from holding a significant influence function in a PRA-authorised firm for breaches related to the running of the Co-op 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-op Bank.

Capital requirements

15 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 EU Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) – which entered into force on 1 January 2014.

The PRA requires banks to hold sufficient capital upon initial authorisation and also capital against risks. The former represents a minimum, although for most banks the capital they are required to hold against risks will be significantly in excess of the authorisation minimum.

Upon authorisation, banks must hold minimum capital resources of €5 million. Thereafter, a bank must hold capital equal to the sum of its requirements for credit risk, market risk and operational risk.

Banks have a choice between a standardised approach to credit risk and advanced internal ratings-based approaches. The standardised approach 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. The PRA recognises two advanced approaches: the foundation internal ratings-based approach (foundation IRB) and the advanced internal ratings-based approach (advanced IRB). Under foundation IRB, banks are required to determine the probability of default of exposures; the other risk factors are calculated based on supervisory estimates. Under advanced IRB, banks determine all the risk factors based on their own internal estimates. For retail exposures, however, there is only one IRB approach under which banks calculate all risk factors.

PRA requirements for market risk follow a 'building block' approach, identifying particular risks against which capital must be held. It follows that if a transaction gives rise to more than one type of risk it may trigger several capital charges. Capital is required to be held in respect of position risk, interest rate risk, counterparty risk, foreign exchange risk and commodities risk.

In addition, banks must hold capital in respect of operational risk. This is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risk includes legal risk but excludes strategic or reputational risk.

Banks are required to assess 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 (ICG) to the firm and setting a capital planning buffer (CPB). 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. The Bank of England published an approach document in October 2015 which set out the main features of its stress testing framework to 2018. The 2016 stress test scenario was the first designed under that framework and details were published in March 2016. The results of the 2016 stress test of the UK banking system were published on 30 November 2016. 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 of at least 5.125 per cent.

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 the CRD IV Directive (CRD V Directive) adopted by the European Commission in November 2016.

16 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 an iterative process, although the PRA can require a bank to hold a specified amount of capital.

17 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 the Banking Act 2009, the Investment Bank Special Administration Regulations 2011 (for banks carrying on investment banking business) and the Banking Reform Act 2013 (see question 18).

18 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 Banking Act 2009 and enhanced subsequently.

The SRR consists of the following 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.

The SRR covers UK-incorporated banks, their holding companies and UK subsidiaries of foreign firms. Branches of foreign firms operating in the UK may be resolved using the UK regime under certain circumstances.

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: the continuity of banking services and critical functions in the UK; the protection and enhancement of the stability of the UK financial systems; the 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 2014. The approach document clarifies the Bank of England's views of the three stages to resolution: stabilisation, restructuring and exit.

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 that 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).

To be eligible for the bank insolvency procedure, the bank must have depositors eligible to be compensated under the Scheme. Banks that do not have such depositors may still be subject to the stabilisation powers referred to above, or to administration or winding up under the Insolvency Act 1986. 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 Insolvency Act 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 the Investment Bank Special Administration Regulations 2011.

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

Yes. The capital structures of many larger EU banks have built up over many decades and are now extremely complex. A first set of amendments to EU bank capital requirements (CRD II) was adopted in September 2009 and came into force on 31 December 2010. This Directive:

- tightened requirements on banks' large exposures. The former exemption from large exposure limits for interbank loans of less than one year was abolished;
- introduced harmonised requirements for Tier I hybrid capital (preference shares and perpetual subordinated debt); hybrid capital is capped at 50 per cent of Tier I after deductions although the recognition of hybrids has been reduced since implementation of Basel III;
- requires Tier I hybrid capital debt to include a feature enabling the instrument to be written down or converted to ordinary shares in specified circumstances;
- improved the supervision of banking groups through reinforcing colleges of regulators for banking groups operating in more than one EU or European Economic Area (EEA) state; and
- strengthened the framework for securitisation; banks may only invest in a securitisation if the originator, sponsor or original lender (which may or may not be regulated) has announced its intention to retain a 5 per cent economic exposure (referred to as 'skin in the game').

Further changes (CRD III) were agreed in November 2010 in respect of trading book capital, resecuritisation and remuneration. The requirements on employee remuneration came into force on 1 January 2011 and place limits on the percentage of staff bonuses that can be paid in cash. The other changes came into force on 31 December 2011 and include:

- an additional capital buffer based on a stressed value at risk (VaR) to the ordinary VaR for banks using their own internal model to determine the capital charge for market risks. The intention is to capture tail events as well as sustained movements in market prices that are not adequately captured under existing VaR models;
- extending the capital charge for default risk in the trading book to capture mark-to-market losses caused by changes in creditworthiness (ie, ratings downgrades). Such downgrades were a major source of loss on traded debt positions during the financial crisis;

- introducing new (and higher) capital charges for resecuritisations (such as CDO of ABS); and
- aligning the capital charges for securitisation positions that are held in a bank's trading book with those in the non-trading book. Previously many banks had treated trading book securitisation positions as straightforward debt positions.

The Basel Committee published the Basel III Capital Accord in December 2010. This has been implemented into EU law by CRD IV, which came into force on 1 January 2014. The main prudential requirements (including the new definitions of capital) are set out in the CRR, which is directly applicable in the United Kingdom.

The main changes include:

- improving the quality of capital through new definitions of core Tier I capital, non-core Tier I capital and Tier II capital;
- raising the minimum common equity Tier I 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 I ratio of 7 per cent;
- increasing the Tier I 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 I capital and Tier III capital. Tier II 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. Under the current framework agreed in October 2013, global systemically important banks are subject to a capital surcharge of between 1 per cent and 2.5 per cent of risk-weighted assets to be covered by common equity, with a currently empty 3.5 per cent bucket for systemically important banks that become even more systemically important.

The PRA also requires banks to carry out stress tests to ensure that they hold adequate capital in the event of plausible adverse economic conditions. As noted in question 15, 'The Bank of England's approach to stress testing the UK banking system' was published in October 2015, and sets out the main features of the Bank's framework to 2018. The 2016 stress test incorporated a synchronised UK and global recession with associated shocks to financial market prices, and an independent stress of misconduct costs. The test examined the resilience of the system to a more severe stress than in 2014 and 2015 and judged banks against the Bank's new hurdle rate framework, which held systemic banks to a higher standard reflecting the phasing-in of capital buffers for global systemically important banks. The PRA found some capital inadequacies; relevant banks put in place plans to build further resilience. See further question 15.

Banks are also required to carry out reverse stress tests that require firms to identify and assess scenarios most likely to render their business models unviable. A firm's business model is described as being unviable at the point when crystallising risks cause the market to lose confidence in the firm. This is different to general stress testing, which tests for outcomes arising from changes in circumstances. Reverse stress testing is not designed as a means of introducing a 'zero-failure' regime or as a way of directly influencing a firm's capital requirements. Reverse stress testing is primarily designed to be a risk management tool, encouraging a firm to explore more fully the vulnerabilities and fault lines in its business model, including 'tail risks', and to explore potential mitigating actions. If a firm's reverse stress testing identifies business model vulnerabilities that have not previously been considered, however, the firm may be required to hold a different amount or quality of capital.

The European Banking Authority published in July 2016 the results of the 2016 EU-wide stress test of 51 banks from 15 countries covering around 70 per cent of banking assets in each jurisdiction and across the EU. The objective of the stress test was to provide supervisors, banks and other market participants with a common analytical framework to consistently compare and assess the resilience of large EU banks to adverse economic developments.

As noted elsewhere, 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 Directive, 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.

Ownership restrictions and implications

20 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 implements, or is based on, EU legislation. The United Kingdom implemented the EU Acquisitions Directive on 21 March 2009. 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 27).

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 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 will be replaced on 1 October 2017 with revised guidelines that 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.

21 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.

22 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 participations (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.

23 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 22). 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 mentioned 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.

Banking groups that establish a core UK group (see question 5) are required to ensure that the non-regulated members of that group enter into a capital maintenance agreement in favour of the regulated firms.

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

We have referred in question 18 to the pre-insolvency stabilisation powers as well as the bank insolvency procedure and bank administration and similar procedures for banks that carry on an investment banking business. 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 23). 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 the Banking Act 2009 and the Investment Bank Special Administration Regulations 2011.

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 under the Company Directors Disqualification Act 1986 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.

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

25 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. Certain changes may require notification to the Information Commissioner under the Data Protection Act 1998.

26 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.

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

See question 20. 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 20, 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.

28 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. The following forms are relevant:

- corporate controllers form, for a controller that is a limited company or a limited liability partnership;
- partnership controllers form, for a controller that is a partnership;
- individual controllers form, for an individual controller; and
- trust controllers form for a trustee, settlor or beneficiary of a trust.

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(s) 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 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.

29 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.

SLAUGHTER AND MAY

Selmin Hakki **selmin.hakki@slaughterandmay.com**
Ben Kingsley **ben.kingsley@slaughterandmay.com**

One Bunhill Row
London EC1Y 8YY
United Kingdom

Tel: +44 20 7600 1200
Fax: +44 20 7090 5000
www.slaughterandmay.com

United States

Richard K Kim

Wachtell, Lipton, Rosen & Katz

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 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.

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 Federal Deposit Insurance Corporation (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.

Notably, the Consumer Financial Protection Bureau, formed in 2011, has broad responsibilities to enforce federal consumer protection laws over both banks and non-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 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 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, the vast majority of 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 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 have adopted a 'macroprudential' perspective and have 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 has 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 has been a wave of sweeping enforcement actions, 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 new Trump Administration has pledged to roll back a significant portion of the regulations adopted post-crisis. At this time, the Administration has not proposed or adopted any specific measures. In Congress, there are several bills pending that would attempt to reduce the regulatory burden on banks, but it is premature at this time to predict whether they will be enacted.

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 – 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.

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 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 new Trump Administration has pledged to roll back a significant portion of the regulations adopted post-crisis so the pendulum should begin to swing in the other direction. At this time, the Administration has not proposed or adopted any specific measures. In Congress, there are several bills pending that would attempt to reduce the regulatory burden on banks, but it is premature at this time to predict whether they will be enacted. Importantly, the Administration also has the ability to appoint the senior-most bank regulators which could have a profound impact on the regulatory environment.

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. Based on these examinations, the authorities issue detailed written reports articulating these 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 expressly 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 past several years 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 was probably 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/AML compliance programmes became particularly widespread. Then, during the financial crisis, BSA/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/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 (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 nonbank 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, nonbank 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.

Capital requirements

15 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	1 January 2016	1 January 2017	1 January 2018	1 January 2019
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%

16 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 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 ofmore 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.

17 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).

18 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.

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

As noted in question 15, 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

20 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 25 and obtain prior approval from the appropriate regulators. As discussed in question 25, 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.

21 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 26. 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.

22 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.

23 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 17. 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 I 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.

24 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

25 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 Bank Holding Company (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;
- The Home Owners' Loan Act (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 consistently taken the view (except in rare 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.

26 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 19, 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 21, in February 2014, the Federal Reserve issued regulations that substantially tightened the regulation of foreign banks operating in the US and required

Update and trends

President Trump issued an executive order in early February 2017 directing the US Department of Treasury and the financial regulatory agencies to reevaluate the banking laws and regulations with a view to reducing their burden on the industry. The executive order has encouraged much speculation about a potential rollback of Dodd-Frank. Moreover, the Administration's ability to appoint the senior-most bank regulators can bring swift changes to the overall regulatory environment for banks. It will be a fascinating year.

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.

27 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 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.

28 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 25. 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.

29 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.

WACHTELL, LIPTON, ROSEN & KATZ

Richard K Kim **rkim@wlrk.com**

51 West 52nd Street
New York 10019
United States

Tel: +1 212 403 1000
Fax: +1 212 403 2000
www.wlrk.com

Getting the Deal Through

Acquisition Finance
Advertising & Marketing
Agribusiness
Air Transport
Anti-Corruption Regulation
Anti-Money Laundering
Arbitration
Asset Recovery
Aviation Finance & Leasing
Banking Regulation
Cartel Regulation
Class Actions
Commercial Contracts
Construction
Copyright
Corporate Governance
Corporate Immigration
Cybersecurity
Data Protection & Privacy
Debt Capital Markets
Dispute Resolution
Distribution & Agency
Domains & Domain Names
Dominance
e-Commerce
Electricity Regulation
Energy Disputes
Enforcement of Foreign Judgments
Environment & Climate Regulation
Equity Derivatives
Executive Compensation & Employee Benefits
Financial Services Litigation
Fintech
Foreign Investment Review
Franchise
Fund Management
Gas Regulation
Government Investigations
Healthcare Enforcement & Litigation
High-Yield Debt
Initial Public Offerings
Insurance & Reinsurance
Insurance Litigation
Intellectual Property & Antitrust
Investment Treaty Arbitration
Islamic Finance & Markets
Labour & Employment
Legal Privilege & Professional Secrecy
Licensing
Life Sciences
Loans & Secured Financing
Mediation
Merger Control
Mergers & Acquisitions
Mining
Oil Regulation
Outsourcing
Patents
Pensions & Retirement Plans
Pharmaceutical Antitrust
Ports & Terminals
Private Antitrust Litigation
Private Banking & Wealth Management
Private Client
Private Equity
Product Liability
Product Recall
Project Finance
Public-Private Partnerships
Public Procurement
Real Estate
Restructuring & Insolvency
Right of Publicity
Securities Finance
Securities Litigation
Shareholder Activism & Engagement
Ship Finance
Shipbuilding
Shipping
State Aid
Structured Finance & Securitisation
Tax Controversy
Tax on Inbound Investment
Telecoms & Media
Trade & Customs
Trademarks
Transfer Pricing
Vertical Agreements

Also available digitally

Online

www.gettingthedealthrough.com

Law Business Research

Banking Regulation
ISSN 1757-4730

THE QUEEN'S AWARDS FOR ENTERPRISE: 2012

LACCA
LATIN AMERICAN CORPORATE COUNSEL ASSOCIATION

Official Partner of the Latin American Corporate Counsel Association

ABA Section of International Law
Your Gateway to International Practice

Strategic Research Sponsor of the ABA Section of International Law